Abstract

Recent financial events indicate it may be time to pose a new challenge to the assumed efficiencies of the shareholder primacy (or market-centered) model of governance practiced in the United States. Reform efforts in the wake of the global financial crisis are now underway. While the shareholder primacy model may be ideologically entrenched in American society, the severity of the crisis has created a window of opportunity to revisit alternative models of governance.

This thesis first contends that if the causes of the global financial crisis are identified solely as failures of securities regulation, without addressing the legal and normative prescriptions found within existing governance structures, then proposed solutions will be impermanent. Reform efforts targeted at the financial market level are indeed necessary, but there is a disservice in classifying the crisis as a one-off event resulting from specific failures in financial regulation, since legislative changes become limited to addressing only those concerns. The ideological support of the existing governance model has laid the groundwork for corporate behaviour that heavily influences political and regulatory (in)action and creates opportunities for crises in the future.

Next, building upon theoretical approaches in corporate legal scholarship, this thesis constructs a framework of four structure-altering recommendations to reform the existing model and promote a new type of corporate existence and behaviour. These recommendations are: (1) deeply entrench stakeholder interests; (2) increase board responsibility and control; (3) expand beyond traditional shareholder value; and (4) normatively embed social responsibility. Situating these recommendations in current corporate practice, grassroots initiatives in the U.S. are examined which have translated into state corporate laws creating new and innovative corporate structures. Finally, complex issues surrounding the governance of financial institutions are highlighted, providing ways in which structure-altering reform can reach fruition in the financial sector.
Preface


See footnotes at the beginning of these two sections for similar information.
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Dedication

This is for Kyle and Lucy.
1. Introduction

Recent financial events indicate it may be time to pose a new challenge to the assumed efficiencies of the shareholder primacy (or market-centered) model of governance practiced in the United States. As the story behind the global financial crisis continues to unfold, there has been an uncomfortable reminder of the significant power and influence large institutional bodies have on society. Reform efforts in the wake of the crisis are now underway. While the shareholder primacy model may be ideologically entrenched in American society, the severity of the crisis has created a window of opportunity to revisit alternative models of governance.

This thesis first contends that if the causes of the global financial crisis\(^1\) are identified solely as failures of securities regulation, without addressing the legal and normative prescriptions found within existing governance structures (and the collateral effects those prescriptions have on political and regulatory action), then proposed solutions will be impermanent. Several U.S. factors have been identified as contributing to the crisis. Two of the major interrelated factors explored in this thesis are: the repeal of the Glass-Steagall Act and subsequent development of large financial conglomerates and shadow banks\(^2\); and the development of the originate-to-distribute model of lending in an unregulated over-the-counter derivatives market.\(^3\) Reform efforts targeted at the financial market level are indeed necessary, but there is a disservice in classifying the crisis as a

\(^1\) It is important to recognize that the account in this thesis is based on American sources. The ‘global’ financial crisis clearly affected many other nations that may differ on the timeline interpretation and causes of the crisis.

\(^2\) See infra notes 95-120 (Section 3.1).

\(^3\) See infra notes 121-154 (Section 3.2). Other contributing factors include complexity in the financial markets and excessive reliance on credit rating agencies for value interpretation. See infra note 145 for more detail on those factors.
one-off event resulting from specific failures in financial regulation, since legislative changes become limited to addressing only those concerns. We have seen time and again how large public institutions, while operating within the confines of the law, focus on profit maximization and increasing share value; following calamitous events, important figures scrutinize what went wrong and reform efforts take place. This thesis draws upon the financial crisis as a comparative tale of an ongoing dysfunction in the high-level governance model of corporate and financial institutions. The legal and ideological support of the shareholder primacy model of governance has laid the groundwork for corporate behaviour that heavily influences regulatory (in)action and creates opportunities for crises in the future.

Chapter 2 begins by looking back in time to other recent corporate events which immobilized the financial markets, being the corporate and accounting scandals of 2001-2002. It first identifies the prevalent American support of the shareholder primacy model prior to the scandals, and then traces three scholarly perspectives that developed immediately following those scandals. Chapter 3 then delves into an analysis of the causes of the global financial crisis, and contrasts the three perspectives examined in Chapter 2 with the present day discussions that have arisen in its wake. Alongside this comparison in Chapters 2 and 3 is an interwoven, juxtaposed tale of the evolution of legal theory, as the traditional principles of rational, wealth-maximizing actors held by neoclassical law and economics scholars and the advancement of behavioural approaches within law and economics scholarship are considered. This narrative of recent financial

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4 Paul Volcker shares this view. See Uchitelle, infra note 195 (Volcker states, “There is a certain circularity in all this business...You have a crisis, followed by some kind of reform, for better or worse, and things go well for a while, and then you have another crisis”).
history illuminates how reform efforts following the crisis have been too limited in scope. The U.S. government has placed a high priority on modifying securities regulation to curtail specific market behaviour, with minimal reform efforts focused on governance issues, and (as has been typical in the past) no changes to address the flaws within the existing governance model itself. This is despite the clear evidence that governance structures supposedly designed to prevent such events have failed.

Next, using the forward trajectory of the crisis, the subsequent Chapters explore how the current governance model can be reconceptualized to promote a new kind of corporate existence and behaviour. In Chapter 4, this thesis takes a closer look into the theoretical side of corporate governance, turning toward legal scholarship to provide valuable insight. Using counter-hegemonic\textsuperscript{5} discourses that have been offered to counteract negative attributes associated with the shareholder primacy model in the U.S.\textsuperscript{6}, I combine

\begin{flushleft}
\textsuperscript{5} Borrowing the term “counter-hegemonic” from Kellye Testy, who describes “hegemonic” discourse as discussions surrounding the shareholder primacy and wealth maximization model, where “the managers’ highest duties are to shareholders and to maximizing their wealth; thus, shareholders must be preferred in the event that a conflict between corporate constituents emerges” (see supra note 14 for more detail on the definition of shareholder primacy). “Counter-hegemonic” discourse thus seeks to describe alternative visions of corporate law. Kellye Testy, “Linking Progressive Corporate Law and Progressive Social Movements” (2002) 76 Tulane L. Rev. 1227 at 1232.

\textsuperscript{6} I have attempted to limit my focus to counter-hegemonic discourses in American corporate legal scholarship. There are a few reasons for this limitation. First, there is already an overwhelming amount of American discourse available critiquing the existing corporate governance model. Opening up the analysis to international critiques would broaden the scope of this work considerably. Second, one has to be particularly careful when considering international alternatives to the American shareholder primacy model; there may be particular cultural, historical, and other normative assumptions that are embodied in such critiques which are not initially obvious. It may be necessary for comparative research to be conducted prior to any adoption of international reform initiatives. That being said, there are a few instances where I have borrowed ideas from across the Atlantic. The first is in Section 3.1 where I have referred to the U.K.’s “enlightened shareholder value.” This concept has been adopted and promoted by several notable American corporate legal scholars who believe the concept can be successfully integrated into American corporate law, and I rely on their research. See infra notes -307-313. The second instance is in Chapter 6, where I discuss the governance of financial institutions and refer to certain recommendations from international organizations; in particular, a set of Green Papers that have been produced by the EU Commission providing a range of high-level options to strengthen the governance of financial institutions in the wake of the crisis. See infra notes 465-471, 500-503. The EU Commission has noted that their observations may be of relevance to all financial institutions. Given the global reach of financial institutions, and the concentrated focus by the U.S. government on increased securities regulation with minimal concern for
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various aspects of these approaches to provide four high-level, structure-altering recommendations that point the way for future reform efforts.

The four high-level recommendations provided are as follows: (1) deeply entrench stakeholder interests; (2) increase board responsibility and control; (3) expand beyond traditional shareholder value; and (4) normatively embed social responsibility. First, using a stakeholder approach to strategic management and principles from progressive corporate law as a guide, I suggest ways in which stakeholder interests can be legally and normatively entrenched into corporate decision-making and actions. Next, I propose increasing the responsibility and control of the board of directors. The “team production theory” suggests the most effective and efficient way for a corporation to be governed is through a strong board of directors acting as a “mediating hierarch” to balance competing stakeholder interests. When considering the criticisms of team production theory, particularly concerns regarding the breadth of directorial discretion, I then utilize ideas from legal scholarship promoting greater individual director accountability as a way to alleviate those concerns. Next, I argue that it is erroneous to view shareholder value as the most efficient measure of corporate success. I promote and encourage the transition in law and economics theory to develop beyond the behavioural approaches explored in Chapter 2 by borrowing critiques from institutional law and economics. Institutional theory is particularly useful in that it dispels the notion of an ultimate efficient result, contending that the perception of an efficient outcome relies primarily on whose rights

governance issues, I thought it was appropriate to incorporate some of the broad picture proposals being considered internationally in these circumstances, if at the very least, to represent that governance concerns following the crisis are certainly recognized and legitimated by other notable groups.

7 Freeman, infra note 236.
8 Blair & Stout, infra note 274.
the government has elected to protect. This theoretical premise effectively challenges the efficiency reasoning behind the continuance of shareholder primacy model as touted by neoclassical law and economics scholars. The concept of “enlightened shareholder value” is then analyzed. This concept, borrowed from the U.K., has been heralded by some U.S. corporate scholars as a “third way” of corporate governance to resolve the traditional shareholder v. stakeholder debate. Lastly, I examine the burgeoning phenomenon of corporate social responsibility, including the “new” wave which embodies certain facets of the “green” movement and the significant role corporations play in the sustainability of environmental resources. I suggest that while legal infrastructure has an important role to play in corporate governance reform, it is imperative that a normative cultural shift of social responsibility permeates into day-to-day management and operations.

Chapters 5 and 6 then explore the practical realities of putting these four high-level recommendations into place by canvassing the current corporate landscape and pinpointing present day initiatives that embody and support these recommendations. Chapter 5 specifically identifies a potentially powerful movement that is occurring in U.S. corporate law, one that began in the 1980s with the inclusion of “other constituency” statutes in several state corporate laws. The B Corporation, a privately designed and regulated corporate structure using existing corporate laws in “other constituency” states as its base, has shown how stakeholder interests can be normatively realized within the modern corporation. The founders of B Corporation have paved the way for the some U.S. states to adopt innovative corporate laws creating a new corporate structure, one that

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9 See infra note 307.
10 Williams & Conley, infra note 310.
11 B Corporation, online: B Corporation <http://www.bcorporation.net/>.
supports the pursuit of both social benefit and economic value.

Finally in Chapter 6, we return to the financial institutions that were at the heart of the global financial crisis. Power and control issues among corporate actors, and the placement of incentives supporting existing power arrangements, are only amplified when viewed from within an industry capable of devastating the economic health and well-being of so many. Several types of corporate and financial institutions played key roles in the crisis, a large scale event that involved a significant cast of characters: banks, shadow banks, mortgage lending institutions, credit rating agencies, trade and lobby groups, among others. The governance of financial institutions may statutorily differ in many ways from that of large, public corporations, but there are intricate and delicate commonalities found in the balancing of relationships between the familiar actors of directors, officers, shareholders, and other stakeholders. The events of the crisis highlight how similar norms seem to pervade both corporate and financial institutions in their structural makeup. Chapter 6 provides a broad overview of specific reform efforts that are being considered in the governance of financial institutions following the crisis. Particularly, this Chapter will touch upon ways to improve risk management policies and increase board competence and control, including potentially extending the scope of directorial fiduciary duties to include nonshareholder interests in some commercial banks.

A small minority of corporate scholars have argued the shareholder primacy model is not
the actual method of corporate practice, but rather, a CEO primacy model prevails.\textsuperscript{12} While I understand the motivations behind this argument, it is the legal, theoretical, and ideological belief that the corporate institution “exists only to make money for its shareholders”\textsuperscript{13} (and all the prescriptions that that accompany and support this belief, such as excluding nonshareholder interests from corporate decision-making and using share value as the sole measure of success), which is of critical importance in this analysis, more so than whether the normative belief manages to be carried out in all aspects of corporate practice. The prescriptive model that drives the ongoing development and application of corporate and regulatory law is what matters. Reforming that model is the key to bringing about lasting change to the way corporate and financial institutions conduct themselves going forward.

\textsuperscript{12} See e.g. Steven Ramirez, “Special Interest Race to CEO Primacy and the End of Corporate Governance Law” (2007) 32 Del. J. Corp. L. 345 (arguing that corporate governance in U.S. public corporations has moved toward a dictatorship of the CEO, and away from the traditional notions of shareholder primacy).

\textsuperscript{13} Lynn Stout, “Bad and Not-So-Bad Arguments for Shareholder Primacy” (2002) 75 S. Cal. L. Rev. 1189 at 1189.
2. Law, Economics, and the Shareholder Primacy Model

In their well-known article “The End of History for Corporate Law,” Henry Hansmann and Reinier Kraakman argued that the basic law of corporate governance had already achieved a high degree of uniformity to the shareholder primacy model\(^\text{14}\) and “continued convergence towards [this] single, standard model is likely.”\(^\text{15}\) Some key normative principles in this consensus include:

(1) ultimate control over the corporation should rest with the shareholder class\(^\text{16}\);
(2) managers should be charged with the obligation to manage the corporation in the interests of its shareholders;
(3) other corporate constituencies, such as creditors, employees, suppliers, and customers (which, together with shareholders, are included as “stakeholders”\(^\text{17}\)) should have their interests protected through contractual or regulatory means rather than through participation in corporate governance;
(4) non-controlling shareholders should receive strong protection from the exploitation of controlling shareholders; and
(5) the market value of the publicly traded corporation’s shares is the principal measure of its shareholders’ interests.\(^\text{18}\)

Hansmann and Kraakman, arguing from an Anglo-American perspective, believed that alternative governance models (identified by them as manager-oriented, labour-oriented,
and state-oriented) had already been tried and had failed. Pointing to the shareholder primacy model’s assumed efficiencies and its historical economic domination, they contended that the ideological convergence of this model is unlikely to be undone, especially since “no important competitors to the standard model of corporate governance remain persuasive.” The American confidence in the shareholder primacy model was at a peak. To Hansmann and Kraakman, the ideological convergence toward the model meant that general convergence in practice will eventually follow – thus signifying, for all intents and purposes, an “end of history for corporate law.”

Economic efficiency was the main force behind Hansmann and Kraakman’s presumption of the long-term international acceptance of the shareholder primacy model. They identified profit maximization, historical success, and international competitive advantage as factors that made the virtues of the shareholder primacy model increasingly salient. Their logic is in line with the beliefs held by scholars of the Chicago school of law and economics, who have frequently used an Anglo-American view of neoclassical economic theory and efficiency analysis to explain and understand the development of law.

Scholars within the Chicago school generally accept and adhere to principles that have

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19 Ibid. at 443-449. Hansmann and Kraakman describe the manager-oriented model as one that existed between the 1930s and the 1960s in the U.S., the labour-oriented model as one that peaked in Germany in the 1970s and caused the drafting of the European Community’s Proposal for a Fifth Company Law Directive, 1983 O.J. (C240) 2, and state-oriented model as one most extensively realized in post-WWII France and Japan. The examination of these historical and international governance systems is beyond the scope of this thesis.

20 Hansmann & Kraakman, supra note 15 at 456.


22 Hansmann & Kraakman, supra note 15 at 449.
been at the core of modern economics since Adam Smith’s *Wealth of Nations*, a work many Chicago scholars cite with regularity.\(^2^3\) The Chicago school’s application of neoclassical economics to legal theory has meant principles surrounding “rational maximizers” who “respond to price incentives” are regarded when implementing and applying legal rules to market and nonmarket subjects.\(^2^4\) Applying the principles of neoclassical law and economics on a global market level, one sees how the singular objective of a higher share price within the shareholder primacy model (the “shareholder wealth maximization norm”\(^2^5\)) is legitimized in theory, providing a necessary “invisible hand” of self-interest to promote efficient outcomes within the supply and demand of the free market.\(^2^6\)

A defining characteristic of the Chicago school of thought is its contention that legal rules and outcomes can be assessed on the basis of their efficiencies. Richard Posner, recognized as the foremost leading proponent\(^2^7\) of the Chicago school, was one of the first to advance the efficiency hypothesis in detail.\(^2^8\) While a host of various measures surround the concept of efficiency, Posner has pointed out that the common operating definition in economics is “nine times of out of ten” in reference to Kaldor-Hicks

\(^{25}\) See e.g. supra note 14 (for definitions of the concept).
\(^{26}\) As Smith famously stated, “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest.” Adam Smith, *The Wealth of Nations* (1776) at I.2.2.
\(^{28}\) Other founding scholars of the Chicago school, identified by many as Ronald Coase, Guido Calabresi, Henry Manne, and Gary Becker, have also made significant contributions to the study of efficiency in law and economics research. See e.g. *ibid.* at 59-83.
efficiency.\textsuperscript{29} Under Kaldor-Hicks efficiency, an outcome is considered more efficient if the monetary value of society’s resources is maximized. If the marginal willingness to pay by those who benefit from an action is equal to the marginal willingness to accept payment by those harmed, Kaldor-Hicks efficiency contends that all parties end up no worse off than before.\textsuperscript{30} In this regard, a legal change can be said to be Kaldor-Hicks efficient “if the gains to the winners exceed the losses to the losers or, alternatively stated, if the wealth of society (as measured by willingness to pay) is increased.”\textsuperscript{31} 

Using this measure in a corporate law context, one can see how the existing shareholder primacy model can purport to be bolstered by neoclassical efficiency analysis. Hansmann and Kraakman have pointed to many notable economic advantages in the standard model, including “access to equity capital at lower cost (including start-up capital), more aggressive development of new product markets…and more abandonment of inefficient investments.”\textsuperscript{32} The common concerns surrounding efficiency and wealth maximization within the corporate form normally relate to agency costs associated with divergent objectives between managers and shareholders.

While recognizing that agency costs limit the efficient size of firms\textsuperscript{33}, Posner has contended that within the separation of ownership and control, agency costs are generally contained. In his 1998 edition of \textit{The Economics of Law}\textsuperscript{34}, Posner noted that “mismanagement is not in the managers’ self-interest; it is in fact very much contrary to

\textsuperscript{29} Posner, \textit{supra} note 24 at 15.
\textsuperscript{30} But, as Gordon Christie pointed out to me, this of course would only be the case if those harmed were paid directly or indirectly by those benefitting or their proxies. See also Mercuro & Medema, \textit{supra} note 27 at 59-60 (providing examples of Kaldor-Hicks efficiency).
\textsuperscript{31} \textit{Ibid.} at 59.
\textsuperscript{32} Hansmann & Kraakman, \textit{supra} note 15 at 450-451.
\textsuperscript{33} Posner, \textit{supra} note 24 at 428.
their self-interest, as it will lead eventually to the bankruptcy of the firm (and of the managers’ future employment prospects), as a result of the competition of better managed rivals.”

According to Posner, agency costs relating to any divergent interests in the manager-shareholder relationship will likely be addressed through protective features within a company’s charter and bylaws, which he believes “shareholders would normally insist upon.”

Hansmann and Kraakman agreed that agency costs are comparatively less, stating that the shareholder primacy model has “stronger incentives to reorganize along lines that are managerially coherent.”

Law and economics scholars have also used normative analysis to explain managerial conduct that does not easily operate within the expected efficiencies of the shareholder primacy model, suggesting that managers “engage in stewardship of the corporation influenced by norms that bridge the gap between efficiency-enhancing activity and duties of care and loyalty.”

2.1 The Corporate and Accounting Scandals of 2001-2002

Hansmann and Kraakman’s article was written in 2000 and published in early 2001, prior to the fall of Enron Corporation and a number of other corporate and accounting scandals that wreaked havoc on the financial markets in the latter half of 2001 through to 2002. Readers are advised to consult the extensive documentation and analysis of Enron’s

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35 Posner’s comment is interesting to compare against the backdrop of the corporate and accounting scandals of 2001-2002, discussed in the following section. The comment did not appear in his next edition.
36 Posner, supra note 34 at 452.
37 Hansmann & Kraakman, supra note 15 at 14.
collapse that is available, but in brief, Enron’s bankruptcy resulted from unlawful transgressions by its managers which included non-transparent financial reporting, mark-to-market accounting, and the creation of complex corporate structures for the sole purpose of concealing billions of dollars in debt. Once this information was revealed to the public, the outrage expressed by investors, employees, pension holders, and politicians was palpable. Following in rapid succession after the fall of Enron were a rash of other corporate and accounting scandals that brought down several other companies, including most notably WorldCom, Inc., whose bankruptcy quickly replaced Enron as the largest bankruptcy in history. Its downfall was due in part to management falsely inflating revenues and underreporting costs.

### 2.1.1. Three Emerging Perspectives

Following Enron’s collapse, there came to be several discussions from legal scholars on

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39 Notable scholarly works are included within these footnotes. Enron’s collapse has also been retold in non-fiction books and movies. See e.g.: (Books) Bethany McLean & Peter Elkin, *Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Portfolio, 2004); and Mimi Schwartz with Sherron Watkins, *Power Failure: The Inside Story of the Collapse of Enron* (New York: Doubleday, 2003); (Movies) “Enron: Smartest Guys in the Room” (Magnolia Studios; 2005); and “FRONTLINE: Bigger Than Enron” (PBS; 2002).

40 For a helpful summary, see e.g. Douglas Branson, “Enron – When all Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?” (2003) 48 Villanova L. Rev. 989 at 997-1002.


42 Other companies included Tyco International Ltd., Adelphia Communications Corp., Peregrine Systems Inc., and Global Crossing Ltd.

43 See Luisa Beltran, “WorldCom Files Largest Bankruptcy Ever” CNN Money (12 July 2002), online: CNN Money <http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy/> (reporting how WorldCom’s bankruptcy is the largest in United States history, with $107 billion in assets, dwarfing that of Enron Corp. which listed $63.4 billion in assets when it filed for bankruptcy). The WorldCom bankruptcy is now the third largest, after the bankruptcies of Lehman Brothers Holdings Inc. ($639.0 billion) and Washington Mutual ($327.9). See Bankruptcy Data, “20 Largest Public Company Bankruptcy Filings 1980-Present” (as of July 2010), online: <http://www.bankruptcydata.com/Research/Largest_Overall_All-Time.pdf>.

the appropriate governmental response to the scandals. Simon Deakin and Suzanne Konzelmann’s brief article entitled “Corporate Governance after Enron: An Age of Enlightenment?” identified three groups that developed after the scandals.

The first group believed Enron’s collapse only confirmed that the existing model was working and “might actually be a reason to be more confident about corporate America.” Enron was an “aberration,” and an example of one ‘bad’ board did not denote that all boards were useless governance mechanisms. This group, echoing Adam Smith’s laissez-faire market principles, felt “market sanctions, in the form of reputational damage to its senior managerial team and to its auditors…served as an effective disciplinary device.” William Bratton described this group as the “supporters of deregulation” who found Enron’s collapse to be “an exemplar of free market success.” In this sense, “Enron was a house of cards; it was free market actors who blew it down, with a free market administration keeping its hands off.” Once discovered by the public, the false inflation of Enron’s stock price was succinctly cut down to size with extreme rapidity in the financial markets. Because of the swift market reactions to Enron’s exposed activities, proponents of this first position believed there was little to be accomplished with wider reforms to the existing corporate model. Enron’s bankruptcy,

46 See John Rossant, “Commentary: Why a Few Enrons Would Do Europe Good” (31 December 2001) Business Weekly at 58 (asserting that Enron shows that government support for industry is a bad thing).
48 Branson, supra note 40 at 989; see also Douglas Branson, “Enron Is an Aberration”, USA TODAY (1 March 2002) at 9A.
49 Deakin & Konzelmann, supra note 45 at 583.
51 Ibid.
then, was a “triumph of capitalism” and the ultimate just desserts.52

The second group acknowledged that both managerial and gatekeeper53 failures had occurred and pushed for reform specifically addressing the misdeeds of Enron’s executives and the lack of proper corporate monitoring. This group focused on tightening securities regulation and improving the functioning of the current shareholder primacy model, without challenging or restructuring it. Governance failures were traced back to conflicts of interest on the part of board members and its auditors. Many pointed to the false comfort of an independent monitoring board. It was concerning that Enron had a board that on paper was ideal in several respects; among other favourable qualities, Enron had a diverse board with only two of their 14 directors classified as insiders.54 Corporate governance issues thus focused on maintaining sufficient director independence and accountability, as well as a subtle shifting of powers from managers back to shareholders. Leading the charge was the Council for Institutional Investors (“CII”), an organization that in 2002 represented institutional investors holding approximately $2 trillion in pension assets. This group provided a detailed list of accounting and corporate governance reform recommendations “to prevent future Enrons.”55

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53 Gatekeepers are reputational intermediaries who provide verification and certification services to investors. The term “gatekeeper” is not simply an academic concept. In Securities Act Release No. 7870 (30 June 2000), the SEC noted that “the federal laws...make independent auditors ‘gatekeepers’ to the public securities markets.” 2000 SEC LEXIS 1389.
55 Council of Institutional Investors, “Accounting/Corporate Governance Reform Recommendations from the Council of Institutional Investors” (4 February 2002), online: State of Wisconsin Investment Board <http://www.swib.state.wi.us/CIIFeb4.pdf> at 1. These recommendations, which were largely adopted by
Many of the CII recommendations, along with others in the second group, eventually coalesced and led to the creation of the *Sarbanes-Oxley Act of 2002*\(^{56}\) (the “SOX Act”), enacted directly in response to the scandals by implementing several new rules and regulations to curtail unwanted corporate behaviour. In particular, the SOX Act contained provisions addressing director and managerial accountability through financial disclosure, including imposing a duty to disclose “on a rapid and current basis” additional information “concerning material changes in the financial condition or operations of the issuer, in plain English”\(^{57}\); greater internal controls, such as stricter standards on the certification of annual and quarterly reports by top executives and prohibiting share sales by corporate officers during ‘pension blackouts’\(^{58}\); and auditor independence, such as rotating the auditor partner every five years\(^{59}\); as well as adding stricter criminal penalties for managers responsible for any violations\(^{60}\).

The third and final group offered what Deakin and Konzelmann called “a radically different explanation for Enron’s fall.”\(^{61}\) While this group generally accepted and approved of the initiatives created by the SOX Act, the underlying belief was that these reform efforts did not go far enough in addressing the root of the problem. Deakin and Konzelmann noted that from this third perspective, “the fate of Enron is less important

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60 *Ibid.* at s. 802.
61 Deakin & Konzelmann, *supra* note 45 at 584.
than the future of the business model which it came to represent” and the group believed “[u]nless the regulatory framework is adjusted to make this model unattractive, it will only be a matter of time before the same approach is tried again.”

The problems of Enron inherently grew from the principles embodied within the shareholder primacy model of the corporation. Senior management of Enron were given stock options that motivated short-term stock appreciation, and their unethical practices exemplified the “dark side of shareholder value.” Proponents of this third position felt the model fostered an environment that created oversized incentives which invited corruption. Governance standards had declined, “particularly those addressed to the numerology of shareholder value,” and the artificial inflation of Enron’s stock was revealed only during the downward cycle of a cyclical economy. Clearly, some argued, a reliable corporate governance model should be designed to catch wrongdoings before they cause serious financial damage to shareholders and other stakeholders; therefore the multiple scandals in 2001-2002 only demonstrated how the current model did not work.

Deakin and Konzelmann also shared this stance, stating:

We believe that this third interpretation of events goes to the heart of the matter...If we are to take this view seriously, nothing less than a fundamental rethinking of corporate governance practices and procedures is required. Above all, corporate governance must no longer confine its analysis to the relationship between managers, boards, and shareholders. The narrowness of this focus is a major contributing factor to the present round of corporate scandals of which Enron is most emblematic.

Other scholars, such as Janis Sarra, identified how the scandals signified a real need to

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62 Deakin & Konzelmann, supra note 45 at 584.
63 Bratton, supra note 50 at 1275.
64 Ibid. at 1283.
66 Deakin & Konzelmann, supra note 45.
reassess other models of corporate governance available throughout the world. When examining governance issues within the global markets shortly following Enron’s bankruptcy, she noted:

Although some scholars have claimed that the development of global capital markets will lead to the inevitable triumph of the market-centered system of corporate governance prevalent in Anglo-American law, the recent failures of large, publicly traded corporations in the United States cast doubt on claims of the ultimate superiority of that system. When this doubt is coupled with the existence of other forms of corporate governance throughout the world, the need for closer examination of potential alternatives or improvements in corporate governance becomes more evident.\(^{67}\)

Still others, such as Cary Coglianese and Michael L. Michael, suggested real corporate governance reform may only be found through the disentrenchment and reinvention of cultural norms, stating:

If corporate scandals stem from the same kind of underlying cultural problems that some insist afflict politics, sports, and even religion, then the core challenge for public policy will be to find ways to engender nothing less than a fundamental cultural shift.\(^{68}\)

These voices aligned with scholars that had been supporting counter-hegemonic discourses on the shareholder primacy model for some time; several of these discourses will be examined in detail in Chapter 4. However, voices from this third group supporting structural changes to the shareholder primacy model did not gain much traction on the pathway to reform after the scandals of 2001-2002. They were easily outnumbered by those leading the second group and the mainstream push for greater regulation of financial reporting and auditing practices. The discussion during that period surrounded the effectiveness of the SOX Act and altering rules to curtail unwanted human behaviour

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\(^{67}\) Sarra, *supra* note 38 at xv.

within existing governance structures, rather than revamping the current corporate form.

### 2.1.2. The Ascendancy of Behavioural Approaches

From a law and economics perspective, the scandals marked an interesting period in this field of study. It is apparent from Posner’s later writings that he firmly belonged with the first group of scholars supporting laissez-faire market principles, and not the second group calling for stricter market regulations to support the current governance model, nor the third group envisioning deep normative and structural reform. In Posner’s 2007 edition of *Economic Analysis of Law*, where he directly responded to the corporate events of 2001-2002, he stated:

> …fraud has long been criminal, and the successful prosecution of the Enron executives suggests that adequate legal tools were in place to deal with such conduct before *Sarbanes-Oxley*. It would be a mistake to forbid all asset transfers to special-purpose entities because such transfers confer genuine economic benefits. …As for the receipt by accounting firms of fees for consulting services, as well as for auditing, Enron’s auditor, Arthur Andersen, had largely effected that separation before the Enron scandal. There is no compelling reason to require such separation by law. It should be enough to require the corporation to disclose to investors the terms of its relations with its auditors, and leave the investors to penalize a corporation by bidding down its stock price if they think the auditor has been “bought.”

Other followers of the Chicago school generally echoed this sentiment. For example, in his March 2002 article entitled “Enron Was Mostly Right About One Thing: Deregulation”, Gary Becker argued that if a fully deregulated energy market been in place “the Enron political scandal would have been largely avoided” since the company “could not have gamed the system by encouraging politicians to deregulate as it

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70 Gary Becker, “Enron Was Mostly Right About One Thing: Deregulation” *Business Week* (18 March 2002), online: Business Week <http://www.businessweek.com/magazine/content/02_11/b3774026.htm>
While conceding that the scandal indicated greater accounting and Internal Revenue Service oversight was required, Becker pointed out that “stock markets have responded by punishing Enron severely for the company’s transgressions,” and concluded that “flexible prices and competition are far more effective ways to improve energy markets than allowing bureaucrats and politicians to determine the speed and direction of deregulation.”

Despite the firm stance by leading scholars in the Chicago school, this controversial period in corporate history provided opportunities for other strains within law and economics scholarship, particularly behavioural approaches, to broaden their audience. Objections to the depiction of human agents as rational actors within the field of law and economics (and especially the Chicago school) had frequently been voiced in the past by both its supporters and its critics. The scandals exposed the startling need for greater quantitative and qualitative research surrounding human behaviour in modern finance, while also providing a golden opportunity to apply behavioural approaches to pressing legal issues. The field was undergoing a transformative period toward the wider acceptance of approaches extending beyond neoclassical economics, including offshoots that developed from the work of the Chicago school such as Guido Calabresi’s influence within the New Haven school of law and economics. The New Haven school emphasizes how governmental intervention is justified based on existing market failures,

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71 Ibid.
72 Ibid.
73 Mercuro & Medema, supra note 27 at 182; see also infra note 77 at 1473 (noting that “[o]bjections to the rational actor model in law and economics are almost as old as the field itself”).
74 See Mercuro & Medema, supra note 27 at 79-83.
arguing that regulatory measures should be limited to correcting these failures with a recognized concern for both allocative and distributional effects.\textsuperscript{75}

Schools were eagerly adopting behavioural approaches in response to the dominant Chicago school’s rational, self-interested actor. Herbert Simon’s concept of “bounded rationality”, being behaviour that is “intendedly rational, but only limitedly so”\textsuperscript{76}, and other approaches addressing limitations in human behaviour\textsuperscript{77} were increasing in influence, which meant those promoting behavioural approaches in the interdisciplinary field of law and economics also gained momentum.\textsuperscript{78} Robert Prentice, for example, noted how the scandals supported his continued attempts “to create more realistic policy prescriptions than have been derived from the Chicago School law and economics reasoning that has dominated the interdisciplinary approach to legal analysis.”\textsuperscript{79} As well, Donald Langevoort asserted that “[t]he ones with the explaining to do [following the Enron debacle] are the believers in market efficiency.”\textsuperscript{80} He contended that “behavioural finance is somewhat better positioned to test the real world impact of bias in market prices than research in more opaque economic settings,” and went on to develop a

\textsuperscript{75} Susan Rose-Ackerman, \textit{Rethinking the Progressive Agenda: The Reform of the American Regulatory State} (New York: Free Press, 1992) at 6-7, 9.

\textsuperscript{76} Herbert Simon, \textit{Administrative Behaviour, 2\textsuperscript{nd} ed.} (New York: Macmillan, 1957) at xxiv; see also Herbert Simon, \textit{Models of Man} (Hoboken: Wiley, 1957).

\textsuperscript{77} See e.g. Christine Jolls, Cass Sunstein, & Richard Thaler, “A Behavioral Approach to Law and Economics” (1997) 50 Stan. L. Rev. 1471 (which in addition to bounded rationality consider concepts of “bounded self-interest” and “bounded willpower”).

\textsuperscript{78} This is not to say behavioural law and economics was not already developing prior to the scandals of 2001-2002, but rather, that these events only raised the platform and broadened the audience for behavioural approaches to take centre stage. There have been disagreements as to when and how behavioural economics began, see Hamid Hossein, “The Arrival of Behavioral Economics: from Michigan or the Carnegie School in the 1950s and the early 1960s” (2003) J. Socio-Econ. 32 at 391; but see also Louis Uchitelle, “Following the Money, but also the Mind: Some Economics Call Behaviour a Key” \textit{The New York Times} (11 February 2001) at 11.


\textsuperscript{80} Douglas Langevoort, “Taming the Animal Spirits of the Stock Markets: A Behavioural Approach to Securities Regulation” in Armour & McCahery, \textit{supra} note 45 at 66.
constructive theory of behavioural securities regulation.\textsuperscript{81} It was clear that those pressing for more contextualized critiques to the mainstream Chicago school of law and economics now had the chance to capitalize on those corporate events.

Law and economics scholars that were adopting behavioural approaches around the time of the Enron scandal held, if anything, beliefs in line with the second group that argued for greater transparency and accountability of directors and managers, and stricter regulation following the scandals to support the shareholder primacy model. The work of behavioural law and economics scholars generally focused on ways in which the law could promote desired human behaviour within pre-existing structures. The field itself utilizes traditional economic tools and enhances them by providing a better understanding of human behaviour in a market-driven environment. While recognizing that there can be novel prescriptions, more often than not the behavioural approaches offered following the scandals were mainly focused on economic improvements within the boundaries of securities regulation and “prescriptions regarding how to make the legal system work better”\textsuperscript{82}, not challenging the very structures and institutions in which the law operated.\textsuperscript{83} Behavioural law and economics served as a useful tool to expose the flaws within the existing model, but the approach was incapable of offering a meaningful alternative.

Nevertheless, the growing movement of behavioural approaches did signal a marked change in law and economics analysis. In a 1998 article, Christine Jolls, Cass Sunstein, and Richard Thaler noted: “Thirty years from now we hope that there will be no such thing as behavioural economics. Instead we hope that…economics [will transform] into

\textsuperscript{81} Ibid. at 67.
\textsuperscript{82} Jolls, Sunstein, & Thaler, supra note 77 at 1546.
\textsuperscript{83} See e.g. supra notes 79 and 80.
behavioural economics, and economic analysis of law into one of its most important branches.”

Following the scandals, it seems the study of behavioural effects on economics garnered greater strength and forward trajectory from these market-immobilizing turns of events. George Akerlof, for example, argued in his Nobel Prize lecture on December 8, 2001 (two months after news of the Enron scandal broke) that macroeconomics should be behavioural and that John Maynard Keynes “was the progenitor of the modern behavioural finance view of asset markets.”

The year following, the selection of Daniel Kahneman as the corecipient of the 2002 Nobel Prize in economic sciences signified to many the beginning of “the ascendancy of behavioural economics.”

One would think the corporate and accounting scandals of 2001-2002 would leave an indelible mark against Hansmann and Kraakman’s claim that the shareholder primacy model was the final resting place of the corporate form. After all, the devastating financial effects of these corporate bankruptcies not only reminded everyone that humans and structures (and the normative ideals that accompanied them) were fallible, but they also signified that something was seriously amiss with the perceived efficiencies embodied behind the current corporate model. It was apparent from the scandals that the human limitations of “bounded rationality, bounded self-interest, and bounded willpower” identified inherent flaws within the perceived transparencies and

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84 Jolls, Sunstein, & Thaler, supra note 77 at 1547.
87 Simon, supra notes 76 and Jolls, Sunstein & Thaler, supra note 77.
efficiencies in the financial market. Following those events, many felt a behavioural approach to law and economics offered a clearer lens in addressing human weaknesses embodied within corporate actions, although the approach contained few positive prescriptions for the development of an alternative, competing model. Instead of disproving Hansmann and Kraakman’s theory of convergence, the endurance of the shareholder primacy model further proved that the ideological support of the current model was deeply embedded in American culture. The burden continued to rest on lawmakers’ ability to adequately protect stakeholder interests through securities regulation, not on the corporate governance model itself. The scandals were potentially damaging to the reputation of the shareholder primacy model, but the continued survival of the model only solidified Hansmann and Kraakman’s argument that it had lasting acceptance within Western ideological thought.
3. Governance Reform and the Global Financial Crisis

Will the shareholder primacy model ideologically withstand the current global financial crisis? It is too soon to tell given the recency of the crisis and its ongoing effects. There is, however, a notable difference between the current crisis and the scandals of 2001-2002. Those past scandals involved conduct by management that was clearly in violation of the law. In contrast, the main factors leading to the crisis were due to corporate actions that were legally permissible, thus the fault cannot be said to rest solely upon the unlawful actions of a few greedy executives.

Across the Atlantic, there have been indications that European regulators are aware that their existing corporate governance model will need to be reformed. A recent green paper produced by the EU Commission outlining several governance initiatives has stated:


89 Corporate executives have been questioned for conducting unlawful activity, such as CEO Ian McCarthy of Beazer Homes USA Inc., who was under SEC investigation for lying about borrowers’ qualifications, see TIME Magazine, “25 People to Blame for the Financial Crisis”, online: <http://www.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877338,00.html>. McCarthy was never criminally sanctioned, but the SEC continues to threaten to sue McCarthy, see Associated Press, “Beazer Homes CEO Ian McCarthy May Face Civil Charges” MSNBC (16 November 2009), online: MSNBC <http://www.msnbc.msn.com/id/33965313/>.
“The financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company’s long-term viability has been severely shaken, to say the least.”

As a direct result of the crisis, the EU Commission has also announced the launch of a broader review of corporate governance within publicly listed companies in general. In the U.S., however, the recent financial regulatory overhaul by the Obama administration makes it seem likely that very little will change in the way U.S. corporate and financial institutions involved in the crisis will ultimately govern themselves.

This Chapter makes the case that the U.S. government should alter the governance model underlying corporate behaviour in its current regulatory reform efforts. Two of the primary and interrelated causes of the global financial crisis are addressed. Section 3.1 first contends that the corporate influence of major financial institutions ultimately caused the repeal of the Glass-Steagall Act, which required a separation between commercial and investment banking. The analysis reveals how regulatory bodies can be intimately involved with the corporate entities that they govern, and thus cannot be relied upon as the sole method of protection for broader stakeholder, community, and environmental interests that have been encroached upon by corporate actions. The section then touches upon how following the repeal, the rapid development of large financial conglomerates and shadow banks cultivated the environment that greatly contributed to the crisis. Next, Section 3.2 explores the development of the originate-to-distribute model of lending in the unregulated over-the-counter derivatives market. In the model, financial

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91 Ibid. at 9.

92 See infra notes 200-201.

93 See supra note 1.
institutions originate consumer mortgage loans which are then tranched, repackaged, and resold in the market to investors, creating a separation in the mortgagor/mortgagee relationship and the accompanying risks. The competitive need to generate profit induced several mortgage lending institutions to conduct questionable and even predatory lending tactics on potential borrowers. The examination also reveals how intensive lobbying efforts by interested corporate institutions essentially forced legislators to role back anti-predatory lending laws. Viewing these two main interrelated causal factors through the lens of a governance reformist, there is a case to be made as to how political and corporate actions in the run-up to the crisis can be seen as being fostered by the legal and normative prescriptions underlying the shareholder primacy model.

3.1 **The Repeal of the Glass-Steagall Act**

The *Banking Act of 1933*, popularly known as the *Glass-Steagall Act* ("GSA"), had restricted commercial banks from any involvement in the securities industry, thus creating a firewall between commercial banking and investment banking. On November 12, 1999, then-U.S. President Bill Clinton signed into law the *Gramm-Leach-Bliley Act* ("GLBA"), which repealed some of the key elements of GSA so that banks could thereafter be affiliated with securities firms.

At the time, then-U.S. Treasury Secretary Lawrence Summers described the repeal of the GSA as “updat[ing] the rules that have governed financial services since the Great Depression and replac[ing] them with a system for the 21st century”, thereby allowing

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95 *Banking Act of 1933*, 48 Stat. 162.
American banks to grow larger and “better compete” on the world stage. Senator Phil Gramm, the chief sponsor of the GLBA, identified the GSA as law that was brought on by fear and popular “demagoguery” from the Great Depression, which imposed an “artificial separation of the financial sector of our economy.” Other senators also argued the GSA created “punitive”, “unnecessary,” and “artificial” barriers in the economy, and applauded its demise.

Looking back, the GSA had already been considerably weakened by incremental bank incursions over the line through the 1990s. But what is less widely known is how one of the largest pending mergers of its time between two financial giants, Citicorp, Inc. (“Citicorp”) and Travelers Group Inc. (“Travelers”), ultimately dealt the final blow to the Act. A deal between them would create the largest “financial supermarket” in the world, allowing both institutions to access an expanded client base, particularly with Travelers promoting its mutual funds and insurance to Citicorp’s retail customers. The pending $70 billion merger (totalling over $698 billion in assets) to form Citigroup Inc. (“Citigroup”) was in violation of certain provisions of the GSA as well as the Bank Holding Company Act because of its combination as a financial services company offering commercial banking and investment operations. All involved were aware the merger violated the law, but the potential financial gains were enough that powerful

99 Id. at S13907 (statements by Senators Joseph Lieberman and Chuck Hagel).
101 Martin, supra note 100.
business executives had gone out of their way to lobby politicians to ensure future law would support it.\textsuperscript{103}

The Citicorp/Travelers merger is often described as occurring following the repeal of the GSA, and as a consequence of that governmental action.\textsuperscript{104} While it is true that the merger legally closed following the implementation of the GLBA, it had already been agreed well in advance of the introduction of that legislation. When Citicorp and Travelers announced the signing of their merger on April 6, 1998, Sandy Weill of Travelers, in response to questions regarding the legal hurdles before them, stated, “We are hopeful that over that time the legislation will change…We have had enough discussions [with the Federal Reserve Board] to believe this will not be a problem.”\textsuperscript{105} In the end, the executives of the future Citigroup “basically drafted the legislation that would govern its behaviour.”\textsuperscript{106} Kenneth Thomas, a consultant and Lecturer in Finance at the Wharton School, noted “Citigroup is not the result of [the GLBA] but the cause of it.”\textsuperscript{107} Weill had forced the issue of repeal of the GSA. In his induction into the Academy

\textsuperscript{103} Senate Banking Committee had approved the initial draft of the GLBA in March 4, 1999, almost a year after the parties announced their deal to the media and five months after the companies had effectively merged, see Senate Banking Committee, “Time Line of Gramm-Leach-Bliley Act,” online: United States Senate Committee on Banking, Housing & Urban Affairs <http://banking.senate.gov/prel99/1105time.htm>, and see also Citigroup website, supra note 26.

\textsuperscript{104} Citigroup even says this itself, see Citigroup website, online: Citigroup <http://www.citi.com/citi/corporate/history/citigroup.htm> (March 2000): “Citigroup Inc. qualifies as a financial holding company, among the first to take advantage of the new Gramm-Leach-Bliley Act, the Financial Services Modernization Act signed by President Clinton in November 1999”).

\textsuperscript{105} Martin, supra note 100.


\textsuperscript{107} Kenneth H. Thomas, Letter to the Editor, “Don’t Underestimate the Power of Sandy Weill” Businessweek (30 September 2002), online: Businessweek <http://www.businessweek.com/magazine/content/02_39/c3801026.htm> (commenting that previous Businessweek articles on the Citibank-Travelers merger do not explain how Citibank essentially caused the GBLA to exist).
of Achievement, Weill’s biography outlines the strategic manoeuvres that came with changing the law, stating:

Weill and Citicorp Chairman John S. Reed decided to force the issue [of repeal]. They went ahead with their plan and secured a waiver whereby the temporary merger of the companies would be permitted, pending congressional action. Weill recruited former President Gerald Ford, a Republican, and former Treasury Secretary Robert Rubin, a Democrat, to serve on the board of the merged companies and assist them in making their case to Congress.108

The timing by which Robert Rubin entered the picture is of particular interest. Rubin was still U.S. Treasury Secretary at the signing of the merger, serving in that capacity from 1995-1999.109 He played a large role as Treasury Secretary in brokering the passage of the final draft of the GLBA, which allowed Citicorp and Travelers to legally merge. Following Senate approval of the bill on May 6, 1999, Rubin resigned as Treasury Secretary. Five months later, he became the Chairman of the Board at the newly formed Citigroup.110 While recognizing that it was Rubin’s expertise and intelligence that made him one of a very small group of people under serious consideration to take on these government and private sector roles, the example is a telling one. It is erroneous to believe that political actions are necessarily separated from corporate influence and powerful lobbying efforts, or that regulators and corporate actors at these elite levels are distinctively separate. The recent Supreme Court decision in Citizens United v. Federal

110 Citigroup website, supra note 104.
Election Commission, which eliminated the ban on corporate political spending, could magnify this point in the future.\(^{111}\)

An extensive consolidation in banking occurred following the repeal of the GSA by the GLBA. Between 1990 and 2005, more than 5,400 mergers occurred in the U.S. banking industry, involving more than $5.0 trillion in banking assets.\(^{112}\) Taking advantage of the “progressive dismantling” of the GSA, U.S. and European banks were rapidly acquiring U.S. securities firms, and large securities firms were making significant acquisitions themselves.\(^{113}\) The bank merger wave meant that the proportion of banking assets held by the 10 largest U.S. banks more than doubled, from 25% in 1990 to 55% in 2005. Wall Street firms also secured bank-like powers by acquiring depository institutions insured by the Federal Deposit Insurance Corporation (“FDIC”), enabling them to offer FDIC-insured deposits, and make commercial and consumer loans.\(^{114}\) By 2006, the four largest U.S. securities firms – Merrill Lynch, Morgan Stanley, Goldman Sachs and Lehman Brothers – had effectively become “de facto universal banks” or “shadow banks.”\(^{115}\)

Many have noted that the problematic mix of the two banking sectors was self-evident. Andrew Sheng, for example, stated “you cannot mix the culture of investment banking (where risk taking is key) and commercial banking (where prudence is vital) under one roof.”\(^{116}\) The repeal of regulatory firewalls under the GSA invited “massive contagion”


\(^{113}\) Ibid.

\(^{114}\) Ibid. at 977, 978.

\(^{115}\) Ibid.

\(^{116}\) Andrew Sheng, From Asian to Global Crisis (New York: Cambridge University Press, 2009) at 326.
between banking industry sectors. Martin Wolf of the Financial Times observed that “financial liberalization and financial crisis go together like a horse and carriage.” Several economists have blamed the shadow banking system as the “core of what happened” in what many perceive to be the first wave of the crisis (as seen from the American perspective), the collapse of the subprime mortgage market.

3.2. The Originate-to-Distribute Model of Lending

An unregulated over-the-counter (“OTC”) derivatives market permitted many

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117 Ibid.
118 Martin Wolf, “This Time Will Never be Different,” (28 September 2009) Financial Times at 8. On December 16, 2009, Senators John McCain and Maria Cantwell proposed legislation to Congress reinstating the GSA or a form of it, forcing large banks “to return to the business of conventional banking, leaving the task of risk-taking or management to others.” The proposal has sparked renewed debate on whether repealing the GSA led to the current financial crisis but regardless of the stance, reactions on the feasibility of the proposal have been mixed, with some very strong dissents. These dissents reflect the loaded question of how practical a reconstruction of former legal structures would be once property has been allowed to disperse and co-mingle to such an extent. The proposed legislation has not moved forward. See “U.S. Senators Propose Reinstating Glass-Steagall Act” Bloomberg, online: <http://www.bloomberg.com/apps/news?pid=20601103andsid= aQfRyxBZ5uc>; Alison Vekshin & James Sterngold, “Reviving Glass-Steagall Means Escalating ‘War’ on Wall Street” (28 December 2009) Business Week, online: Businessweek <http://www.businessweek.com/news/2009-12-28/reviving-glass-steagall-means-escalating-war-on-wall-street.html>; Michael Hirsh, “An Odd Post-Crash Couple” (15 December 2009) Newsweek, online: Newsweek <http://www.newsweek.com/id/226938 /page/2>. Interestingly, see Posner’s comments at infra note 175.
119 See infra note 93.
121 An earlier version of this Section 3.2 was published in Ford & Liao, supra note 94 at 904-908.
122 For those unfamiliar, derivatives are financial instruments that are derived from some other underlying asset. See generally Merton Miller, Merton Miller on Derivatives (New York: Wiley, 1997). Derivatives can generally be classified into three groups: futures/forwards, swaps and options. Every derivative specifies a future price at which some item can or must be sold. The present value of a derivative is determined, in part, by value fluctuations in the underlying asset. The underlying asset may be a commodity, a financial security, or something more abstract like a price index. A simple historical example of a forward derivative would be an agreement between a farmer and a miller on the price to be paid in the future for the farmer’s yet-to-be-harvested wheat crop. In this agreement, the farmer hedges against the risk that the market price of his or her wheat will be lower in the future than the current price agreed upon with the miller, and vice versa for the miller, who hedges against the risk that the future market price will be
corporate institutions to capitalize on inventive methods of generating income, and capitalize they did. One of these methods was the originate-to-distribute model of lending (“OTDM”), which allowed financial institutions to reduce their capital charges higher. Today, much derivatives activity is fundamentally concerned with the process of unbundling and repackaging credit and market risk and, particularly for the investor, with whether a derivative effectively hedges an existing risk.

The United States has largely regulated derivatives through a “two-pronged” approach. Lynn Stout, “How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another” (2009) 1 Lombard Street 7. Derivatives are traded either through specialized derivative stock exchanges or privately between market participants. Exchange-traded derivatives are formally overseen by the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”), who have delegated the role to organized exchanges like the New York Stock Exchange and the Chicago Mercantile Exchange. Outside the exchanges, historically the act of over-the-counter derivatives trading was discouraged by a common law rule dating back to 1884. *Ibid.*, citing *Irwin v. Williar* (1884) 110 U.S. 449. In *Irwin v. Williar*, the court adopted a “rule against difference contracts” under which, in order for a court to enforce a contract, the demanding party would have to show to the court’s satisfaction that at least one of the contracting parties had an interest in the underlying asset. (In the U.K., the “rule against difference contracts” was overturned with the implementation of the Financial Services Act of 1986, c. 60 (FSA). This was confirmed in s. 412 of the Financial Services and Markets Act of 2000 (Consequential Amendments and Repeals) Order 2001 and The Financial Services and Markets Act (Gaming Contracts) Order 2001 SI 2001/2510, Therefore, speculative trading using OTC derivatives left parties with little legal protection if a deal were to go sour. The courts’ ability to disregard speculative OTC derivatives as merely off-exchange futures contracts undeserving of legal enforceability meant that an incalculable amount of outstanding swaps were at risk of being legally invalidated. This risk might have caused “chaos in financial markets, as swaps users would suddenly be exposed to the risks they had used derivatives to avoid.” Mark Jickling, “Regulation of Energy Derivatives” National Council for Science and the Environment (2006), online: <http://ncseonline.org/NLE/CRSreports/08Jun/RS21401.pdf>.

The U.S. Congress changed this in 2000 with the adoption of the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763. (“CFMA”), which confirmed the legal recognition and enforceability of purely speculative OTC derivatives. The CFMA also confirmed OTC derivatives were off banks’ balance sheets and not subject to CFTC or SEC oversight. This is not to say the CFTC and SEC did not make some efforts to oversee the OTC derivative market, but their efforts were severely limited. See U.S. Commodity Futures Trading Commission, “OTC Derivatives Oversight: Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Securities and Investments Board,” online: U.S. Commodity Futures Trading Commission <http://www.cftc.gov/international/currentinternationalinitiatives/otderovst.html> (using soft language to describe how the regulatory bodies will “work together” and with appropriate industry groups and participants to “promote” the development of sound internal management controls, etc.). On efforts at industry self-regulation, see Stephen Labaton & Timothy L. O’Brien, “Financiers Plan to Put Controls on Derivatives” The New York Times (7 January 1999), online: The New York Times Online <http://www.nytimes.com/1999/01/07/business/financiers-plan-to-put-controls-on-derivatives.html?n=Top/Reference/Topics/People/R/Rubin,%20Robert%20E.> (discussing the move towards self-regulation in derivative markets, prior to the GFC); Christopher Cox, “Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions” (Before the Senate Committee on Banking, Housing, and Urban Affairs, 23 September 2008), online: Securities and Exchange Commission <http://www.sec.gov/news/testimony/2008/ts092308cc.htm> (recognizing a lack of regulatory oversight in the market for CDSs and other derivative products). According to Lynn Stout, the motivation behind the Act’s promulgation was largely to help the U.S. maintain its competitive position in global OTC derivative markets vis-à-vis its European counterparts. Stout, *supra* note 123.
and transfer the risks associated with securitized loans to a market hungry to buy them. The strategy worked as follows: (i) originate consumer mortgage loans; (ii) package the loans, in tranches, into mortgage-backed securities (“MBSs”) and collateralized debt obligations (“CDOs”); (iii) create additional OTC derivatives whose values are derived from the underlying loans; and (iv) distribute the repackaged securities to investors.¹²⁴ Most institutions only held onto mortgages long enough to sell them off to investors, which promoted a higher-risk environment for loan production.

In addition to creating a separation between the mortgagor-mortgagee relationship and the accompanying mortgage risks, originating financial institutions sold mortgages immediately to investors and were therefore able to replenish their funds and issue more loans to generate greater transaction fees. The financial incentive was so great that it motivated corporations to (i) originate risky loans without screening borrowers and (ii) avoid post-loan monitoring of the mortgagees’ behaviour because the loans were transferred to investors.¹²⁵ A potential mortgagee used to be required to provide documentary evidence of adequate income and assets to support the repayment of the loan. With time however, the fierce competition between lending institutions caused the requirements to dwindle down to a point where “No Income, No Asset” (“NINA”) mortgages were created. In these NINA mortgages, a potential mortgage borrower would not be required to provide any evidence of their income or assets to qualify for a loan. Of course, this development also meant that no information would be verified by the mortgage lender. As put by one former executive director at the mortgage trading desk of Morgan Stanley, “We’re setting you up to lie. Something about that feels very

¹²⁴ See Wilmarth, supra note 112.
¹²⁵ Ibid.
wrong…Unfortunately, what happened, we did it because everyone else was doing it.”¹²⁶

How did the mortgage lending industry get to this point? Why weren’t stiff anti-predatory lending laws in place to, at the very least, curtail some of the worst corporate behaviours being exhibited by the industry? After all, one of the shining tenets in the shareholder primacy model is that stakeholder interests are exclusively within the purview of the government and protection must be sought through contractual and/or regulatory means. The simple and easy answer would be to blame state and federal legislators for failing to govern effectively, as many have.¹²⁷ But pointing to governmental inaction is only part of the story. Powerful lobbying efforts by corporate institutions, just like those found in preceding narrative, played a critical role in influencing regulatory inaction. These lobbying efforts prevented regulations from being implemented that could have contained reckless lending practices. More troubling, a recent International Monetary Fund paper has provided empirical evidence supporting the correlation between corporate and financial institutions lobbying on issues related to mortgage lending and securitization, and significantly riskier mortgage lending strategies by those institutions in the run-up to the crisis.¹²⁸

Several subprime lenders and banking trade groups, particularly Ameriquest Mortgage Company (‘Ameriquest’), but also including Citigroup, Wells Fargo & Co., Countrywide Financial Corp., and the Mortgage Bankers Association, “spent heavily on political donations, campaign contributions and lobbying activities to defeat anti-predatory

¹²⁷ See e.g. Posner, infra note 168.
lending legislation” in the run-up to the crisis.\textsuperscript{129} From 2002 through 2006, Ameriquest and its affiliates donated at least $20.5 million to state and federal political groups.\textsuperscript{130} Hiring lobbyist Lisa Andrews as senior executive for government affairs at Ameriquest meant the company gained access to several lobbying firms dedicated to politically influencing legislation. During her tenure at Ameriquest, Andrews noted on her separately owned Washington public relations firm, Washington Communications Group Inc., that she had “built a coalition of mortgage brokers, mortgage bankers, appraisers, title companies, and others involved in home mortgage lending to create a grass-roots lobbying campaign…” which, when required, was “capable of producing 7,000 emails and faxes to state policymakers in a six-week time frame.”\textsuperscript{131} Andrew’s husband, Wright Andrews, and his governmental relations firm of Butera & Andrews, collected at least $4 million in fees from the subprime industry from 2002 through 2006.\textsuperscript{132}

This effort to influence state laws governing the industry worked tremendously well.\textsuperscript{133}


\textsuperscript{131} Cited in Simpson, \textit{supra} note 129. The Washington Communications Group Inc. no longer has a website.

\textsuperscript{132} Wright Andrews was also involved in three different subprime-industry trade groups: the National Home Equity Mortgage Association, of which Ameriquest was a member; the Coalition for Fair and Affordable Lending, which spent $6.3 million lobbying against state laws before it dissolved in early 2007; and the Responsible Mortgage Lending Coalition. Simpson, \textit{supra} note 129.

\textsuperscript{133} Public choice theorists may regard these developments as supportive of their main conclusion that an official at any level, in both public and private sectors, “acts at least partly in his own self-interest, and some officials are motivated solely by their own self-interest.” Anthony Downs, \textit{Inside Bureaucracy}
For example, consider how industry lobbying efforts influenced Georgia’s anti-predatory legislation. On April 22, 2002, Georgia signed into law the Georgia Fair Lending Act (“GFLA”) which became effective on October 1, 2002. Among other things, the GFLA required lenders to be able to prove that a refinancing of any home loan less than five years old would provide a “tangible net benefit” to the borrower. Ameriquest began lobbying the state legislature to remove that provision, arguing the standard was too vague. The company began contributing to Georgia politicians and the subprime industry mounted a campaign against the rule in the GFLA.

In October 2002, Ameriquest announced it would stop doing business in the state until the law changed. Other lenders also complained about the law, as did the Federal

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(Boston: Little, Brown and Company, 1967). Public choice theory “recognizes that men are not angels and focuses on the importance of the institutional rules under which people pursue their own objectives.” William F. Shughart II, “Public Choice” in David Henderson, ed., The Concise Encyclopedia of Economics (Indianapolis: Liberty Fund, 2008), online: Library of Economics and Liberty <http://www.econlib.org/library/Enc/PublicChoice.html>. The self-interest of governmental officials may play a significant role in regulatory inaction, but this narrative suggests that powerful corporate influence can practically compel legislators to act or not act in favour of corporate interests, regardless of an official’s self-interest. The theory is, however, useful as a critique for highlighting how “electing better people will not, by itself, lead to much better government” and therefore, “institutional problems demand institutional solutions.” Ibid.

134 Georgia Fair Lending Act, O.C.G.A. Title 7, Chapter 6A. See also, Department of Banking and Finance, “Georgia Fair Lending Act Resources”, online: Department of Banking and Finance <http://www.georgia.gov/00/article/0,2086,43414745_46387757_69095972,00.html>. A helpful summary of the terms of the original GFLA can be found on the Federal Reserve Bank of Atlanta website, “Georgia’s Anti-Predatory Lending Law” online: Federal Reserve Bank of Atlanta <http://www.frbatlanta.org/pubs/partners/partners-vol_12_no_2-georgias_anti-predatory_lending_law.cfm?redirected=true>.

135 Ibid.

136 See Munlo & Padilla, supra note 130 at 91-93; Simpson, supra note 129. A whitepaper produced by the Georgia Credit Union Affiliates, the Community Bankers Association of Georgia, the Georgia Bankers Association outlines some of the concerns held by those opposing the new legislation at the time. See Mortgage Bankers Association, “Georgia Fair Lending Act: The Unintended Consequences” (January 2003), online: Mortgage Bankers Association <http://www.mbaa.org/industry/reports/03/ga-abaf_0210.pdf>.

137 For example, Simpson reports that, according to records at the State Ethics Commission of Georgia (records are no longer available via the Internet as they are over five years old) in December 2001, Ameriquest donated $2,500 to Lt. Gov. Mark Taylor after he emerged as an influential figure in the debate, and then with another $2,500 in September 2002. Simpson, supra note 129.

138 Ibid.; records of any such announcement are no longer available online.
National Mortgage Association (commonly known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (commonly known as Freddie Mac). Both announced plans to leave the “high-cost loan” market in Georgia, with Freddie Mac declaring that it would stop purchasing those loans as of November 2002 and Fannie Mae as of January 2003. Fannie Mae in particular announced that would conduct additional quality assurance reviews of mortgages secured by Georgian properties and required the “immediate repurchase” of high-cost loans as defined under the GFLA, or other federal, state or local laws. Shortly thereafter, Standard & Poor Corp. (“S&P”) and Fitch Ratings (“Fitch”) announced they would no longer assign credit ratings to many mortgage securities containing subprime loans from Georgia. Both S&P and Fitch believed that if loans were found to be in violation of the law, the legal risk could carry onto the investors, 

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139 Federal Reserve Bank of Atlanta website, supra note 134. The original announcements are no longer available on Fannie Mae and Freddie Mac’s websites.

140 Ibid. Fannie Mae and Freddie Mac were some of the surprise leading lobbyists behind the anti-predatory legislation. The government-chartered mortgage funding companies were in the business of buying mortgages from lenders, providing cash for lenders to issue more loans, and also packaging mortgages into securities for sale to investors. The Washington Post reported in October 2004 that both these companies “continued to spend more on lobbying in the first half [2004] than almost every other corporation in the United States.” David Hilzenrath, “Mortgage Giants Are Near Top in Lobbying Costs” (25 October 2004) The Washington Post, online: The Washington Post Online  <http://www.washingtonpost.com/wp-dyn/articles/A60010-2004Oct24.html> (noting as well that, beyond in-house lobbying staffs, Fannie Mae and Freddie Mac hired “dozens of outside firms…paying them fees up to $340,000 for six months in Freddie’s case, and up to $200,000 in Fannie’s case”). Freddie Mac spent $6.7 million in lobbying expenditures during that time period, ranking it sixth on a list of more than 600 companies and organizations spending more than $250,000. The issue of the companies’ extreme lobbying arose at a hearing in October 2004 addressing regulators’ allegations that Fannie Mae violated accounting rules. Connecticut Representative Christopher Shays stated, “I am tempted to ask how many people in this room are on the payroll of Fannie Mae, because what they do is they basically hire every lobbyist they can possibly hire – they hire some people to lobby and they hire some people not to lobby so that the opposition can’t hire them.” Ibid. See also video and transcript regarding the hearing at NewsHour with Jim Lehrer “Shaken Giant” (6 October 2004), online: Public Broadcasting Corporation  <http://www.pbs.org/newshour/bb/business/july-dec04/fanniemae_10-06.html>.


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potentially tainting the securities. S&P contended that under the new law, “liability for predatory lending practices does not stop with the lender guilty of the predatory practices but transfers to all purchasers of the mortgage, including purchasers who had no knowledge or role in the predatory lending.” Without credit ratings, such securities would have been virtually unmarketable. The change raised the possibility that subprime lenders would simply stop making loans in Georgia. Within months, the Georgia state government passed new law that eliminated the tangible net benefit requirement opposed by the industry for nearly all loans. The same scenario began to play out in other states, including in New Jersey, Illinois, New York, Pennsylvania, and Texas, where their anti-predatory lending laws were also rolled back.

The mass production of subprime mortgage loans by the mortgage lending industry allowed for the derivative producing machine of the OTDM to operate on overdrive.

142 Ibid.
143 The State Senate voted 29-26 in favour of amendments; the State House of Representatives passed the law, 148-25. Mortgage Banking Association Business Alert “Georgia Passes Fair Lending Act Amendments” (1 April 2003), online: All Business <http://www.allbusiness.com/finance/3595211-1.html> (reporting that the bill “clarifies ambiguities in the GFLA and repeals provisions that had caused many mortgage lenders to cease lending activities in Georgia since the GFLA became effective in October 2002”). For a timeline of the GFLA, see Community Investment Network, “Georgia Predatory Lending Laws Legislative History”, online: <http://www.communityinvestmentnetwork.org/nc/single-news-item-articles/article/georgia-predatory-lending-legislative-history/?tx_ttnews%5BbackPid%5D=293&cHash=79c6658f2a>.
144 See Munlo & Padilla, supra note 130 at 92; and Simpson, supra note 129. The Mortgage Bankers Association website also lists a significant number of news releases issued from groups in the mortgage lending industry that lobbied against anti-predatory lending laws in several states, online: The Mortgage Bankers Association <http://www.mortgagebankers.org/IndustryResources/ResourceCenters/PredatoryLendingNewsArchives.htm>.
145 This in turn created a level of remarkable complexity in the financial markets, one that has been called “the greatest financial market challenge of the future.” Steven L. Schwarcz, “Regulating Complexity in Financial Markets”, (2010) 87 Wash. L. Rev. 2 at 213, online: Social Science Research Network <http://ssrn.com/abstract=1240863>; see also Cristie Ford, “New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation” (2010) Wisc. L. Rev. 101 at 125-129. Complexity surrounding derivatives resulted in market participants being overly dependent on S&P and other credit rating agencies (“CRAs”) to determine the risk level of CDOs and other financial products when making investment decisions. Understanding the credit and default risk behind a particular tranche of a CDO would require an extraordinary amount of time and expertise. This meant institutions heavily relied upon the credit rating
By 2005-2006, the U.S. housing market was resting on what some have called a system of “Ponzi finance,” where subprime borrowers took out new loans secured by equity in their homes to pay off their existing mortgages on those same homes. In January 2006, Ameriquest announced a $325 million settlement with state attorneys general, law enforcement agencies, and financial regulators across the U.S. over allegations of predatory lending practices used to encourage homeowners to refinance mortgages. These allegations included “misrepresenting and failing to disclose loan terms, charging

assigned by CRAs to represent an accurate overall assessment of a debt obligor’s creditworthiness. The CRA interference in market pricing mechanics, with regards to CDOs, would not necessarily have been as problematic but for the fact that the calculations behind the CRA risk models were wrong. First, their models assumed housing prices would generally continue increasing in value and that the correlation between mortgage defaults would be small. Christian Opp, Marcus Opp & Milton Harris, “Rating Agencies in the Face of Regulation: Rating Inflation and Regulatory Arbitrage” (January 2010), online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1540099>. Second, CRAs had limited to no information on the creditworthiness of the (multitude of) individual sub-prime borrowers behind the MBSs and CDOs and, therefore, erroneously relied on historical data to compensate. Christopher Cox, “Statement at Open Meeting on Credit Rating Agency Reforms” (3 December 2008), online: Securities and Exchange Commission <http://www.sec.gov/news/speech/2008/spch120308cc.htm> (“One of the significant weaknesses in the credit rating process has been that while the credit rating agencies often relied on others to verify the quality of assets underlying structured products—and thus their ratings were often reliable in the absence of incorrect information—there was frequently insufficient explanation of the limitations on the ratings of these products”). Third and finally, the level of complexity behind the MBSs and CDOs became too much to handle for some CRAs. In a July 2008 report on CRAs by the SEC, it noted that “there was a substantial increase in the number and in the complexity of . . . MBS and CDO deals since 2002, and some [CRAs] appeared to have struggled with the growth.” Div. of Trading & Mkts. & Office of Econ. Analysis, SEC, Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies (1 July 2008), online: Securities and Exchange Commission <http://www.sec.gov/news/studies/2008/cra examination070808.pdf>.

The reliance on CRA credit ratings turned out to be very problematic with regards to firms’ risk management levels. Sophisticated investors often purchased (or were permitted to purchase) a CDO note only if it obtained a certain credit rating, such as investment grade, from a CRA. See e.g. Frank Partnoy, “The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies” (1999) 77 Wash. U. L.Q. 619; Roger Lowenstein, “Triple-A Failure” The New York Times Magazine (27 April 2008), online: The New York Times <http://www.nytimes.com/2008/04/27/magazine/27 Credit-t.html>. In order to generate a high return for perceived risk, these institutional investors would tend to buy notes issued by CDOs that were inexpensive (i.e. had high yields) relative to the CRA credit rating. However, the CDO notes were inexpensive because, notwithstanding the CRA credit rating, the market as a whole viewed them as riskier than more expensive CDO notes. Thus, in a classic case of adverse selection, investors such as pension funds (of all things) would tend to purchase the riskiest CDO notes within a certain CRA credit rating. Wilmarth, supra note 112 at 1028-1029. When the CRAs’ risk models turned out to be based on incorrect assumptions about housing prices and mortgage default rates, these investors were left with particularly risky CDO notes.

146 Ibid. at 964; see also Igan, Mishra, & Tressel, supra note 128.
excessive loan origination fees and inflating appraisals to qualify borrowers for loans."147 The settlement covered approximately 725,000 loans valued at more than $109 billion made by Ameriquest from January 1, 1999 to December 31, 2005.148 In May 2006, Ameriquest announced that it was closing all of its retail offices, and in September 2007, all of its mortgage assets were sold to Citigroup.149

When real estate prices fell in 2007, and subprime homeowners could no longer refinance, defaults skyrocketed and the subprime financial crisis began. Afterwards, it was revealed that “too big to fail” institutions had engaged in a multitude of credit default swaps on those MBSs, CDOs and other bundled securities, which were intended to insure investors against what these institutions believed was the almost impossible event of default.150 By some estimates, the collective exposure of institutional investors in mid-2007 exceeded even that of banks.151 As the crisis continued to unfold, institutional investors in need of cash began to face a serious liquidity problem, but could not sell the

150 A. Blundell-Wignall, “Structured Products: Implications for Financial Markets” (2007) Organisation for Economic Co-operation and Development (quoting a private investment bank estimate where insurance companies and asset managers together are shown to have delta-adjusted exposure to 28.6% of existing CDOs, whereas hedge funds and banks split the remaining exposure at 46.5% and 24.9%, respectively).
asset-backed securities in their portfolios due to the low liquidity levels in the market.\footnote{Ibid.} Thus, they turned to their more liquid holdings of corporate bonds, but with several mutual funds and other institutional bond investors also trying to liquidate their corporate bond holdings, “the market for these, too, was flooded and so prices plunged.”\footnote{Ron Goldsmith, “‘Intoxicated’ Institutional Investors: How the Financial Crisis Infected the Real Economy” (15 June 2010) INSEAD, online: INSEAD <http://knowledge.insead.edu/Investors-crisis-100615.cfm>}. As a result, the cost to corporations to finance their operations through corporate bonds was “crippled” by increased costs, spreading the crisis to the real economy and catapulting the credit crunch into the worldwide financial crisis.\footnote{Ibid.}

3.3. Development Arising from the Crisis

The fallout from the crisis led to numerous calls for accountability. The OTC derivatives market, despite its long existence, was suddenly being referenced in the media as the “dark market” that fueled the meltdown\footnote{David Cho & Zachary Goldfarb, “U.S. Pushes Ahead With Derivatives Regulation” The Washington Post (14 May 2009).}; “dark” presumably implying that the market was not overseen by a specialized governing authority like the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”). When asked who was to blame for the crisis, U.S. Treasury Secretary Tim Geithner did not place the blame on the mortgage lenders that had enticed borrowers to accept mortgages beyond their means. Geithner did not cite greed on the part of the financial institutions, or the imprudence of the borrowers; instead, he stated, “[t]he financial crisis was caused by significant gaps in oversight. One of the reasons crisis can spread so
rapidly…is the uncertainty people have in judging risk.”

The identified events from the global financial crisis give a striking example of how large public institutions are almost regarded as large beasts needing to be tamed, with regulatory bodies acting as lion tamers that are at fault if there is injury to the public. While it is certainly reasonable and necessary to have a level of expectation rest on the state to govern corporate behaviour to the extent it affects the wider community, the ability of institutions to disregard the impact their corporate actions have on stakeholders is discouraging, and the extreme influence these institutions have on the very governing bodies supposed to regulate them, through lobbying efforts or otherwise, is the most troubling.

Until the crisis, the OTDM may have been perceived by outsiders as acceptable behaviour furthering the purpose of increasing profit and/or share value under the shareholder primacy model. As such, the managers were doing what they were supposed to do within one set of norms guiding behaviour. It was the failure of the government in allowing these institutions to get carried away with their legally permitted (and arguably encouraged) activities. As well, the reactionary push for further regulatory reforms on a market level show how corporate culture has structured the law to be held accountable not despite its inexistence in an area, but because of its inexistence. The OTDM, NINA mortgages, the greed of the mortgage lenders, the imprudence of the mortgage borrowers, the incessant lobbying by interested bodies, the overhedging by financial products traders

156 Ibid.
157 This metaphor has been used frequently, with a well-known reference being from Ralph Nader, Mark Green, Joel Seligman, Taming the Giant Corporation: How the Largest Corporations Control Our Lives (New York: W.W. Norton & Company, 1977)
– all played an undeniable role in the lead-up to the crisis, but most of those involved have not been touched by the law, because despite “breathtakingly bad behaviour” and “real dishonesty” by those involved, no laws were broken. The reaction to the crisis by the public was to hold someone accountable, and the governing authorities were willing to allow the law and regulators shoulder much of the blame. Thus the crisis has shown how corporate behaviour that is influenced by the governance structure in the capital markets can have the amazing result of causing the public and governmental authorities to hold market rules accountable for failing to restrict this conduct, rather than the actual corporate conduct itself.

3.3.1. Returning to the Three Perspectives

Looking back at the three positions identified by Deakin and Konzelmann that developed following the scandals of 2001-2002, one can see how there are contrasting notes this time around. The position of the first group, which held that market sanctions alone were effective disciplinary devices, cannot seriously be considered any longer in the wake of the global financial crisis. In fact, the crisis may have destroyed the very premise on which this position rests. Paul Krugman, in his September 2009 article in The New York Times, “How Did the Economists Get It So Wrong?” blasts economists like Olivier Blanchard, now chief economist at the International Monetary Fund, for “clinging to the vision of capitalism as a perfect or near perfect truth.” Blanchard had written an article in 2008 declaring that “the state of macro[economics] is good” and, in a tone reminiscent to Hansmann and Kraakman’s “End of History,” argued that there had been a

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158 Ford, *supra* note 145 at 121.
159 See, however, exceptions to this identified at *supra* notes 88 and 89.
} Krugman in his critique writes, “[t]he renewed romance with the idealized market was, to be sure, partly a response to shifting political winds, partly a response to financial incentives,” but ultimately this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets — especially financial markets — that can cause the economy’s operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don’t believe in regulation.\footnote{Krugman, supra note 160.}

Posner, however, has found the large apportionment of blame laid upon capitalism to be misdirected. In his 2009 book examining the crisis and what Posner calls “the descent into depression” he admits that “laissez-faire capitalism failed us”, but on the question of who was more responsible, the industry or the government, Posner emphatically believes the responsibility lies with the government. For Posner, “the government allowed the preconditions of depression to develop and wreak havoc with the economy”\footnote{Richard Posner, \textit{A Failure of Capitalism: The Crisis of ’08 and the Descent into Depression} (Cambridge: Harvard University Press, 2009) at 236.\textit{ Ibid.}} and it was the government who provided “late, slow, indecisive, and poorly articulated” responses to the crisis.\footnote{Ibid.} Directing a pointed attack at Krugman, Posner states “the journalists and politicians, and some who should know better, like the distinguished macroeconomist Paul Krugman, are engaged in an orgy of recrimination against Wall Street. They have the wrong target. The responsibility for building the fences that prevent an economic
collapse as a result of risky lending devolves on the government.”

Posner has been careful in distancing himself from scholars that have applied behavioural analysis in the autopsy of blame. He has insisted that those on Wall Street were acting rationally, calling media coverage of Wall Street greed and extravagance as “ignorant” and “silly”, and rhetorically asking “What did reporters think businessmen were like?”

Posner has said, “I am skeptical that readily avoidable mistakes, failures in rationality, or the intellectual deficiencies of financial managers whose IQs exceed my own were major factors in the economic collapse.” He insists that blame rests on the lack of regulation by the government, and not the “rational” actions conducted by individuals which ultimately led to the crisis. Posner states:

By having over a period of decades [deregulated banking and credit], the government inadvertently allowed the rational self-interested decisions of private actors – bankers, mortgage brokers, real estate salesmen, homeowners, and others – to bring on a financial crisis that the government was unable to prevent from molting into a depression. A profound failure of the market was abetted by governmental inaction.

Posner’s position is helpful to highlight many of the problematic arguments I believe avid supporters of the shareholder primacy model generally hold. First, Posner has identified reckless behaviour – as clearly evidenced in the OTDM and the NINA mortgages – as rational. The stylized ideal of holding self-interest as the epitome of good business has been repeatedly proven problematic on so many levels that the continual confidence by supporters of this position, without at the very least acknowledging any nuances, is

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165 Ibid. at 285.
166 Ibid. at xiii.
167 Ibid. at 77.
168 Ibid. at 242-243.
almost bewildering. Second, as the previous narratives have shown, Posner has ignored how large institutions are capable of invoking powerful, immense, and unrelenting lobbying efforts on U.S. lawmakers whenever issues regarding their regulation and governance are at stake. Lastly, Posner’s position seems to be almost an about-face to the standard deregulatory position regarding the government’s role which has traditionally been favoured by the Chicago school, including after the Enron scandal. This inconsistency to me is a form of hindsight bias, one which frequents the analysis of those typically in strong support of deregulation prior to events of financial turmoil. The inconsistency should be considered a problematic trait by any interdisciplinary study offering broad-based theoretical analysis.

Since writing his book detailing the crisis in 2009, Posner has written another book, _The Crisis of Capitalist Democracy_, where he admits that he and the Chicago school believed erroneously that “markets were perfect, which is to say self-regulating, and government regulation in them almost always made things worse.” He now believes the crisis showed that pure market competition “can cause people to take reckless and irrational risks, with short-term profit-maximizing behaviour jeopardizing society’s long-term interests” (a point that one reviewer has noted, is “hardly a revelation”). He berates the three major CRAs of Moody’s, S&P, and Fitch, arguing they should lose their quasi-official status for their role in perpetuating the crisis and surprisingly suggests, among

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169 See e.g. supra notes 76-86.
170 See supra notes 105-111, 128-144.
171 See Becker, supra notes 70-72.
174 Posner, supra note 172 at 349.
other things, that reinstating the GSA is a viable and realistic solution.\textsuperscript{175} It seems that Posner, a U.S. Court of Appeals judge and prolific writer in his own right, has been struggling since the crisis to gain his bearings on what went wrong in relation to the theoretical offerings he has disseminated for decades as a founder of the Chicago school. The Chicago school of law and economics as a whole may need to readjust itself to the new political and economic climate or its influence will continue to weaken as other theories challenging the status quo in corporate law gain greater traction and forward trajectory.

Still, Posner’s strong reproach of governmental inaction during the crisis did not mean he shied away from recognizing the crisis was also “a failure of capitalism” and the unfettered market. The first position we examined in response to the scandals of 2001-2002 – being the belief that laissez-faire market sanctions are sufficient in times of financial turmoil – is now on tenuous ground. It was almost simple to call Enron an aberration and leave things as-is. However, the global financial crisis cannot be called an aberration, a market hiccup, or a normal “bubble” that burst. The $700 billion bailout and stimulus package by the U.S. government has significantly limited the viability of that argument.\textsuperscript{176} The crisis has thus caused many belonging in the first group following the scandals of 2001-2002, including Posner, to shift into the second group focused on improving corporate behaviour through the tightening of securities regulation.

In fear of the crisis causing the “Next Great Depression”\textsuperscript{177}, the U.S. government first

\textsuperscript{175} Ibid. at 353-354; but see also supra note 118 (discussing the problems with reinstating the GSA).
\textsuperscript{176} See infra note 179.
implemented emergency response acts through the *Housing Rescue and Foreclosure Prevention Act of 2008*\(^{178}\) and the *Emergency Economic Stabilization Act of 2008*\(^{179}\), the latter of which authorized the government’s $700 billion bailout. Following these Acts, Geithner in general championed a relatively circumscribed regulatory response to the crisis, based primarily on requiring banks to hold more capital in reserve to cover losses.\(^{180}\) Geithner’s view seemed to have been that broad-based prohibitions on specific risky activities would be less effective, in part because such bans would unnecessarily eliminate some legitimate activity. Instead, on January 21, 2010, President Barack Obama chose a more aggressive (and some would say, populist) option. He announced his support of the position held by Paul Volcker, former chairman of the U.S. Federal Reserve and head of President Obama’s Economic Recovery Advisory Board, by calling for limits on the size and trading activities of financial institutions in order to reduce excessive risk-taking activity.\(^{181}\) Volcker’s most significant recommendation, dubbed the “Volcker Rule” by President Obama, was to specifically prohibit banks from engaging in proprietary trading that was not on behalf of its clients, and from owning or investing in a hedge fund or private equity fund, as well as limiting the liabilities that the largest banks could hold.\(^{182}\)

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The appointment of Volcker has been heartening for many seeking more aggressive ways to reform Wall Street. As part of his argument that banks should be prevented from taking advantage of governmental safety nets in order to make speculative investments, Volcker has acknowledged the need for deep, sweeping, and multifaceted structural reform in the financial services industry, while also pointing to reform measures that could substantially alter the internal governance of financial institutions (to be discussed in more detail in Chapter 6).  

Volcker’s participation in governmental reform efforts has led to numerous changes that have been adopted in the Restoring American Financial Stability Act of 2010\textsuperscript{184}, or otherwise known as the Dodd-Frank Act (the “DFA”), which President Obama signed into law on July 21, 2010.\textsuperscript{185} The 2,300+ page Act is aimed at improving accountability and transparency in the financial system, protecting consumers from abusive financial services practices, with the “the most important goal….being to prevent future bailouts” and preventing financial institutions from “taking risks that threaten the whole economy.”\textsuperscript{186}

The legislation puts a great deal of faith in the watchful eye of regulators to prevent another financial crisis, “leav[ing] the financial industry largely intact but facing a more


\textsuperscript{184} For the Act in its current bill form, see Financial Reform Legislation Bill (as of 19 July 2010), online: United States Senate Committee on Banking, Housing & Urban Affairs <http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf>

\textsuperscript{185} The DFA, after much political wrangling, had been approved by the House of Representatives on June 30, 2010 (after three failed attempts at its passage), and approved by the Senate on July 15, 2010.

powerful network of regulators who could impose limits on risky activities."¹⁸⁷ The Act creates new agencies to police consumer lending, financial products innovations, and trading in the “dark markets” of complex derivatives.¹⁸⁸ Consumer lending is now under the purview of a new consumer financial protection bureau, while the SEC is granted authority to broaden the regulation of hedge funds and credit rating agencies. Many derivatives are now required to be traded through clearinghouses, and traders must disclose pricing data to encourage transparency and competition. The legislation also increases the regulatory powers of the Federal Reserve and establishes a systemic risk council of high-ranking federal regulators, led by the Treasury Secretary, to detect potential threats to the overall financial system, and providing new powers to constrain and even dismantle troubled companies, forcing creditors and shareholders to bear losses so taxpayers do not end up footing the bill.¹⁸⁹ The Act also leaves a vast number of details for regulators to work out, which to some is “inevitably setting off another round of battles that could last for years.”¹⁹⁰

Prior to the final approval of the bill, a flurry of lobbying efforts and deal-making allowed several industries to escape many of the provisions found in the DFA. Intensive lobbying efforts translated into automobile dealers receiving an exemption from oversight by the new consumer bureau, despite being “among the biggest originators of consumer

¹⁸⁸ DFA, supra note 184; see also e.g. Peter Henning, “A New World Begins for Wall Street Oversight” The New York Times (19 July 2010), online: <http://dealbook.blogs.nytimes.com/2010/07/19/a-new-world-begins-for-wall-street-oversight/>.
¹⁹⁰ Ibid.; Henning, supra note 188.
Dealers argued that the rules would place unnecessary restrictions on their financing business. The Obama administration opposed such an exemption, but gave in to these demands during negotiations. Most significantly, industry lobbyists made a concerted effort to push for a series of exemptions to the Volcker Rule, allowing banks to continue to operate businesses as investment funds that hold only client funds. Asset management and insurance companies pushed for a carve-out to exclude them from the Act outright, succeeding in large part. As well, Senator Scott Brown, the Republican representative of Massachusetts, pushed for an exemption from the Volcker Rule allowing banks to continue to invest in hedge funds and private equity firms, which ultimately succeeded. It was reported that Brown was largely focused on assisting the corporate interests of Boston-based money management giants like Fidelity Investments and State Street Corporation, but the exemption also allows many of the financial institutions at the core of the crisis to keep any assets and/or subsidiaries that would have violated such regulations.

Volcker himself endorsed the final version of the DFA, but “rather unenthusiastically.”

He admits that for all the Act’s strengths in limiting trading activities, he still feels that the legislation “doesn’t go far enough in curbing potentially problematic bank activities,”

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194 Stephen Gandel, “In Financial Reform, Rules Made to Be Broken” *TIME* (24 June 2010). For example, JPMorgan Chase would be able to retain its Highbridge Capital Management unit, and Goldman Sachs could hold on to several large hedge funds, including its Global Alpha franchise. Morgan Stanley could keep FrontPoint Partners and several other smaller hedge funds. *Ibid.*

such as investing in hedge funds.\textsuperscript{196} He believes that banks still have “too much wiggle room” to repeat the behaviour that caused the crisis to occur in the first place.\textsuperscript{197} Both critics and endorsers alike have also contended that the Volcker Rule has been weakened to the point where it will be likely be ineffectual.\textsuperscript{198} Many have pointed out that the DFA leaves so much decision-making in the hands of regulators that it could lead to field day for lobbyists in the financial industry.\textsuperscript{199} 

It has been easy for commentators to point out that the legislation gives “the least attention to changes in the ways public companies are overseen.”\textsuperscript{200} Unlike what was seen following the corporate and accounting scandals of 2001-2002, the U.S. government has not capitalized on efforts to improve governance within the institutions that brought about the crisis. Other than allowing shareholders to have an advisory vote on executive compensation (which conceptually simply aligns with the principles behind the shareholder primacy model), there are no corporate governance reform measures addressed in this legislation, let alone any that challenge the present day model. There are no regulations set to tighten internal governance, make boards more competent and

\begin{flushleft}
\textsuperscript{196} Ibid.
\textsuperscript{197} Ibid.
\textsuperscript{198} See e.g., William Black, “Why the Financial Reform Bill Won’t Prevent Another Crisis” \textit{CNN Money} (19 July 2010), online: CNN Money <http://money.cnn.com/2010/07/18/news/economy/finreg_law_incentives_bill-black.fortune/> (arguing that the bill does not address perverse compensation incentives); Mark Thoma, “The Dodd-Frank Financial Reform Bill” \textit{CBS Money Watch} (15 July 2010), online: <http://moneywatch.bnet.com/economic-news/blog/maximum-utility/the-dodd-frank-financial-refrom-bill/725/?tag=coll1;blog-river> (describing how the Volcker Rule has been so weakened by exemptions that it is likely to be ineffectual); Aline van Duyn & Francesco Guerrara, “Dodd-Frank Bill is No Glass-Steagall” \textit{Financial Times} (27 June 2010), online: <http://www.ft.com/cms/s/0/e355c680-8212-11df-938f-00144feabcd0.dwp_uuid=ffa475a0-f3ff-11dc-aaad-0000779fd2ac,s01=1.html> (describing the bill as one that came out of a “20-hour horse-trading session” where firms have to “navigate a maze of prohibitions”); but see Reid Cramer, “Dodd-Frank Financial Reform: The Rise of the Regulators” \textit{The Huffington Post} (13 July 2010), online: The Huffington Post <http://www.huffingtonpost.com/reid-cramer/dodd-frank-financial-refo_b_644933.html> (arguing that the bill will go a long way in creating meaningful reform).
\textsuperscript{199} Dash & Schwartz, supra note 192.
\textsuperscript{200} Chan, supra note 186.
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accountable for complex risk-taking activity, improve internal risk management, or address stakeholder interests in corporate decision-making. President Obama indirectly said this himself, stating “[u]nless your business model depends on bilking people, there is little to fear from these new rules.”

And indeed, the corporate behaviour of these institutions may prove President Obama’s words to be true. Wall Street firms have been aggressively seeking ways to get around restrictions in the DFA. For example, according to media reports, UBS has recently prepared a 20-page “action plan” outlining various options to curtail the effects of the Act, while senior managers at Goldman Sachs have had preliminary discussions on eventually dropping its status as a federally insured bank, allowing it to escape several of the most stringent provisions in the new law. It has been reported that “Wall Street trading floors are buzzing about creative ways to possibly limit the impact” of the Volcker Rule, with unidentified traders informing reporters how it will be difficult for regulators to legally define what constitutes “a proprietary trade” as opposed to “a reasonable hedge against looming risks.” Thus banks may still be able to make big bets by simply classifying them differently. Frank Partnoy has commented, “Wall Street has always been very skilled at getting around rules, and this law will be no exception…Once you open up the door just a crack, Wall Street shoves the door open and runs right through it.” As Volcker cautioned, “People are nervous about the long-term outlook,

202 Dash & Schwartz, supra note 192.
203 Ibid.
204 Ibid. (quoting Partnoy),
and they should be.”

3.4. *Time to Reassess the Alternatives*

The focal point of Chapters 2 and 3 is to provide an overview of governance reform efforts following recent grand scale events of financial calamity. Governance reform operates on two levels. The first level of reform attempts to make the actors in an existing model more accountable to the roles they are supposed to play in that model. The other level reconsiders the very model itself. It asks, what are the legal principles that we want to guide our corporate laws?

It seems that American culture is at least passively settled with the model as it currently exists. Governments are responsible for adjusting legal rules to restrain certain incentives that guide the existing model. If corporate conduct causes negative ramifications to society without appropriate regulation to address it, the solution is to create reactionary law to address and prevent such specific conduct from recurring in the future. It suggests a cyclical pattern of disaster and reactionary lawmaking will always accompany the financial markets if the shareholder primacy model is here to stay. This pattern is particularly concerning as innovative financial products are produced with a level of rapidity and complexity that has regulators struggling to keep up. After considering the regulatory overhaul plan when it was initially proposed by the Obama administration, even before it was whittled down by lobbying groups and partisan politics, Krugman already saw that it was not enough, stating “[i]t seems all too likely that the industry will soon go back to playing the same games that got us into this mess in the first place.”

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lasting change on a broader scale is expected, other pathways to reform need to be considered.

The global financial crisis should awaken us to the fact that reform efforts are not reaching far enough. Corporate governance reform needs to be made a part of any sweeping overhaul of the financial system, which cannot simply to reinforce the current shareholder primacy model. It is worthwhile to explore the alternatives and consider the possibilities that are available. These alternatives we turn to in the subsequent Chapters.
4. Structure-Altering Recommendations

It is unclear whether Hansmann and Kraakman are correct in asserting that corporate law has reached the end of its history. The fact is that unforeseeable events are generally not calculated in such theories. The ideological entrenchment of the shareholder primacy model seems firmly implanted in American culture, as its steadfast existence in history, particularly following the scandals of 2001-2002, can attest. After the fall of Enron, scholars like Deakin and Konzelmann wondered if the catastrophic market events would “usher in a new age of enlightenment” to corporate governance reform.\textsuperscript{207} The question now is whether the global financial crisis will be enough an uprooting force leading to a serious reconsideration of the model underlying corporate behaviour.

The importance of proper governance, and in particular, addressing the problematic separation of ownership and control within the corporate institution, was most notably identified in the 1932 book by Adolf Berle and Gardiner Means, \textit{The Modern Corporation and Private Property}\.\textsuperscript{208} Berle and Means described how public corporations were beginning to comprise of two factions: controlling managers, considered the new “princes” of the social institution, and passive shareholders, being the only residual claimants to the company’s net assets.\textsuperscript{209} In a later article, Berle succinctly outlined how management’s authority was to be exercised for the benefit of the corporation’s shareholders. According to Berle, “all powers granted to a corporation or to the management of a corporation, or to any group within the corporation . . . [are] at all times exercisable only for the ratable benefit of all the shareholders as their interest

\begin{footnotesize}
\begin{itemize}
\item Deakin & Konzelmann, \textit{supra} note 45 at 583.
\item Adolf Berle & Gardiner Means, \textit{The Modern Corporation and Private Property} (1932).
\item \textit{Ibid.} at 116.
\end{itemize}
\end{footnotesize}
Following Berle’s article, an active exchange appeared between Berle and E. Merrick Dodd in the *Harvard Law Review*, an exchange that is generally regarded (some say, erroneously\(^\text{211}\)) as originating the current debates between advocates of shareholder primacy and corporate social responsibility. In response to Berle, Dodd argued for “a view of the business corporation as an economic institution which has a social service as well as a profit-making function,” claiming to identify an emerging public consensus that corporations should operate as “good citizens.”\(^\text{212}\) Berle replied in a subsequent note that discarding a specific duty to shareholders, without substituting a reasonably clear alternative mandate, would impart too much discretion to management. In light of the separation between ownership and control, Berle believed the result would be vast, uncontrolled power with no reason to assume it would be used responsibly.\(^\text{213}\)

A few decades later, Berle eventually conceded that Dodd’s position had at least temporarily prevailed, as he observed actual practice and common law decisions had over time accepted Dodd’s general viewpoint against a stricter fiduciary duty.\(^\text{214}\) As David Millon describes, “by then it had been established in practice and in law that corporations were free to engage in philanthropy, despite objections that they were spending shareholders’ money. There was no need to show that such expenditures were at least in

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\(^\text{210}\) Adolf Berle, “Corporate Powers as Powers in Trust” (1931) 44 Harv. L. Rev. 1049 at 1049.

\(^\text{211}\) William Bratton & Michael Wachter, “Shareholder Primacy’s Corporatist Origins: Adolf Berle and ‘The Modern Corporation’” (2008) 34 J. Corp. L. 99 (describing how the Berle-Dodd debate has been wrongly categorized as a debate between shareholder primacy and corporate social responsibility from mistaken readings of old material outside of its original context).

\(^\text{212}\) E. Merrick Dodd, “For Whom are Corporate Managers Trustees?” (1932) 45 Harv. L. Rev. 1145 at 1148

\(^\text{213}\) Adolf Berle, “For Whom Corporate Managers Are Trustees: A Note” (1932) Harv. L. Rev. 1365.

Nevertheless, historical events would frequently create a push-and-pull over the (imagined or existing) dichotomy between the two sides. The exchange between Berle and Dodd has provided much fodder for corporate legal theorists: Does the firm exist only to increase shareholder wealth? Or, should managers also seek to serve the interests of employees, creditors, customers, and the broader society? Stout put it well by stating that after reading contemporary works on these issues, “one might be tempted to throw up one’s hands and conclude that academics have not lent much more insight into this question since the original Berle-Dodd debate.”

Recently, some scholars have put forth the proposition that Berle and Dodd were ultimately concerned with different issues. It seems common for Berle to inaccurately be labelled as an advocate of shareholder wealth maximization at the expense of all else. But Berle, who has been labelled as “progressive” by some current scholars, was perhaps focused on ensuring a meaningful alternative to the shareholder primacy model was available before he could in good conscience lend his support. His later works indicate his interest in containing the pervasive levels of power that could be effectuated through the corporate institution, rather than protecting the profit-maximizing function of

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217 Stout, supra note 13 at 1190.
218 Ibid. at 1190.
219 See Millon, supra note 215 (pointing to public policy controversies generated by the hostile takeover boom of the 1980s as the true origins of the current debate). Others have suggested that that they ultimately shared the same viewpoint. See e.g. Fenner, supra note 216.
220 See Bratton & Wachter, supra note 211 (highlighting this common error).
the model. Berle believed that “a power vacuum is always filled by a power holder” and thus, for Berle, the issue at hand was really about ensuring that those in power were properly and effectively regulated.

In the decades following the Berle-Dodd debate, various alternative theoretical models and approaches have emerged in an attempt to highlight and counteract the problems associated with the modern corporation’s focus on shareholder wealth maximization. These works generally consider how to improve and potentially redesign the corporate institution so that it “can assure that power is deployed in the service of individual and societal flourishing rather than against it.”

Nevertheless, while scholarly criticisms against the shareholder primacy model have been widely available, disagreements on the measure of success and the way forward have made concentrated efforts to reform the current model difficult to sustain and maintain.

This difficulty may be due to the fact that corporate governance itself is a complicated matter, being derived from various laws, customs, and processes; it is undeniable that there are normative underpinnings. While the proper structuring of hard laws is critical to reform efforts, it is important to also consider the need for normative cohesion. When

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222 Adolf Berle, Power Without Property: A New Development in American Political Economy (1959) at 19. Interestingly, Berle has reflected upon how he felt The Modern Corporation “in no way broke new ground.” For Berle, pointing out that corporations increasingly held large concentrations of power was not a new realization and he queried as to why the book had been received in the academic community as novel. He felt that he had been “describing a phenomenon with which everyone was familiar” and still thought this to be the case. Ibid. at 19–20. For more on Berle’s work with power, see Ford & Liao, supra note 94 at 924-929.

223 Berle extended his theories on power in Adolf Berle, Power (1969), in which he describes the sources and limits of four manifestations of power: economic, political, judicial, and international.

224 Testy, supra note 5 at 1228.

225 Sarra describes it this way: “[R]ules or standards of corporate stewardship evolve in the context of the larger public policy and regulatory framework of corporate law, securities law, and a highly developed scheme of credit enforcement and bankruptcy law, which provide the normative “muscle” to encourage particular kinds of governance behaviour.” Sarra, supra note at 38 at 42.
envisioning new governance structures for the corporate form, there needs to be serious consideration as to what is formed by the law, and what is embodied normatively, with perhaps the vision of legal teeth without actual capability of ‘bite.’ “Hard” law and “soft” law are common concepts recognized in academia, typically in international law, which may be useful to consider in this corporate context. While “hard” law should be self-explanatory as it is the common mainstream understanding of law, “soft” law is non-binding, quasi-legal, and offers a flexible option for containing inspirational goals and wish-list type aspirations without committing to legal liabilities in the event such goals fail to be realized. In some instances, particularly those where the corporation is a willing participant in governance reform, the expansions into “soft” law options are useful in developing a more complete and well-rounded governance structure. Thus, in pursuing an alternative governance system, it seems establishing the best combination of legal and normative constructs is integral to permeating and maintaining the desired corporate environment to instigate both social and economic change in the way institutions do business.

The following are four high-level, interrelated and interconnected recommendations that together should provide the base for a tight combination of new architecture aimed at redesigning the current governance model: (1) deeply entrench stakeholder interests; (2) increase board responsibility and control; (3) expand beyond traditional shareholder value; and (4) normatively embed social responsibility. These recommendations represent big picture ideas that connect key concepts from several counter-hegemonic models, theories, approaches, and ideas available in legal scholarship, presented together to form

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a broad-based plan to reform the shareholder primacy model. I believe these recommendations in combination represent a whole that is greater than the sum of its parts. Implementing one recommendation may produce positive results, but it is the layering of support from other recommendations that can ultimately redesign our existing corporate governance structures. Later in Chapters 5 and 6, I elaborate on how these recommendations can be (and have been) utilized in corporate practice to improve the governance of corporate and financial institutions.

4.1. Deeply Entrench Stakeholder Interests

Since the Berle-Dodd exchange, the shareholder v. stakeholder debate in U.S. corporate law “has proven most fundamental and enduring.” Now in the wake of the global financial crisis, it seems to me that the stakeholder side to the debate has become all the more compelling. Two particular strains of counter-hegemonic discourse will be closely examined here: stakeholder theory and progressive corporate law. I believe these strains offer valuable insights on how stakeholder interests can effectively be entrenched into corporate culture. Stakeholder theory proposes that all stakeholder interests should be taken into account for the effective management of a corporate institution. Progressive corporate law challenges head-on the shareholder wealth maximization norm and insists that public responsibilities and obligations should be inherent in any corporate governance structure.

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227 It has also been called the monism v. pluralism debate. See e.g. Ian Lee, “Corporate Law and the Role of Corporations in Society: Monism, Pluralism, Markets and Politics” (2006) Canadian Bar Rev. 85; Robert Clark, Corporate Law (Boston: Little Brown, 1986) at §16.2.2.

As already noted, I believe legal and normative action are required in all four recommendations for there to be optimal transformation of corporate behaviour – but of all four recommendations, I find this particular one is most in need of a two-pronged approach. For ‘deep’ entrenchment of stakeholder interests to be realized (1) directors and managers need to embrace and instil the consideration of stakeholder interests into corporate culture and management styles and (2) laws need to be put in place to ensure management is, at the very least permitted to, and ideally required to consider stakeholder interests. I offer stakeholder theory and progressive corporate law as a theoretical basis for each. In practice, the establishment of “other constituency” statutes in several states seem capable of addressing the latter legal concerns. These statutes, along with ways to improve them, will be examined in greater detail in Chapter 5.

4.1.1. Stakeholder Theory

Stakeholder theory is “a theory of organizational management and ethics”\(^ {229}\) which views “organizations [as] multilateral agreements between the enterprises and its multiple stakeholders.”\(^ {230}\) The rise of business models specifically addressing stakeholder interests took to the forefront in the mid-1980s, although some have attributed it to earlier beginnings.\(^ {231}\) While the notion of stakeholder interests may have roots in a number of academic fields, much of the theoretical development behind stakeholder theory has been credited to work from The Wharton School at the University of Pennsylvania. The theory

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has also had its application stretched into several interdisciplinary fields such as corporate law, feminist ethics, and philosophy, among others. The “wide-ranging intuitive appeal” and avid adoption by several schools of thought has led some of the early developers of the theory to decry “distortions” in its interpretation, with later works attempting to address the exact scope of the theory in response to both “explicit and implicit” criticism.\footnote{Robert Phillips, R. Edward Freeman, and Andrew C. Wicks, “What Stakeholder Theory is Not” (2000) 13:4 Bus. Ethics Q. 479.}

The motivation behind stakeholder management was to build a framework that was responsive to the concerns of managers who in the 1980s were experiencing a business environment similar to our current corporate landscape, one that was “buffeted by unprecedented levels of environmental turbulence and change.”\footnote{Freeman & McVea, supra note 231 at 189.} A stakeholder approach sought to broaden the concept of strategic management beyond its traditional economic origins. The definition of stakeholder included “any group or individual who is affected by or can affect the achievement of an organization’s objectives,” thus including any person or entity that simply could assist in or benefit from a corporation’s success.\footnote{Freeman, supra note 229 at 46.}

As well, corporate legal scholars have gone on to define the term stakeholder perhaps more broadly, as “any individual or group on which the activities of the company have an impact,” implying stakeholders include those that have been affected by any and all corporate actions, not just those that have been for the achievement of the organization’s objectives.\footnote{Christine Mallin, \textit{Corporate Governance} (Oxford: Oxford University Press, 2004) at 43. See Jean Jacques du Plessis, James McConvill, and Mirko Bagaric, \textit{Principles of Contemporary Corporate}
The central task in the “stakeholder approach to strategic management,” as coined by R. Edward Freeman, is “to manage and integrate the relationships and interests of shareholders, employees, customers, suppliers, communities and other groups in a way that ensures the long-term success of the firm.” Freeman and John McVea noted in 2001 that:

Many traditional views of strategy have ignored some stakeholders, marginalized others and consistently traded-off the interests of others against favored stakeholder groups. Such an approach may well be appropriate in relatively stable environments. However, in a world of turbulence and accelerating change the limitations of traditional approaches to strategic management become increasingly apparent. The interests of key stakeholders must be integrated into the very purpose of the firm, and stakeholder relationships must be managed in a coherent and strategic fashion.

In order to survive in an unstable, fast-changing market environment as it was then following the corporate and accounting scandals of 2001-2002, and ever more as it is today in the wake of the crisis, management “must direct a course that does not merely optimize current output.” Freeman and McVea suggest that as the business world becomes increasingly tumultuous and interconnected, and “as the boundaries between firms, industries and our public and private lives become blurred, a stakeholder approach has more and more to tell us about both values and value creation.” Management must have the support of those who can affect the institution and understand how the institution will affect others. Thus, a stakeholder approach rejects the very idea that a single objective of increasing shareholder wealth is a useful way of thinking about management strategy. Rather, stakeholder management is “a neverending task of

Governance (New York: Cambridge University Press, 2005) at 16-28, for further detail on the definition of “stakeholder.”

236 Freeman & McVea, supra note 231 at 192.
237 Ibid. at 189.
238 Ibid. at 194.
239 Ibid.
balancing and integrating multiple relationships and multiple objectives.” Managers must find ways to satisfy multiple stakeholders simultaneously.

The prescriptive and descriptive “approach” (later to evolve into a “theory” by its originators) encourages management to develop strategies by looking outwards from the corporation and investing in all the relationships that will ensure its long-term success. It is more concerned about actual “names and faces” of stakeholders rather than summarizing particular stakeholder roles. There is critical importance placed on developing an understanding of the actual stakeholders specific to the institution, since through this level of understanding management can create strategies that have the support of all stakeholders to ensure the long-term survival of the institution.

In terms of an institution’s shareholders, stakeholder theory contends that it matters less that management understands “shareholders-in-general” expect steady dividend growth. Instead, it matters more that management comprehends the expectations shareholders hold in increased share value, such as an expectation that a corporation be the “first to market” with a next generation product. Good strategic management, according to this approach, “emerges from the specifics rather than descending from the general and theoretical.”

As well, lower priority is placed on management understanding the reaction of “customers-in-general” to a price rise. Using the mortgage borrowers in the subprime mortgage crisis as the notable example, it matters more that the management in those

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240 Ibid.
243 Ibid. at 195.
mortgage lending institutions first recognize borrowers’ interests as fundamental to the success of their organization, and second, understand how actual borrowers react, bearing in mind borrowers’ personal financial circumstances, their lifestyles, their expectations for the future, how they would react to a change in their mortgage rates, and even (to make a blatant point) how they would perceive of corporate lobbying efforts against anti-predatory lending laws. The focus on a single objective led mortgage lending institutions to ignore how the successes and failures of their stakeholder mortgage borrowers’ could ultimately affect the long-term success of their business, with painful consequences.

Advocates of stakeholder theory suggest that its distinctive feature is how “it addresses morals and values explicitly as a central feature of managing organizations.” The foundations of stakeholder theory are terms that are “explicitly and unabashedly moral.” Managing for stakeholders involves attention to more than shareholder wealth. Attention to the interests and well-being of those who can assist or hinder the achievement of the organization’s objectives is the “central admonition” of the theory.

Stakeholder theory has had a general level of enthusiastic acceptance by corporate legal scholars on both sides of the shareholder v. stakeholder debate. For those believing corporations should have the singular objective of shareholder wealth maximization, the theory easily supports that belief by its claim that incorporating stakeholder interests

244 See infra notes 129-144.
245 Phillips, Freeman & Wicks, supra note 232 at 481.
246 Ibid. (listing several sources of stakeholder theory literature examining the moral foundations of the theory as an example).
simply furthers such cause.\textsuperscript{248} For those believing managers should seek to serve the interests of other stakeholders, stakeholder theory also appeases. While many corporate legal theorists, being convinced of its merits, have simply applied and pursued stakeholder theory without concern or regard for its roots, there are some concerns I have with an argument put forth by its advocates that changes to the law are unnecessary to effectively implement stakeholder theory.\textsuperscript{249} My concerns indicate a divergence with stakeholder theorists, who insist the approach can survive within a shareholder primacy model (suggesting it only need exist normatively and thus be subject to management’s discretion). I prefer the inclusion of stakeholder interests in corporate decision-making to be deeply embedded both normatively and legally. My concerns regarding the need for “hard” law support is addressed in Section 5.1 when discussing the development of state “other constituency” statutes, alongside the similar argument made by the originators of the team production theory.\textsuperscript{250}

\textbf{4.1.2. Progressive Corporate Law}

As put by Kellye Testy, “[i]n the realm of corporate law, unlike perhaps other legal systems of ordering, a progressive vision is at an embryonic stage.”\textsuperscript{251} The term “progressive” is normatively vague, and its usage in a corporate law context requires clarification. As a starting point, progressive corporate law generally expands on the need to identify some form of corporate recognition beyond shareholder interests. The lack of


\textsuperscript{249} See \textit{infra} notes 385-389.

\textsuperscript{250} See \textit{infra} notes 390 and 391.

a mutually accepted terminology, a collective voice, and common goals within what I shall tentatively call the “progressive movement in corporate law” has amounted to disagreements on what constitutes success in corporate practice.

While some scholars have attributed many counter-hegemonic discourses in corporate legal scholarship as progressive, others describing similar ‘progressive’ discourses have bifurcated their research from a progressive approach, implying that their positions should stand alone as separate work. The conflicting descriptions create a puzzle as to how to categorically place progressive corporate law in the context of alternative discourses. Still others critiquing progressive corporate law have found the term “progressive” contentious, attributing it as “simply a code word used by the left to take advantage of the positive connotations associated by most Americans with the idea of progress.” There are multiple challenges posed in the exercise of clarifying this field of study. If progressive corporate legal scholarship is to be viewed broadly, there may be a chronological wrinkle in retroactively placing previous ideas under the rubric of modern progressive corporate law, increasing the possibility of purposeful self-selection and greater levels of incongruity among scholarly work. Furthermore, the origins and historical usage of the term ‘progressive’ make it, accurately or not, potentially

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252 See e.g. Testy, supra note 5 (hinting at several discourses as falling under the purview of progressive corporate law). In order to address the evident classification problems within counter-hegemonic corporate legal scholarship pertaining to progressive corporate law (if only temporarily), I have identified scholars as “progressive” in this section only if they have previously identified themselves under such title.

253 See e.g. Blair & Stout, supra note 274 at fn. 83 (stating “our argument departs from those of the progressives because the latter commonly argue that corporate directors do not take sufficient account of nonshareholders’ interests and that changes in the law are required to make this happen”); see also Ronald Columbo, “Ownership, Limited: Reconciling Traditional and Progressive Corporate Law via an Aristotelian Understanding of Ownership” (2008) 34 J. of Corp. L. 1.

attributable to certain political genres. There is also the chance that an all-encompassing definition of progressive corporate law may dilute the meaning and purpose of such a movement, leading to concerns of domestication for those carrying more radical notions of change.

A notable example of this field of scholarship is the appearance of the 1995 book *Progressive Corporate Law: New Perspectives on Law, Culture, and Society*, a collection of scholarly essays that, despite its interesting premise, is now out of print. It provided voices from several corporate legal scholars considering how for-profit companies and corporate law could be better designed to emphasize “responsibility, altruism, and unity within the corporate form and between the corporation and broader society.” The editor, Lawrence Mitchell, identified the common premise of progressive corporate law being the belief that “it was no longer reasonable (if it ever was) to treat the corporation as a purely private mechanism” and “to disregard the actual public character of the modern corporation simply is wilfully to disregard reality.” Quoting sociologist Alan Wolfe, Mitchell contends that progressive corporate law serves to improve or redesign the corporate form to account for the fact that “[c]orporations really are both private and public simultaneously…They are institutions that sometimes act as quasi-governments

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256 See e.g. Testy, supra note 5 at 1249.
258 *Ibid*.
259 *Ibid* at xiv.
and, even when they do not, they take actions that affect every aspect of people’s lives, including people who have no formal contractual relationship with them.”

Further prescriptive parameters within progressive corporate law have been suggested by other scholars, such as Kent Greenfield and Testy, but continue to be initial stage ideas in the movement. Greenfield has described five progressive principles as being: (1) the ultimate purpose of corporations should be to serve the interests of society as a whole; (2) corporations are distinctively able to contribute to the societal good by creating financial prosperity; (3) corporate law should further principles one and two; (4) a corporation’s wealth should be shared fairly among those who contribute to its creation; and (5) participatory, democratic corporate governance is the best way to ensure the sustainable creation and equitable distribution of corporate wealth. Testy has contended that a progressive corporate law project should: (1) seek an increased dispersion of wealth in society; (2) seek measures that reduce all forms of subordination and discrimination; (3) be consistent with environmental justice movements; and (4) seek to enhance social democracy.

The challenge of progressive corporate legal scholarship continues to be the struggle toward agreed upon normative goals, and concentrated efforts in reaching those goals. It is useful for scholars with mutually supporting ideas to share an ideological base, and be capable of understanding where to place oneself within an ongoing dialogue. Voices advocating seemingly progressive projects tend to be disparate and, other than a few

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262 Testy, supra note 7 at 1244.
exceptions within the 1995 book, fairly individual. As well, progressive corporate scholars may find the title of “progressive” too unwieldy or political and elect to shed the label in their work. The inability to produce a common terminology has created a significant stumbling block to internal organization and cohesion.

Nevertheless, the commonalities noted by Mitchell indeed exist. As Dalia Tsuk Mitchell proposes, progressive corporate law may be perceived as “twentieth-century corporate law scholarship that criticizes the shareholder primacy vision of corporate law and views corporations as institutions with public obligations.”\(^{263}\) Progressive corporate law may be appropriately described as a field focused structural reform where, “[i]nstead of regulating the uses to which the tool is put, [progressive corporate law scholars] look to redesign the tool itself.”\(^{264}\) Progressive corporate scholars commonly argue that changes in the law are required to make corporate directors take account of stakeholder interests. In this way, progressive corporate law is incredibly valuable. Rather than insisting there are ways in which corporate behaviour can be improved without disturbing the focus on shareholder wealth, this approach challenges the fundamental core of the shareholder primacy model.

It is unclear how the field of progressive corporate law is going to define itself going forward; it is still young and immature, with ambiguous historical ties that have supplied reasons for detractors to favour stifling its growth. While progressive corporate law faces its own challenges, on the whole it broadens the conceptual scope of governance. Stakeholder theory does break the mould of the shareholder primacy model, but its

\(^{263}\) Tsuk Mitchell, supra note 255 at ftn. 7.
\(^{264}\) Mitchell, supra note 257 at xiv.
insistence that stakeholder-oriented management ultimately increases shareholder wealth implies an adherence to the status quo.\textsuperscript{265} The theory is then vulnerable in cases where there are conflicts between stakeholders. Progressive corporate law, on the other hand, seems to push stakeholder interests to a new level, expanding the definition to the larger community and environment, and demanding public obligations of corporations be recognized both legally and normatively. Thus, while its practical applications are currently somewhat sparse, it has significant appeal in challenging how stakeholder interests can indeed be ‘deeply’ embedded into corporate culture.

4.2. Increase Board Responsibility and Control

The common debate regarding corporate control has typically rested on whether or not shareholder voting can effectively control corporate management if ownership is widely dispersed. Berle and Means noted that shareholders in public companies are subservient to directors “who can employ the proxy machinery to become a self-perpetuating body.”\textsuperscript{266} Scholars in the years since have continued to weigh in on the subject. Some have maintained that shareholders actually do have meaningful control over the corporation, even in cases of a diverse ownership base with no clear majority shareholder.\textsuperscript{267} The majority, however, agrees with Berle and Means that shareholder voting power is insignificant because the obstacles in the way of achieving collective

\textsuperscript{265} See \textit{supra} note 248.
\textsuperscript{266} Berle & Means, \textit{supra} note 208 at 6.
\textsuperscript{267} See e.g. Dennis Leech, “Corporate Ownership and Control: A New Look at the Evidence of Berle and Means” (1987) 39 Oxford Econ. Papers 534 (maintaining that shareholders actually do have meaningful control over the corporation, even in cases where there is a diverse ownership base with no clear majority shareholder).
action are too difficult and expensive to surmount. In reaction, a few scholars have offered ways to improve shareholder control. As Cristie Ford and I have elaborated, while the debate is still relevant, it is losing some of its descriptive and normative force as the exponential growth and development of derivatives has begun to adjust common assumptions related to shareholder voting rights. The growing phenomenon of shareholder decisions being manipulated by “new vote buying” through the use of equity derivatives has amplified the need for increased board responsibility and control.

Models that are stakeholder-based will vastly benefit from greater board responsibility and control. I agree with scholars who have argued that a stronger board of directors can promote efficient and informed decision-making, deter inter-shareholder opportunism, and allow for greater investment in other corporate stakeholders. An alternative model offered in legal scholarship which emphasizes these traits, the “team production theory”

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268 See e.g. Lucian Bebchuk, “The Myth of the Shareholder Franchise” (2007) 93 Va. L. Rev. 675 (describing shareholder voting power is insignificant because the obstacles in the way of achieving collective action are too difficult and expensive to surmount).

269 See e.g. Lynn Stout, “The Mythical Benefits of Shareholder Control” (2007) 93 Va. L. Rev. 789 (finding the lack of actual shareholder control preferable, arguing that board control promotes efficient and informed decision-making, deters inter-shareholder opportunism, and allows for greater investment in other corporate stakeholders).

270 Ford & Liao, supra note 94 at 897-898.

271 This phenomenon has been examined in detail by two corporate scholars, Henry Hu and Bernard Black, who in a series of acclaimed articles have outlined the deleterious potential effects that arise from so-called “empty voting” and “hidden (morphable) ownership,” where derivatives have allowed investors to readily separate economic ownership of shares from voting rights. Hu & Black have produced a series of articles on the matter. For their landmark piece, see Henry T. C. Hu & Bernard Black, “The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership” (2006) 79 S. Cal. L. Rev. 811, for their initial work. Consider as well the “director primacy” model. This model also has directors holding more responsibility and control for the purpose of more effectively increasing shareholder wealth. Stephen Bainbridge argues that shareholders lack both the information and the incentives necessary to make sound decisions and overcoming these obstacles would be difficult and costly. Thus, he contends the board of directors should serve as the requisite central office for corporate decision-making. Stephen Bainbridge, “Director Primacy and Shareholder Disempowerment” (2005) 119 Harv. L. Rev. 1735; Bainbridge, supra note 14.

272 See e.g. Stout, supra note 269.
will be examined. Next, the concept of increased individual director accountability is explored as a way to alleviate some of the perceived weaknesses in the theory.

4.2.1. Team Production Theory

The team production theory was developed in 1999 by two American corporate legal scholars, Margaret Blair and Lynn Stout.\footnote{Margaret Blair & Lynn Stout, “A Team Production Theory of Corporate Law” (1999) 85 Va. L. Rev. 248.} Since its appearance, the theory has had some level of prominence within other scholarly journals that have either advanced its theoretical merits\footnote{See e.g. Stephanie Ben-Ishai, “A Team Production Theory of Canadian Corporate Law” (2006) 44 Alta. L. Rev. 299; Testy, infra note 7 at 1232-1238.} or critiqued its apparent flaws.\footnote{See e.g. Alan Meese, “The Team Production Theory of Corporate Law: A Critical Assessment” (2002) 43 Wm. & Mary L. Rev. 1629. George Dent, “Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance” (June 2007) Case Legal Studies Research Paper No. 07-21, online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=995186> (while not in support of the CEO primacy model, this article contends that the CEO primacy model reflects reality); Millon, infra note 295.} Blair and Stout offer what they believe to be an accurate description of corporate law as it currently is, and a prescriptive order for what it should continue to be. They do not question neoclassical measures of efficiency, but rather, believe their model creates a more efficient method of decision-making within the corporation, while increasing share value and reducing agency costs.

Taking issue with the shareholder primacy model’s misleading view of ownership, what Stout calls “the most common, and the worst, of the standard arguments for shareholder primacy”\footnote{Stout, infra note 13 at 1190.}, Blair and Stout adopt their ideas of vesting allocational authority in an independent third party from Armen Alchian and Harold Demsetz’s work on economic organization\footnote{Armen Alchian & Harold Demsetz, “Production, Information Costs, and Economic Organization” (1972) 62 Am. Econ. Rev. 777.} as well as Raghuram Rajan and Luigi Zingales work on team
production. Their theory offers a “mediating hierarchy” approach to corporate governance. Here, the perception is that “directors should be viewed as disinterested trustees charged with faithfully representing the interests not just of shareholders, but of all team members.”

The public corporation is best viewed as a team of “shareholders, managers, rank and file employees, and possibly other groups, such as creditors.” Team members are required “to give up important rights (including property rights over the team’s joint output and over team inputs such as financial capital and firm-specific human capital) to a legal entity created by the act of incorporation. In other words, corporate assets belong not to shareholders but to the corporation. In this sense, directors of public corporations do not maximize shareholder value but instead resolve competing claims that various “stakeholders” might have to the collective residual product of the corporation’s activities.

Relying on Rajan and Zingales’ research on team production, Blair and Stout give credence to the propositions that (1) team members will only want to be part of a team if by doing so they can share in the economic surplus generated by team production, and (2) team members intuitively understand that it will be difficult to convince others to invest firm-specific resources in team production if shirking and “rent-seeking” go uncontrolled. Thus, team members realize that it is in their own self-interest to create a

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279 Raghuram Rajan & Luigi Zingales, “Power in the Theory of a Firm” (1998) 113 Q.J. Econ. 387 (identifying the regulation of access to resources as the mechanism by which participants in a joint production process acquire power over other participants who make specific investments).

280 Blair & Stout, supra note 274 at 286.

281 Ibid. at 253

282 Ibid. at 250-251

283 Blair and Stout describe “rent-seeking” as “situations where individuals expend time, money, and other resources competing for a fixed amount of wealth, in effect squabbling with each other over the size of their individual pieces of a fixed group pie.” Ibid. at fn. 4.

284 Ibid. at 249-250; see also Rajan & Zingales, supra note 279.
higher authority that can limit this behaviour among team members. In other words, “team members submit to hierarchy not for the hierarch’s benefit, but for their own.”285 The team forms because the members perceive that each will obtain more from the cooperative enterprise than from individual action.286

As Blair and Stout envision it, the primary job of the board of directors of a public corporation is not to act as agents who “ruthlessly pursue shareholders’ interests at the expense of employees, creditors, or other team members.”287 Rather, the directors are trustees for the corporation itself – “mediating hierarchs” whose job is to balance team members’ competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.288 The corporate team gives up control rights to a third party board, “outsiders” to the actual productive activity that makes no firm-specific investment itself.289 The board is, however, given control over the team’s assets, as well as the right to allocate output among team members, fire individual members or even break up the team. In return, the board is rewarded with a nominal share of the team’s output. As a result, the “outsider” directors have an incentive to choose an efficient and productive team and team members feel they can now safely invest.290

The implication is not that directors manage the corporation on a day-to-day basis. To the contrary, Blair and Stout expect that most corporate decisions are made collegially

285 Blair & Stout, supra note 274 at 275-276.
286 Ibid. at 264-271.
287 Ibid. at 280.
288 Ibid. at 280-281.
289 Ibid. at 274.
290 Ibid.
among team members at lower levels. They believe it is enough for the possibility that the board could make allocations that discourages the more egregious forms of shirking and rent-seeking among team members. A comparative example they offer is for directors to be seen as judges who render decisions in litigation between parties.

Testy has called the team production theory a “[s]uperior normative theory of what corporate governance should be once unyoked from slavish devotion to shareholder interests” which “holds promise.” Taking away the insistence on shareholder primacy, Blair and Stout leaves the allocation of resources to the board, with the result that the costs of obtaining team specific investments are lowered and the potential to maximize social wealth. It sees the corporation as a collective enterprise, and recasts the duties that management might owe to those stakeholders affected by it.

There have nevertheless been criticisms, from both supporters and detractors of the shareholder primacy model. Millon has pointed out that decision-making regarding the allocation of resources then becomes “a matter of power rather than principle.” Power just flows to directors and then theoretically another Enron situation could occur, but this time it is the directors that have acted corruptly rather than the managers. As David Skeel

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291 Blair & Stout contend that the existence of a mediating hierarch may heighten incentives for team members to work out conflicts among themselves “because the alternative is kicking the problem upstairs to a disinterested – but potentially erratic or ill-informed – hierarch. Thus an independent board of directors may be able to encourage shareholders, executives, and employees to invest in corporate production not because these team members expect the board to determine which group gets what portion of the resulting economic surplus, but because the possibility that the board could make that allocation discourages the more egregious forms of shirking and rent-seeking among team members.” Ibid. at 282. This reasoning from Blair and Stout is surprising to me – and seems incredibly problematic. However, I assume that Blair and Stout are focusing on the perceived (but ideally erroneous) fear by team members that this may be the case, rather than implying directors would be prone to making poor decisions.

292 Ibid. at 282.
293 Ibid. at 284.
294 Testy, supra note 7 at 1233.
points out:

The problem with inviting directors to abandon their focus on shareholders is that directors who are told to be loyal to many constituencies are too likely to prove loyal to none. The effect...is to give directors unfettered discretion, since nearly any decision they wish to make can be defended as benefiting one or more constituencies.\(^{296}\)

The “stakeholder” excuse then can be used by directors to usurp control for ulterior motives.\(^{297}\) Advocates of shareholder primacy have repeated several of these criticisms, drawing sharp attacks for how directors would have free reign to serve their own interests without being held accountable to anyone.\(^{298}\) Many have also asserted that shareholders require a privileged status, and the ability to challenge directors whenever they fail to maximize shareholder gain.

In response to criticism of greater director control, advocates of stakeholder interests downplay the risk that directors will inevitably run amok unless held to strict standards of accountability to shareholders. Mitchell, for example, has argued that, in general, it is appropriate to trust directors to act in good faith, taking all stakeholder interests into account.\(^{299}\) He has pointed out, for one thing, that shareholders will still enjoy a positive return on their investment.\(^{300}\) For another, he has argued that the obsession with holding managers strictly accountable to shareholders is actually counterproductive. It treats managers as if they are “moral infants, incapable of living up to higher expectations”

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\(^{296}\) David Skeel, Jr. “Icarus and American Corporate Regulation” in Armour & McCahery, *supra* note 45 at 129.

\(^{297}\) Dent, *supra* note 276.


which ultimately encourages selfish, irresponsible behaviour on their part; giving boards discretionary power “allows them develop as morally mature decision-making bodies.”

Furthermore, higher levels of moral maturity at the corporate helm are worth the risk that some managers may not rise to the occasion.

4.2.2. Individual Director Accountability

Concerns regarding director accountability in the team production model may to some extent be legitimate, but individual director accountability is one proposal that can effectively address some of those concerns. It is clear that if board responsibility is expected to be elevated to the level of a “mediating hierarch,” the directors on the board must also become more accountable. Lawrence Mitchell has suggested that accountability has too often been expressed in the aggregate, when in fact “[h]uman accountability is a matter of individual accountability. In order for us to hold corporate managers truly accountable, we need more.”

Mitchell has suggested one way of ensuring this accountability by requiring each director to be given the opportunity to include a statement in the corporation’s annual report discussing his or her views of the significant events of the year and the important challenges for the future. In Mitchell’s opinion,

Each director would be required to stand exposed…as an individual human being with his or her own ideas, thoughts, positions and values. Those interested…would start to be in a position to evaluate each director as an individual human being, and to hold each accountable for the fit between his or her decisions, the well-being of the corporation, his or her own attitudes and accepted social norms of business conduct. Such a requirement would force

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301 Ibid.
302 Ibid. at 537.
303 Mitchell, supra note 300 at 305-306.
directors to think deeply not only about the immediate effects of his or her decisions on the corporation, but on its broader effects on society and, perhaps most significantly, on his or her personal reputation.304

Mitchell recognizes the limitations in his proposal, agreeing for example that it would be difficult to subject these statements to antifraud provisions, and as with all decisions, people can and will disagree. Nevertheless, Mitchell’s proposal is more important as a useful reminder of how corporations are ultimately comprised of people first. It is almost ancillary whether or not the market can serve as an effective disciplinary device from this disclosure. What adds credence to Mitchell’s suggestion is that directors will feel increased intrinsic responsibility purely by drafting and publishing such a statement, which will compel higher levels of honesty and integrity in day-to-day operations. As Mitchell points out, “their interests in their own reputations should ensure that their decisions are defensible.”305 There are other ways of heightening disclosure on an individual basis. These methods, as well as how to address issues of board competency in complex businesses, are examined in relation to the global financial crisis in Section 6.2.306

4.3. Expand Beyond Traditional Shareholder Value

As seen in Chapter 3, neoclassical law and economics analysis on the shareholder primacy model has had its share of problems. The preponderance of evidence against placing unrealistic assumptions on investors and the financial markets has raised questions as to why such rationale continues to dominate in academic work.

From a law and economics perspective, can the shareholder primacy model still be

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304 Mitchell, supra note 300 at 306.
305 Ibid.
306 See infra notes 479-504.
considered the most economically efficient corporate form? Surely the unprecedented $700 billion bailout by the U.S. government was not efficient, by way of Kaldor-Hicks measure or any other. If Hansmann and Kraakman are correct and corporate law has indeed reached the end of its ideological history, it should be noted that their justification of economic efficiency cannot be applied any longer. Ideological complacency and resistance to change are likely playing larger roles than previously acknowledged. The crisis should change the state of play for corporate legal scholars. It has opened up an opportunity for the perceived benefits of the current governance model to be reconsidered using the very reasons used to suppress other models – being the neoclassical measure of efficiency based on monetary value.

To attempt to argue against the neoclassical law and economics definition of efficiency here would be repeating an immense array of existing scholarship. Instead, Section 4.3.1 will first consider the 2006 emergence of the concept of “enlightened shareholder value” in the U.K. and its recent embrace by American corporate scholars seeking ways to alter the shareholder primacy model, and then in Section 4.3.2 offer an innovative restatement of the concept of efficiency through an institutional law and economics perspective. Institutional theory is particularly useful in that it dispels the notion of an ultimate efficient result, contending that the perception of an efficient outcome relies primarily on whose rights the government has elected to protect. This theoretical premise effectively challenges the efficiency reasoning behind the continuance of shareholder primacy model as touted by neoclassical law and economics scholars. Since the government holds the power to create the skeletal corporate framework recalibrating measures of efficiency, there is a real potential for change in how corporate institutions perceive success. This
fact becomes even more evident later in Section 5.3, when I examine how a few states have recently introduced laws creating a new corporate model that allows for both the pursuit of social and economic value.

4.3.1. Enlightened Shareholder Value

In 2006, the United Kingdom enacted the *Companies Act*\(^{307}\) (the “Companies Act”) which introduced the concept of “enlightened shareholder value” (“ESV”) to the for-profit corporate governance structure.\(^{308}\) Several American corporate scholars took advantage of the shared adherence to the shareholder primacy model by both countries to capitalize on the U.K.’s innovative measure in their work. The core principle behind ESV is embodied in Section 172 of the Companies Act, which defines the fiduciary duties of directors as follows:

> A director [must act] in good faith . . . to promote the success of the company for the benefit of its members as a whole, and in doing so have regard to . . . (a) the likely consequences of any decision in the long term, (b) the interest of the company’s employees, (c) the need to foster the company’s business relationships with suppliers, customers and others, (d) the impact of the company’s operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.\(^{309}\)

ESV recognizes the idea that corporations should pursue shareholder wealth with a long-run orientation that seeks sustainable growth and profits based on responsible attention to the full range of relevant stakeholder interests. Similar to stakeholder-based approaches,

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309 *Companies Act, supra* note 307 at s. 172.
ESV strives to expand beyond the short-term focus of increasing share price, particularly when such focus has the ability to produce negative effects for other stakeholders. In the U.K. version of ESV, management’s ultimate responsibility still lies with shareholders, but it is required to pursue that objective through the stakeholder parameters outlined in the statute.

American scholars have pointed to ESV an “emerging third way” in the classic shareholder v. stakeholder debate.310 Beyond the specific mandate of Section 172, Cynthia Williams and John Conley have described ESV as a broader conceptual transformation in the U.K. that explicitly shifts the focus of corporations to longer-term interests of extended stakeholder constituencies. Millon also sees ESV as serving as both a legal and normative approach to management that can significantly alter core tenets of the shareholder primacy model.311 By broadening the range of interests attended to by management to include important stakeholder considerations, ESV does have the potential to produce social benefits. In this way, ESV might realistically be characterized as an alternative to short-term shareholder primacy as well as an effective legal base to justify strategic styles of management based on stakeholder theory.

For the U.S., since laws have not reflected an ESV-style mandate to redefine management responsibility and corporate purpose, Millon has suggested that extra-legal pressures can have that effect instead. He believes that if concerned private actors apply pressure, public opinion about socially acceptable behaviour may drive management to

rethinking its role. The result may be “a richer, more socially-oriented notion of the corporate objective, shaped by public opinion, which could arguably occur without public intervention through law.” 312 However, since ESV is still about shareholder value, this objective imposes a limit on how far corporations are likely willing to go. It is doubtful that market-driven ESV will itself be sufficient to produce a commitment to long-run sustainability. Millon has pointed out, “Certainly this approach to management will not necessarily result in corporations ‘doing the right thing’ where that would be costly to shareholders.” 313 Thus critics should not expect that a normative commitment to ESV – even if enlightened – will necessarily generate the measure of socially responsible behaviour that they believe to be appropriate. Laws need to change in order for corporate behaviour to transform in the long term.

4.3.2. Institutional Law and Economics

In pursuit of an alternative corporate governance model, the need for supporting hard laws is evident, and is further clarified when considering the issue through the lens of institutional law and economics. The field of institutional law and economics is said to have “had its heyday in 1920s and early 30s” but some concepts within the field should be revitalized in the wake of the global financial crisis, particularly to counter Hansmann & Kraakman’s neoclassical law and economics view of the dominant shareholder primacy model. 314

From an institutional perspective, the law is fundamentally a matter of rights creation and

312 Ibid. at 5.
313 Ibid. at 6.
314 Medema and Mercuro, supra note 27 at 115; see also John Bell, A History of Economic Thought (New York: Ronald Press, 1967) at 539.
re-creation.\textsuperscript{315} The government is seen as playing a central and inevitable role within the process, for “rights are whatever interests government protects vis-à-vis other interests when there is a conflict.”\textsuperscript{316} Significant importance rests on whose rights are enabled through law, as well as the subsequent structures which perpetuate those rights. Thus, “terms such as regulation, deregulation, and government intervention [are] misleading” as the critical issue turns “on whose interests the government allows to be realized and who is able to use government for what ends.”\textsuperscript{317}

The recognition of governmental rights creation also means institutional scholars challenge their neoclassical counterparts on the notion of an ultimate efficient result, arguing that an outcome is efficient only with regard to an assumed initial structure of rights.\textsuperscript{318} The way in which a structure is formed “give[s] rise to a particular set of prices, costs, outputs, and the like, and thus to a particular efficient allocation of resources.”\textsuperscript{319} In this sense, institutional scholars strongly contend “there is no independent test by which the law’s solutions can be said to be the efficient solution.”\textsuperscript{320} A structural change means a corresponding modification of what is regarded as most efficient. As Warren Samuels asserts, “[t]o argue that [any efficiency criterion] can determine rights serves only to mask a choice of which interests to protect as rights. Legal decisions or changes can be said to be efficient only from the point of view of the party whose interests are given

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\textsuperscript{315} Medema and Mercuro, \textit{supra} note 27 at 115.
\textsuperscript{316} Warren Samuels, \textit{Commentary: An Economic Perspective on the Compensation Problem} (1974) 21 Wayne L. Rev. 113 at 127; see also \textit{ibid.} at 116
\textsuperscript{317} Medema and Mercuro, \textit{supra} note 27 at 117.
\textsuperscript{319} See Medema and Mercuro, \textit{supra} note 27 at 118.
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Because the government and institutional structures are seen as primary sources through which control or power is effectuated, the main focus of institutional scholars is in understanding how the governmental allocation of rights within such institutions shapes the performance of the economic system over time.

Institutional scholars take a critical look at the measure in which neoclassical efficiency is calculated. For institutional scholars,

the definition of “output” – of what it is that one is to be efficient about – requires an antecedent normative specification as to the appropriate performance goal for society. Social output (the aggregate well-being of society), consumptive output (the value of goods from the consumer point of view) and productive output (the value of goods from the producer point of view, i.e. profits) are three examples of alternatives that are available. The value-laden choice of a particular definition of output as the maximand, which in effect is the choice of a particular social welfare function where many are possible, will drive the decision as to what constitutes the efficient allocation.

The recognition of alternative efficient solutions, as well as the contingent nature of any ‘efficient’ result on a presumed rights structure and definition of output, exposes the inherent normative elements embodied within the shareholder primacy model. The title “shareholder primacy” model itself leaves little doubt as to which corporate actor is perceived as having the greatest legal and normative rights. Share value as the principle measure of interest amplifies how the determination of efficiency involves “a normative and selective choice as to whose interests will be accommodated, who will realize gains, and who will realize losses.” Alternative legal models that allocate rights differently, or include other methods of calculating output, will invariably point to different efficient outcomes.

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321 Ibid. at 154; see also Medema and Mercuro, supra note 27 at 118.
322 Medema and Mercuro, supra note 27 at 174.
323 Ibid. at 119; see also Warren Samuels, Normative Premises in Regulatory Theory (1978) 1 J. of Post-Keynesian Econ. 100 at 102-104.
324 Medema and Mercuro, supra note 27 at 119.
Critiques by institutional law and economics scholars are effective in deconstructing the efficiency premises in which the shareholder primacy model stands. Through the neoclassical law and economics lens, singular solutions are given to issues which “reflect only one particular set of value premises and one particular conception of the facts, benefits, and costs at issue,” whereas the institutional approach, “by recognizing the multiplicity of potential solutions and underlying value premises, attempts to flesh out the alternative possibilities that are open to society in the ongoing social construction and reconstruction of legal-economic reality.”325 Institutional law and economics draws attention to the prospect of alternative structures in which corporations can thrive – structures that do not require the concept of (and indeed, desire for) efficiency to be thrown out. Instead, efficiency can be normatively reconceptualized to move beyond the narrowness of increasing share value and broadened into the social context in which corporations clearly hold formidable power and influence.

Workable solutions, and their accompanying measures of achievement, continue to be a source of contention for those in field of the corporate law. Nevertheless, offering an institutional perspective reawakens oneself to the possibilities that are available. Institutionalists point out how government has discretionary authority to dictate rights, and narratives from the previous chapters have highlighted the concern of how governmental interests can at times seem to be intertwined with corporate interests. Regardless, it is the top-down view of institutional law and economics that is a useful starting point. And later in Chapter 5, new corporate structures created by state governments will be identified that allow for the hybrid mission of profit and social

325 Medema and Mercuro, supra note 27 at 129.
benefit to exist in corporations, only confirming the validity behind this institutional perspective.

4.4. **Normatively Embed Social Responsibility**

Shifting the allocation of responsibility and control over corporate interests, and redefining the meaning of corporate interests, are integral factors to restructuring the corporate model, but governance reform efforts mean little if the normative belief system within an institution remains the same as it was under shareholder primacy. In order to effectively redesign the model, there needs to be a rethinking of corporate culture beyond the capability of hard law enforcement. Providing the board of directors with greater control over decision-making only addresses problems that have reached a certain calibre of importance. In combination with stakeholder-based management and accounting beyond shareholder value, true operational changes can occur in how management conducts itself on a day-to-day basis. Adding a normative layer of corporate social responsibility (“CSR”) effectively permeates and solidifies this shift in the ideological purpose of corporation.\(^\text{326}\)

\(^{326}\) Blair & Stout, *supra* notes 291-293.

\(^{327}\) Branson has situated the CSR movement as beginning in the 1970s, where CSR was mainly viewed as the act of corporations making charitable donations and investing in philanthropic endeavours. Branson, *infra* note 329 at 611-615; see also David Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* (Washington: Brookings Institute, 2005). The late 1990s marked the beginning of a “new” CSR movement (“New CSR”), with initiatives focused more on attuning corporate behaviour to social effects. Branson ties this “New” CSR as one that is closely connected to the environmental or “green” movement. *Ibid.* at 644-646. For the purposes of this Section 4.4, I have elected to combine both the terminology of “CSR” and “New CSR” as described by Branson to refer to CSR as it is currently used in corporate practice. While Branson’s description of these two separate periods of CSR is helpful for historical references, present day usage generally continues to refer to this second wave, this New CSR movement, as simply CSR. There have been instances where social entrepreneurs have attempted to dispose of the term CSR based on its old definition, calling New CSR as “corporate social innovation.” See e.g. Tim Draimin, “Corporate Social Responsibility is Dead, Long Live Corporate Social Innovation” (as of July 2010), online: Plan Institute <http://www.planinstitute.ca/blogs/bsmith/corporate_social_responsibility_dead_long_live_
CSR is a phenomenon growing in worldwide business practice that is now being classified by some observers as “mainstream.” However in the U.S., many corporate legal scholars have been somewhat skeptical of CSR’s true impact to American companies. Douglas Branson has noticed that “many corporate managements have wrapped themselves in the banner of corporate social and public responsibility. They have done so, though, with a mixed or hidden agenda.” Millon contends that managers of U.S. corporations continue to conceive of their duties in terms of shareholder primacy, and institutional shareholders share this view. The environmental aspects surrounding the CSR phenomenon will be briefly addressed in Section 4.4.2 to shed light on how the sustainable management of environmental resources can be incorporated in corporate governance reform.

4.4.1. Corporate Social Responsibility

CSR is differentiated from the core profit-making responsibility of shareholder primacy and the social responsibilities found in governmental bodies. Despite the vast and ever-increasing body of literature on CSR, the prospect of defining CSR is not an easy one. In fact, there has been much work produced in legal scholarship that has specifically

corporate_social_innovation%E2%80%A8>. Testy has also recognized the problems in classification, stating that the concept of “new” corporate social responsibility itself also falls under various labels, such as “good governance” “social disclosure” and “socio-economics.” Testy, supra note at 5 at 1228-1229. See e.g. “Special Report on Corporate Social Responsibility” The Economist (19 January 2008) at 3 (citing CSR as mainstream, but noting that few companies do it well).


330 Millon, supra note 311 at 15.

addressed the difficulties in determining what CSR means. Dirk Matten and Jeremy Moon explain:

First…CSR is an ‘essentially contested concept’ being ‘appraisive’ (or, considered as valued); ‘internally complex’; and having relatively open rules of application. Secondly, CSR is an umbrella term overlapping with some, and being synonymous with other, conceptions of business-society relations. Thirdly, it has clearly been a dynamic phenomenon.

Scholars such as Geoffrey Heal have described CSR with a pointed focus, arguing that CSR is a process where corporations are “taking actions which reduce the extent of externalized costs or avoid distributional conflicts.” To some extent, Heal believes his description draws upon the tradition established by Ronald Coase in his well-known work “The Problem of Social Cost.” Heal states,

In cases where costs are externalized, corporations bargain with society about who will ultimately bear these costs. The corporation is not – currently – legally bound to bear them but society could change this if it wished, and indeed could go further and impose penalties for the past externalization of costs. The result is an implicit contract: society accepts the legal status quo provided that the corporation does not exploit it to society’s disadvantage.

Heal believes that Andrew Beltratti has made an interesting point by identifying CSR as “an attempt to escape profit maximization in the recognition that agency problems and

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333 Ibid. Matten and Moon note that their classification, rooted in the above distinctions, discerns seven ideal types of CSR innovations: individual firm efforts; individual firm and individual NGO agreements; public-private partnerships; information-based approaches; environmental management systems; industry association corporate codes of conduct, and private-sector hard law known as nonstate market-driven governance.
336 Heal, supra note 334 at 391.
incomplete contracts undermine the basic idea of shareholders’ supremacy.” Certain proponents of CSR have worked under the premise that “being socially responsible is good for business,” attributing this concept to Milton Friedman’s work. Matten and Moon contend that at the heart of CSR is the notion that it “reflects the social imperatives and the social consequences of business success.” Thus, from an empirical perspective, CSR consists of corporate policies and practices that reflect the business responsibility for a broader social good.

Ultimately, “[t]heories of corporate social responsibility cast a potentially broader net, emphasizing all of the social costs of corporate activity, and therefore embrace, for example, environmental or political concerns as well as stakeholder interests.” The convoluted and, at times, contradicting way in which CSR has been defined by academics, governmental bodies, and corporations means that some may view the concept of CSR crossing over into many of the previous counter-hegemonic approaches and theories previously discussed in this Chapter. There is little doubt in my mind that some scholars would be willing to classify this entire work as under the umbrella of CSR. I am not concerned with this classification, so long as it does not detract from the potential moral underpinnings of the CSR movement, beyond economic analysis. Nevertheless, an all-inclusive classification of CSR seems to lessen the effectiveness and impact of CSR as a normative tool. It also makes pointed criticisms of CSR confusing and difficult to properly address, to the movement’s detriment.

338 Geoffrey Heal, When Principles Pay: Corporate Social Responsibility and the Bottom Line (New York: Columbia University Press, 2008); Friedman, supra note
339 Matten & Moon, supra note 332 at 3.
A recent empirical study showed that corporations providing ‘experience’ or ‘credence’ goods (goods that must be used or consumed before their true value to the consumer can be determined, such as automobiles or mutual funds) were much more likely to promote and be social responsible than corporations selling ‘search’ goods (goods that can be readily evaluated prior to purchase, such as clothing or furniture). In general, almost all scholars tend to agree that companies act socially responsible because they anticipate a benefit from these actions. Scholars seem to respond to this observable fact in one of two ways. The first is promote this profit-maximizing attribute of CSR, encouraging companies to advocate CSR since it “can play a valuable role in ensuring that the invisible hand acts, as intended, to produce the social good.” These advocates conceptually hold several commonalities with those in the Chicago school of law and economics. Posner and Becker continue to advocate a neoclassical law and economics view on corporate behaviour in a CSR context, contending that the shareholder primacy model is the most effective way to bringing about the positive effects expected from CSR. In response to his own question, “Do corporations have any responsibilities beyond trying to maximize stockholder value, adhering to contracts, implicit as well as


343 Heal, supra note 334.

344 Posner has stated that in the competitive markets, “a sustained commitment to any goal other than profitability will result in the firm’s shrinking, quite possibly to nothing.” Posner, supra note 24 at 461-462.
explicit, and obeying the laws of the different countries where they operate?,” Becker puts it this way,

My answer is “no”, although maximizing value, meeting contracts, and obeying laws help achieve many of the goals by those claiming corporations should be “socially responsible” by taking care of the environment, considering the effects of their behavior on other stakeholders, and contributing to good causes. A corporation may [act socially responsible and] appear to reduce shareholder value because that sufficiently improves the government regulations that affect their profitability...[but] [t]reatment...that on the surface appear to reduce profitability often are in fact consistent with the criteria of maximizing stockholder value while respecting laws and contract. 345

The core argument behind Becker’s position is that, when exposing the ‘hidden agenda’ behind CSR (as Branson has also pointed out), the shareholder primacy model is ultimately revealed. 346

The second response perceives the pure economic incentives driving CSR as a negative aspect of the movement. These advocates are concerned that CSR initiatives will automatically lose out in circumstances where social initiatives are not good for business. Testy, for example, has warned that CSR may become “just another commodity that businesses sell in the service of short-term shareholder wealth maximization, rather than

345 Gary Becker & Richard Posner, “Do Corporations Have a Social Responsibility Beyond Stockholder Value?” The Becker-Posner Blog (24 July 2005), online: The Becker-Posner Blog <http://www.becker-posner-blog.com/2005/07/do-corporations-have-a-social-responsibility-beyond-stockholder-value-becker.html>. 346 Furthermore, Posner has said, “I am quite sympathetic to [the argument] that the social return to profit-maximizing activities may actually be higher than the social return to corporate philanthropy, when ‘corporate philanthropy’ isn’t just a fancy name for public relations.” Posner contends that philanthropic gifts, private or public, will “retard serious efforts” by organizations that also have genuine interest from the public, raising the question of whether the net benefit of corporate philanthropy might be higher if directed to commercial or other private ends instead. Gary Becker & Richard Posner, “Posner Response to Comments” (30 July 2005), online: The Becker-Posner Blog <http://uchicagolaw.typepad.com/beckerposner/2005/07/social-responsibility-posners-response-to-comments.html>. To me, Posner is referring to strains of CSR that were familiar in its earlier days identified by Branson and Vogel, where efforts “largely focused on corporate philanthropic activities that usually had little to do with the firm’s core business practices.” The last few decades have meant that recent developments of CSR expand beyond Posner’s recent analysis of it. See supra note 327.
to achieve substantive changes.’” She is also uncomfortable with the fact that, in terms of the direction and manifestation of CSR, all discretion seems to lie with corporate management. She contends that having managers focused on social issues may be controversial, and question how to ensure the managers “serve the progressive ends reformers seek.”

It is clear that CSR, on its own, is incapable of altering the shareholder primacy model. I share the concerns of those who feel CSR (as a normative concept) does not ‘do enough’ to change existing corporate governance structures, particularly since the values of CSR tends to be left vulnerable to market pressures and turbulent economic events. The BP oil spill exhibits the evident commodification of CSR in corporate practice, and how it is ineffectual in significantly altering corporate behaviour. Nevertheless, research has shown that corporate marketing of CSR does correlate to more proactive corporate efforts. Thus, critics may simply hold expectations that outsize CSR’s capabilities. CSR should be regarded as part of a broader set of initiatives in order for there to be any lasting impact on corporate behaviour. In combination with the three previous recommendations, which include the implementation of hard laws, some of these concerns can be alleviated.

Testy’s worry of broad managerial discretion is less of a concern. Social issues are vast and varying and, so long as core principles of proper governance are mandated by government, there is a level of participatory social democracy that is justified, and even healthy, for the well-functioning of society. Directorial discretion is best when

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347 Testy, supra note 5 at 1239.
348 Ibid.
349 See e.g. Heal, supra note 338.
accompanied by established legal fiduciary duties to stakeholders, but this attribute is not necessary. Corporations already have enormous power over societal development, more so than many would care to admit. A pluralistic CSR scenario with significant managerial discretion should be preferred to one without the existence of CSR, or one where specific social values are dictated by government.

Pragmatically, until the economic sustainability of a particular company is achieved, or until laws fundamentally adjust corporate economic objectives, a level of economic viability has to take priority over social responsibility. Viability concerns are not an issue when the CSR objective is wholly aligned with the economic objective, a “win-win” situation. Becker has stated, “I am bothered only when managers, founders, or others in control of corporations that behave in a ‘socially responsible’ manner try to pass the cost of behaving in this way on to others rather than bearing the costs themselves.”

While I do not necessarily accept this statement as fact in all contexts, such as if CSR means lower profits or executive compensation at the expense of societal good or other “win-lose” situations, it is applicable in circumstances where a company is struggling to maintain economic viability in the early stages of its development, and/or if it is at risk of insolvency. It would be irresponsible for management to look towards CSR in a win-lose scenario at times when all its stakeholders are at risk. These particular economic limitations of CSR have been and need to continue to be explicitly recognized.

Nevertheless, the vast majority of scholars generally seem to agree that CSR on a whole,

350 Graeme Auld, Steven Bernstein, & Benjamin Cashore, “The New Corporate Social Responsibility” (2008) 33 Annu. Rev. Environ. Resour. 413 at 415 (stating that in win-win situations, solutions are available internally, where improvements in practices are also profitable).
351 Becker & Posner, supra note 345.
352 Auld, Bernstein & Cashmore, supra note 350 at 415-416.
353 See Ibid.
even as a confusing and disorganized movement, is a good thing for corporate America. CSR, unwieldy as it is, serves an important normative purpose in corporate governance reform. To Branson, the movement this time seems “more muted, less shrill, and therefore more sustainable.”\(^{354}\) As well, the movement is “converging with, rather than diverging from, broader trends in corporate governance.”\(^{355}\) The avid adoption of CSR by many large corporations, as opposed to progressive corporate law, underlies an important attribute to this phenomenon – traction in corporate practice.

While much time can be spent clarifying the definition of CSR, it is important to understand that this search for a definition (whether in the field of academics, in the executive, legislative, and judicial arms of government, or in corporate practice) is valuable in and of itself by challenging the current mode of thinking behind corporate behaviour. CSR advocates are consistently pushing for CSR to “go beyond market demands” and “promote behavior beyond compliance with existing laws.”\(^{356}\) Thus in many ways, I am untroubled by the seemingly haphazard way which CSR is evolving, “with stakes so high, and feelings and emotions running both ways.”\(^{357}\) As a normative concept, in combination with my three previous recommendations, I believe the passion and energy surrounding the CSR movement serves as an effective tool for change.

### 4.4.2. The Green Movement

Present day CSR is intimately intertwined with environmental initiatives. The growing “green” movement will be touched upon briefly here to address these environmental

\(^{354}\) Branson, Redux, \textit{supra} note 329 at 1225.
\(^{355}\) \textit{Ibid.}
\(^{356}\) Auld, Bernstein & Cashmore, \textit{supra} note 350 at 416.
\(^{357}\) Branson \textit{supra} note 329 at 641.
concerns embodied in CSR, and the effects of the recent BP Deepwater Horizon oil spill on the CSR movement in general.\textsuperscript{358}

CSR has been readily adopted by environmental activists and supporters to take advantage of the enormous and integral role corporations play in the sustainable management of environment resources. Scholars have pointed out that in the past several years “an array of stakeholders have turned to firms, rather than governments, to address enduring environmental problems including forest degradation, fisheries depletion, mining destruction, and even climate change.’’\textsuperscript{359} The recent increased visibility of socially responsible investments dedicated to environmental sustainability\textsuperscript{360} has also suggested a progression toward new modes of good governance. Branson notes that one example of its staying power “may be the appearance in the legal periodicals of a steady steam of crossover articles dealing with environmental subjects and corporate responsibility.’’\textsuperscript{361} Heal, for example, has taken his economic analysis of corporate social responsibility and how firms “internaliz[e] external costs, with a view to reducing the potential for conflict between themselves and other groups in society” through an environmental lens.\textsuperscript{362}

Branson views the green movement as having three components: green advertising, green product manufacture and competition, and green management.\textsuperscript{363} To Branson’s list I also

\textsuperscript{358} See \textit{ibid.} at 644-646.
\textsuperscript{359} Auld, Bernstein & Cashmore, \textit{supra} note 350 at 416.
\textsuperscript{361} Branson, Redux, \textit{supra} note 329 at 1225.
\textsuperscript{363} Branson, Redux, \textit{supra} note 329 at 1222-1225.
add green investing. Branson notes that green advertising is driven, at times, by consumer preference rather than any strong corporate social responsibility mission. Green product introductions and green product competition form a bridge between green advertising and green management. Green management is a broader topic, including “protection of the biosphere, sustainable use of natural resources, reduction and disposal of waste, wise uses of energy,” while management is seen to have specific environmental responsibilities. Green management can range from observance of environmental standards to actual subscription to private initiatives such as CERES Principles, which were created in 1989 following the Exxon Valdez crisis by the Coalition for Environmentally Responsible Economies, to provide broad environmental standards for evaluating corporate activity with the intention of helping organizations set environmentally sound business practices. Green investing accounts for the rapid growth of socially responsible investment funds in the capital markets, which have resulted in many open-ended questions regarding the proper governance and regulation of these products going forward.

Few, if any, have challenged the theoretical merits behind the green movement and its important contributions to environmental sustainability. However, the recent BP Deepwater Horizon oil spill has been a sobering reminder of limits of CSR. The spill began on April 20, 2010 when a BP drilling rig exploded 50 miles off the coast of Louisiana in the Gulf of Mexico. Crude oil flowed through a damaged well at an

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364 Ibid.
365 Ibid.
367 See e.g. Cragg & Richardson, supra note 360 (stating that “[t]o keep ethical investment ethical will likely require institutionalizing new norms and governance standards, in such domains as reforming fiduciary duties and the internal governance of financial organizations”); Heal, supra note 362 at 8-14.
estimated rate of 12,000 to 19,000 barrels a day.\footnote{See Erin Aigner, et. al., “Tracking the Oil Spill in the Gulf” \textit{The New York Times} (updated as of July 20, 2010), online: \textit{The New York Times} \texttt{http://www.nytimes.com/interactive/2010/05/01/us/20100501-oil-spill-tracker.html?ref=us}>. On July 15, 2010, after months of failed attempts, BP announced that it had managed the stop the spillage, but problems continue to surface.\footnote{Guy Chazan, “Cheers, Worries Greet New Oil Well Cap” \textit{The Wall Street Journal} (17 July 2010), online: \textit{The Wall Street Journal} \texttt{http://online.wsj.com/article/SB10001424052748704229004575371333339830808.html?mod=WSJ_hpp_LEFTTopStories}> A relief well is still required to provide a permanent solution. To date, over 3,000 birds, sea turtles, and dolphins have been found dead or debilitated since the oil spill began.\footnote{See Aigner, \textit{supra} note 368.} These tragedies of course do not take into account wildlife that will continue to perish from the damage going forward, the financial effects on those whose livelihoods depend on the Gulf, and the other countless negative environmental effects that will result from a spill of this magnitude.

It is troubling to many that BP frequently held itself up as a champion of environmental sensitivity and sustainability\footnote{For example, on BP’s website it states: “At BP we define sustainability as the capacity to endure as a group, by: (1) Renewing assets; (2) Creating and delivering better products and services that meet the evolving needs of society; (3) Attracting successive generations of employees; (4) Contributing to a sustainable environment; and (5) Retaining the trust and support of our customers, shareholders and the communities in which we operate.” BP plc, “BP and Sustainability” (as of 20 July 2010), online: BP plc \texttt{http://www.bp.com/sectiongenericarticle.do?categoryId=2312&contentId=7061112>}.}, but yet has caused unprecedented environmental and financial disaster. There have also been troubling reports that BP is attempting to control the dissemination of the scientific research collected from the Natural Resources Damage Assessment (NRDA) process, which determines how much ecological damage the Gulf of Mexico region is suffering from the spill.\footnote{See Ben Raines, “BP Buys Up Gulf Scientists for Legal Defense, Roiling Academic Community” \textit{Press-Register} (16 July 2010), online: \texttt{<http://blog.al.com/live/2010/07/bp_buys_up_gulf_scientists_for.html>}; see also Brad Johnson, “BP Launches Effort to Control Scientific Research of Oil Disaster” (16 July 2010), online: Think Progress \texttt{<http://thinkprogress.org/2010/07/16/bp-closed-research/>}.} BP hired several Gulf Coast scientists to work on their behalf in the NRDA process, requiring them to sign confidentiality
agreements prohibiting them from publishing their research, sharing it with other scientists, or speaking about the data that they collect for at least the next three years. Scientists from Louisiana State University, Mississippi State University, and Texas A&M have agreed to these contractual terms. The University of South Alabama refused based on those confidentiality restrictions.

Countless people have understandably attacked BP, citing its spotty history with major pollution and claiming BP “has simply co-opted the language of environmentalists without any real commitment to deliver.” The term “greenwashing” is generally used to describe when a company spends significantly more time and money on “green” advertising rather than spending resources on environmentally sound practices. This description is applicable in BP’s case. BP’s “Beyond Petroleum” campaign began in 2000 which presented BP as socially conscious oil company concerned about the environment. The company spent on average between $100 million and $150 million annually on U.S. media. It also agreed to invest $8 billion over 10 years toward alternative energy exploration. Their rebranding effort paid itself off in spades. A Landor “ImagePower Green Brands Survey” conducted in 2007 determined that BP was regarded by the public as the greenest energy brand available.

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376 Ibid.
brand awareness jumped from 4% to 67%. Its sales also rose from $180 billion in 2002 to $266 billion in 2006.

People are legitimately outraged. The BP spill is a black eye on the CSR movement in many ways, emphasizing the tenuous relationship CSR has with profit-maximizing behaviour, as well as the movement’s inadequacy in holding companies accountable for their actions. To me, this example signifies the real need for CSR to somehow peel itself away from commodification. The effectiveness of CSR is seriously compromised when its usage is limited to “win-win” situations where CSR and profit-maximization are aligned under the existing corporate model. The BP oil spill has been an unfortunate reminder of how CSR is in real danger of being diminished. Graeme Auld, Steven Bernstein, and Benjamin Cashore have pointed out that win-lose situations “deserve the most sustained attention because if they emerge as enduring and purposeful features of the marketplace, they hold the greatest transformative potential.” I am in agreement that win-lose situations are what should be the focus going forward. Past the minimum level of economic viability, corporations need to extend themselves beyond the traditional measures of success and look outwards at their roles and responsibilities within society. CSR can be an effective and innovative tool for change, particularly when combined with my three previous recommendations, but it is important that the spirit of the movement is preserved when being implemented into corporate practice.

377 Ibid.
378 Auld, Bernstein & Cashmore, supra note 350 at 415-416.
5. Corporate Governance Reform in Context

It is important that corporate legal scholarship does not become stagnant in relation to practical reform efforts. Opportunities are available to seriously push for redesigning the corporate model, whether from a grassroots level or as a result of legislative reforms in response to the global financial crisis. While there seems to be a lack of cohesive theory in counter-hegemonic discourses on corporate law, and potentially divergent language between corporate scholarship and practice, there must continue to be a stream of intelligent and thoughtful commentary addressing the structural problems of the shareholder primacy model.

The purpose of this Chapter is to identify practical reform efforts that have begun to take place in altering the standard, for-profit corporate model of the American business world. These real life examples identify how the application of my four structure-altering recommendations in Chapter 4 can begin to be actualized in corporate practice. Section 5.1 deals with the establishment of “other constituency” statutes in many U.S. states. Surprisingly, advocates of both stakeholder theory and team production theory have insisted that the implementation of hard laws allowing for greater consideration of stakeholder interests is unnecessary. I disagree with this premise and outline my concerns, as well as point out ways in which states can improve their “other constituency” laws. Existing alternative models are then explored. Section 5.2 addresses the privately regulated “B Corporation,” which has capitalized on the “other constituency” statutes and has been gaining notoriety in the U.S. for its novel way of
“using the power of business to solve social and environmental problems.” Next, Section 5.3 examines the recent innovative development of state “benefit” corporations in Maryland and Vermont. Giving credence to the institutional law and economics perspective, these corporate models have been designed by state governments to facilitate the dual corporate purposes of creating social benefits and shareholder value.

5.1. “Other Constituency” Statutes

Consideration of stakeholder interests has generally been allowed under several state laws since as far back as the 1980s, when the takeover boom saw several American states implement “other constituency” (also known as “nonshareholder constituency” or “corporate constituency”) legislation expressly permitting (and in at least one state, requiring) directors to consider interests of groups in addition to shareholders in decision-making, often particularly contemplating takeover situations. To date, over 40 states have implemented such legislation.

As mentioned in Chapter 4, advocates of stakeholder theory have deliberately remained indifferent on the question of whether stakeholder interests need to be codified into law. Robert Phillips, Freeman, and Andrew Wicks contend that if managing stakeholders is in fact the most effective way to run a business for all stakeholders, including shareholders,

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379 B Corporation, online: B Corporation <http://www.bcorporation.net/>.
382 Connecticut Business Corporations Act, Sec. 33-600.
383 For more on this, see Andrew Keay, “Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value and All That: Much Ado About Little?” (2010), online: <http://ssrn.com/abstract=1530990>; Bainbridge, supra note 383; Mitchell, supra note 381.
then “changes in the laws are superfluous.” They suggest that the theory “can reasonably remain agnostic” with regard to whether any changes the governance model are required for it to work effectively. The theory does not rule out the possibility, or even advantage, of having stakeholder representation on boards, for example, but these sorts of efforts “[are] not theoretically necessary or intrinsic to stakeholder theory per se.” They point out that as a theory of strategic management, “changes in law would be no more necessary than laws requiring organizations to be visionary, excellent, or learning.” Recognizing that the topic of stakeholder legislation “may be the knottiest log we herein hew,” Phillips, Freeman, and Wicks insist that while discourse concerning the legal relationship between the corporation and its stakeholders is welcome, stakeholder theory does not require changes in the law to remain viable.

With some exceptions, there is an interesting parallel between stakeholder theory and team production theory, both in positive attributes which are very closely connected and in how each set of originators hold agnostic positions with respect to legal reform. Blair and Stout have also insisted that no changes to the law are required for their team production model to work effectively. They believe that “even though legal constraints on directors are weak, market constraints – product markets, capital markets, the market for corporate control, and so forth – keep directors focused on maximizing profits and share value.” To Blair and Stout, their work carries very different policy implications from the legal implications of progressive corporate law. They state, “[w]here

385 Phillips, Freeman, & Wicks, supra note 232 at 491.
386 Ibid.
387 Ibid.
388 Ibid.
389 Ibid.
390 Blair & Stout, supra note 274 at 253.
progressives have argued that corporate law ought to be reformed to make directors more accountable to stakeholders, the mediating hierarchy approach suggests that directors should not be under direct control of either shareholders or other stakeholders.”

I believe both sets of originators are in error when they insist changes to the law are not required. If directors are to act as hierarchs, they need to hold ultimate decision-making authority and be allowed discretion to represent competing stakeholder interests. But what is to be done in the case where running the business for stakeholders means, on some occasional instances, that shareholders end up receiving less (short or long term) wealth? Whether or not it automatically means other stakeholders will lose out from a management perspective, both sets of originators have ignored the fact that traditional corporate laws indicate shareholder interests are supposed to prevail. Corporate statutes allowing other constituencies to be considered in board decisions must be in place for stakeholder theory and team production theory to reach its fullest potential.

Thus, despite the “agnostic” position of both advocates of stakeholder theory and team production theory, normative reform efforts are best achieved in partnership with legal reform. Interestingly, Thomas Clarke has observed that while stakeholder theory “has historical lineage, practical applications, and intellectual appeal” it nevertheless “has had much less impact on thinking and policy concerning corporate governance in recent times.” The minimal impact may be due to the fact that, until recently, the application of “other constituency” laws proved to be somewhat inconsequential in terms of altering certain negative aspects of corporate behaviour. As mentioned in the previous Chapter, it

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391 Ibid. at 254
392 Clarke, supra note 230 at 10.
has been pointed out that allowing directors to be accountable to many generally results in directors becoming accountable to no one, and it is true that allowing directors to consider stakeholder interests actually reduces director liabilities on a whole. The formidable business judgement rule applies, rendering the provision somewhat latent in practice. Granting directors the permission to consider broader stakeholder interests still means the power lies in the hand of directors to accept or ignore such interests in their sole discretion. However, a level of director discretion and flexibility is imperative if the board is expected to play its proper role in governance. The need for balance between stakeholder interests and business judgment has meant that the inclusion of stakeholder interests in law has been unremarkable for those looking to reform the model through purely legal means. That may be why, on a theoretical level, almost all corporate governance reformists have agreed the inclusion of stakeholders in the governance model is necessary and the issue seems to have reached a plateau in scholarly discussions.

Nevertheless, laws do matter, and a stakeholder-based and director-controlled style of governance requires a minimal level of legal backing when the interests among

393 See e.g. supra notes 295-298.
394 In this common law rule, the courts will defer to the directors’ business judgment so long as they brought an appropriate degree of prudence and diligence in reaching a reasonable business decision at the particular time it was made.
395 Others have recognized the normative aspects of implementing stakeholder interests. See e.g. Mitchell, supra note 381.
396 There are other alternative ways in which stakeholder interests can be embodied in corporate governance that have not been significantly examined in U.S. corporate legal scholarship. For example, certain stakeholders could be permitted to participate in some manner in director elections, such as through voting or on an advisory basis. Future exploration of a stakeholder alternative in the election process would require careful examination of any expansion of nonshareholder rights and director fiduciary obligations, as well as who could bring legal claims against the company for any breach. More research needs to be done to identify the implications of such measures. The benefit corporation laws in Vermont examined in Section 5.3 may provide a middle ground by expanding fiduciary duties of directors to stakeholders but limiting rights to make claims, nevertheless, the structure of director elections remains unchanged to the traditional shareholder voting scheme. See infra note 444.
stakeholders do not align, particularly if shareholders are able to bring legal claims against directors for the fiduciary duties owed to them.\footnote{For example, considering stakeholder interests is considerably easier in Canada. The 2008 decision of the Supreme Court of Canada in \textit{BCE Inc. v. 1976 Debentureholders}, [2008] 3 S.C.R. 560., confirmed the decision in \textit{Peoples Department Stores Inc. (Trustee of) v. Wise}, [2004] 3 S.C.R. 461, 2004 SCC 68, that directors owe their fiduciary duty to the corporation in all circumstances. In rendering this decision, the court rejected the duty applied by American courts in \textit{Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.}, 506 A.2d 173 (Del. 1986), where directors were found to owe a fiduciary duty to maximizing shareholder value. In deciding what constitutes the best interests of the corporation, the SCC provided directors with considerable flexibility in considering the interests of other stakeholders. In doing so, however, directors are required to treat other stakeholders whose interests are affected by their decision fairly and equitably. Further, the court held that determining what is in the best interests of the company is not confined to short term profit or share value. Where the corporation is a going concern, the board should focus on the long term interests of the corporation. The SCC also reinforced its support for the business judgment rule (where courts will defer to the directors’ business judgment so long as they brought an appropriate degree of prudence and diligence in reaching a reasonable business decision at the particular time it was made) in making it clear that, provided a board’s decision is within the range of reasonable alternatives, the court will defer to such judgment.} For stakeholder theory and team production theory to be fully actualized, the constating documents of a corporation must permit directors to consider stakeholder interests in corporate decision-making. Thus it is important to recognize that the “other constituency” statutes from the last several decades accomplish the first legal step of allowing directors to consider stakeholder interests. At minimum, they allow for the normative application of stakeholder theory and team production theory to have legal backing in scenarios where shareholders are unhappy that their interests have been encroached upon by other stakeholders.

Thus, in terms of legislative action for corporations under current constructs\footnote{This is because these practical reform recommendations are secondary if significant legislative changes similar to those seen in Section 5.3, “State Benefit Corporations”, are available.}, the first order of business would be for remaining U.S. states to adopt the “other constituency” provisions in their corporate laws, preferably similar to those in New York, Nevada or Pennsylvanlinia, which have particularly broad statutes, or even better, requiring
stakeholder interests be required, as in Connecticut. Ideally, implementing provisions similar to the “enlightened shareholder value” provision, as discussed in Chapter 4, would go a long way to reforming corporate behaviour. The next step would be for corporate institutions to capitalize on the “other constituency” statutes and embed in their constituting documents the ability for directors to consider stakeholder interests in their decision-making, similar to those found in the requirements to become a “B Corporation” as discussed in the following Section 5.2. In order for these reform initiatives to be effective, there must also be a focus on driving the normative appeal of including stakeholder interests and director control in the strategic management decisions of these corporate institutions.

5.2. The B Corporation

Developed by Jay Coen Gilbert, Bart Houlahan, Andrew Kassoy, and 81 founding

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399 See Connecticut Business Corporations Act, supra note 382. New York, Nevada and Pennsylvania are recognized as particularly hospitable by B Lab. See B Lab, infra note 407. Each state has a relatively broad statute, but Nevada’s seems potentially the most sweeping, permitting directors to consider inter alia the interests of society writ large. See Nev. Rev. Stat. Section 78.138(4); N.Y. Bus. Corp. Law. Section 717(B); 15 PA. Cons. Stat. Section 1715.

400 See infra notes 307-313.

401 Corporations may also consider the establishment of a classified board (also known as a staggered board), which prevents the carte blanche removal of an entire board of directors in one meeting. Implementing a classified board is aligned with the spirit behind the team production theory, although Blair and Stout do not explicitly state as such. By providing directors with overlapping multiyear terms, a classified board effectively limits the control of the board by shareholders. Institutional shareholders in the United States have traditionally lobbied against classified boards (which are mainly viewed as defensive mechanisms against hostile takeovers), and there is a growing trend of U.S. companies declassifying their boards. See Erik Krush, “Proxy Disclosure: Boards Stagger to Declassification” Westlaw Business Precedent Watch (4 March 2010): online, Westlaw Business Currents <http://currents.westlawbusiness.com/Articles/2010/03/201_00302_0032.aspx>. The question is whether a corporation would like its balance of power and control to favour shareholders or directors. See e.g. ibid. (“At the heart of the issue: declassified boards give shareholders more power”). If the decision is greater director control, as this thesis has argued, then it may be worthwhile for corporations to implement a classified board structure. However, the effect of such a legal change to a corporation’s constituting documents on its behaviour may be minimal if not accompanied by the principles outlined in both the team production and stakeholder theories. Nevertheless, such a change may provide greater continuity and stability within a corporation, and there is potentially increased individual director accountability due to the fact that fewer directors are up for election each time and directors are not consistently re-elected together as a group.
companies in 2008, B Lab is a Philadelphia based non-profit organization that has developed the “B Corporation” rating system and certification, which evaluates companies on social, environmental and workplace criteria. Self-imposed and privately regulated, B Corporation is an initiative growing in recognition in the U.S. as it attempts to establish a new form of socially-minded corporation “which harnesses the power of private enterprise to create public benefit.” Also called a “for-benefit” corporation, the B Corporation uses available state law to form its base. Currently, there are 305 B Corporations, with the number steadily increasing.

In order to become a B Corporation, a company is first required to take a “B Impact Assessment” which asks various socially-minded questions (under the categories of Accountability, Employees, Consumers, Community, and Environment), and sectors also receive questions specific to their industry. The B Impact Ratings System tends to heavily weigh questions on how the company integrates its business and social goals, including relationships with employees, suppliers, local communities and the environment. Governance-related questions are addressed under “Accountability”, which divides into two subsections, Governance and Transparency. These questions strongly imply support for greater stakeholder-based and board-controlled management.

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402 According to their website, Jay Coen Gilbert, Bart Houlahan, and Andrew Kassoy are the named co-founders who have “developed, incubated and funded B Lab to date” (as of July 2010), online: B Corporation <http://www.bcorporation.net/team>.

403 B Corporation, “Declaration of Interdependence” (as of July 2010), online: B Corporation <http://www.bcorporation.net/declaration>.

404 B Corporation, “FAQ” (as of July 2010), online: B Corporation <http://www.bcorporation.net/faq>. For a point of reference, in August 2008, there were 120 B Corporations.


406 For example, here are some following questions from Version 2.0 of the B Impact Ratings Assessment:

(A) Does your company have a Board of Directors or other governing or advisory body that: (1) Meets at least twice annually; (2) Includes at least 1 independent member; (3) Oversees executive compensation; (4) Company has no governing body.
composite score of 80 or more (out of a possible 200 points), means a corporation is able to continue with the certification process. Following some additional internal reviews and documentation procedures, the company may become certified and entitled to a license to use the “certified B Corporation” trademark. Ninety days following the certification, companies are required to submit supporting documents for 10% of the answers to the questions they provided in the B Impact Assessment. B Lab relies on this certification and a separate auditing system to ensure B Corporations are pursuing and achieving the social mandates.

Next, the newly certified B Corporation has one year to make certain amendments to their articles of incorporation. Specifically, B Corporations are required to include language instructing directors to consider more than just shareholder interests when carrying out their duties. Companies must already be incorporated in a state with an “other constituency” statute or have to reincorporate in such a jurisdiction. Certain states, like the aforementioned New York, Nevada or Pennsylvania, have relatively broad constituency statutes that allow directors to consider the interests of employees, retirees, creditors, and customers and the broader community when they take decisions in the context of changes of control or otherwise. These statutes allow for language that can

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(B) Does the company produce financials that are reviewed by the Board, other governing body, or independent third party? (1) Yes (2) No
(C) Please describe how your company engages its external stakeholders (check all that apply): (1) Annual stakeholder meetings; (2) Stakeholder forum on company website; (3) Third party or anonymous surveys; (4) Other; (5) No formal stakeholder engagement.
(D) Does the company have a formal process to share financial information (except salary info) with its full-time employees? (1) Yes (2) No
(E) Do all full-time employees have access to written information that identifies all material owners and investors of the company? (1) Yes (2) No

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408 See New York, Nevada, and Pennsylvania laws, supra note 399.
be more effective in ingraining stakeholder interests. For example, B Lab would require a New York B Corporation to insert the following language into its articles of incorporation:

In discharging his or her duties, and in determining what is in the best interests of the Company and its shareholders, a Director shall consider such factors as the Director deems relevant, including, but not limited to, the long-term prospects and interests of the Company and its shareholders, and the social, economic, legal, or other effects of any action on the current and retired employees, the suppliers and customers of the Company or its subsidiaries, and the communities and society in which the Company or its subsidiaries operate (collectively, with the shareholders, the “Stakeholders”), together with the short-term, as well as long-term, interests of its shareholders and the effect of the Company’s operations (and its subsidiaries’ operations) on the environment and the economy of the state, the region and the nation.

Nothing in this Article express or implied, is intended to create or shall create or grant any right in or for any person or any cause of action by or for any person.

Notwithstanding the foregoing, any Director is entitled to rely upon the definition of “best interests” as set forth above in enforcing his or her rights hereunder and under state law, and such reliance shall not, absent another breach, be construed as a breach of a Director’s fiduciary duty of care, even in the context of a Change in Control Transaction where, as a result of weighing other Stakeholders’ interests, a Director determines to accept an offer, between two competing offers, with a lower price per share [emphasis added].

Other states with less broad statutes have language that is similarly of less impact. B Lab vets the changes and the company’s structure and operations as part of its certification system.

The requirement that a director “shall” consider the various stakeholder interests for the New York B Corporation is an interesting one. Permitting directors to consider certain stakeholder interests, rather than obligating them to do so, is a significant legal difference. As mentioned, granting a director permission to consider broader stakeholder

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409 B Corporation, “Legal Roadmap” (as of July 2010), online: B Corporation <http://survey.bcorporation.net/become/legal2.php>.
interests lacks some punch, as the power lies in the hand of the director to accept or ignore stakeholder interests in their sole discretion. Also, a permissive provision may somewhat lessen the sustainability of a company’s social objectives upon the exit of key players or transfer of control, more so than if director duties to stakeholder interests were obligatory. Obligatory duties thus hold directors to a much higher standard, although B Lab’s insertion “as the Director deems relevant” may soften the obligation considerably.

Dana Brakman Reiser has pointed out that the range of outside interests the director must consider in the proposed New York B Corporation language “is even broader than that described by the statute, including abstract social and environmental concerns.” It is critical that any expansion of duties does not unreasonably bind a director to an unascertainable number of people. As well, upon any such expansion of stakeholder rights and/or director duties, the typical protections granted to directors in exercising their duties, such as limitations on liability and indemnity rights, should be expressly identified. However, despite what Reiser describes as “forceful” director obligations, B Lab does not require the creation of new rights of legal action for stakeholders, leaving little concern that director protections need to be extended. Reiser suggests, “Perhaps this is merely pragmatism on the part of the B Corporation’s creators. It seems likely courts would enforce a mandate that directors consider social impact in their decisions, but even strong ‘other constituency’ statutes frequently block enforcement rights expressly.”

The explicit inclusion of stakeholder interests in directorial decision-making during

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411 Ibid. at 18.
potential change of control scenarios, with the specific inclusion that directors may select an offer with a lower share price based on stakeholder interests, is a significant amendment. This provision directly carves the B Corporation out of the landmark decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*\(^{412}\), where the court held that directors were found to owe a fiduciary duty to maximizing shareholder value in takeover contexts, regardless of nonshareholder interests. The *Revlon* decision is generally regarded as the decision that exemplifies the existence of the shareholder primacy model in corporate America, and the founders of B Corporation are addressing it head on. The inclusion of this provision could perhaps in many ways be a response by the social entrepreneurial industry over legitimate concerns regarding the potential loss of a business (and a social mandate) due to a hostile takeover situation.\(^{413}\)

Corporations may choose to become B Corporations for several reasons. They would be aligning themselves with like-minded companies, and the B Corporation branding “may draw directors committed to a blended mission and investors willing to enforce it.”\(^{414}\) It could one day be a brand popularly recognizable to consumers. Nevertheless, Reiser cautions that “it remains to be seen whether this system will have strong teeth.”\(^{415}\) Little has been written in academia on the B Corporation, which began to get picked up by the media in 2008, but only now has been gaining more significant coverage.\(^{416}\) As well, to date there seem to have been no legal challenges to any of B Lab’s suggested amendments to company articles. B Lab’s website claims that the 305 companies that

\(^{412}\) 506 A.2d 173 (Del. 1986).

\(^{413}\) See e.g. *infra* note 441.

\(^{414}\) Reiser, *supra* note 410 at 19.

\(^{415}\) *Ibid.*

\(^{416}\) B Corporation, “B Media” (as of July 2010), online: B Corporation <http://www.bcorporation.net/media>.

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certified as B Corporations collectively represent $1.1 billion in revenues. While the numbers are impressive as a grassroots phenomenon, they are infinitesimally small when compared to the amount of corporations existing in the U.S., which according to the Office of Advocacy totaled 29.6 million businesses in 2008.\textsuperscript{417} As well, no public companies have yet elected to be B Corporations.

Reiser has commented that the B Corporation

realistically offers only moral, rather than legal, assurances to nonshareholder constituencies and social interests. Stakeholders have no structural rights in governance and no additional parties are granted standing to litigate. B Corporation directors are empowered to act in the interests of other constituencies; whether they do so will depend on their own desires or feelings of moral obligation.\textsuperscript{418}

Her concerns echo the many scholarly voices that were represented and addressed earlier in Chapter 4 regarding stakeholder interests and director control, so I will be brief here and only make one new point. Using the earlier New York B Corporation provision as the reference, allowing stakeholders a right to litigate would be incredibly problematic when the number of stakeholders is almost incalculable. Therefore, rights must be explicitly stated\textsuperscript{419}, or there may be potential legal issues down the road that will require common law intervention. I am also comfortable with directorial discretion being the guide, particularly when companies are certified B Corporations, as the assumption is management is socially motivated.

Given the B Corporation started from private citizens, their hands are somewhat tied as to the existing legal structures they have to work within. I do not believe the B Corporation


\textsuperscript{418} Reiser, \textit{supra} note 410 at 19.

\textsuperscript{419} As they are in the Vermont state benefit corporation, to be examined in the following section.
should be disregarded as ‘just’ branding. The B Impact Assessment goes to the core of the business purpose and mission, and addresses (among other things) stakeholder and sustainability concerns that are highly relevant in this day and age. As well, it seems it would be incredibly beneficial if the B Corporation branding did take off and impact the choices of mainstream consumers. The B Corporation is still in its early stages, and good intentions are at a high. The initiatives by B Corporation generally incorporate in spirit the four recommendations outlined in Chapter 4 for improving corporate governance, and embody many potential solutions to the problems with the modern corporation.

The recent 2009 B Corporation Annual Report stated in its progress summary: “The financial crisis has created a unique opportunity to define success in business.”420 Many advocates of B Corporation have been heavily involved in pushing state governments to change their corporate laws, creating business/mission hybrids that now have legal infrastructure, such as those in Maryland and Vermont which will be examined next. It is likely these legislative amendments would not have taken place if the founders of B Corporation had not identified the need in the business world for a new type of corporate structure, and the recent crisis has allowed them to capitalize on an opportunity in financial history. As a strategic and thoughtful grassroots movement that has tapped on the shoulders of many prominent business leaders and politicians for support, I believe the B Corporation is becoming one of the starlet initiatives that will go far in helping change the way corporations do business.

5.3. **State Benefit Corporations**

On April 13, 2010 and May 19, 2010, Maryland and Vermont, respectively, passed legislation establishing “benefit corporation” law, which forms a new kind of corporate structure designed to creating both social benefit and shareholder value.\(^{421}\) Maryland’s benefit corporation laws are to take effect on October 1, 2010\(^{422}\) and Vermont’s on July 11, 2011.\(^{423}\) The New York state government also seems poised to making similar changes to its corporate statutes\(^{424}\), and five other states are said to be in the initial stages of the drafting benefit corporation legislation.\(^{425}\) There are no tax incentives currently attributed with these laws.

Maryland and Vermont’s benefit corporation laws are substantially the same, with a few notable additions to Vermont’s laws that will be highlighted. Since Maryland was the first state to pass these laws, Vermont has had the advantage of building upon Maryland’s statute as it sees fit. As well, it seems many of the original drafters of Maryland’s benefit corporation laws have crossed over and contributed to the drafting Vermont’s

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\(^{422}\) Maryland Benefit Corporations Act, s. 690 [hereinafter, the “Maryland Act”].

\(^{423}\) Vermont Benefit Corporations Act, s. 263 [hereinafter, the “Vermont Act”].


\(^{425}\) B Corporation reports on their website as having started initial drafts of benefit corporation legislation in Pennsylvania, North Carolina, Washington, Colorado, and Oregon. See B Corporation, “Benefit Corporation Legislation” (as of July 2010), online: B Corporation <http://www.bcorporation.net/publicpolicy>. 

legislation.\textsuperscript{426} A broader initiative seems to be in the making, as the founders and supporters of B Corporation have initiated a national campaign to getting benefit corporation laws adopted in every American state.\textsuperscript{427}

Both acts state that the purpose of a benefit corporation is to create a “general public benefit”, which is defined as “a material, positive impact on society and the environment, as measured by a third-party standard, through activities that promote a combination of specific public benefits.”\textsuperscript{428} A “third party-standard”, used in various provisions in the statute for “defining, reporting, and assessing best practices in the corporate social and environmental performance”\textsuperscript{429}, means a standard that is

(1) developed by a person or entity that is independent\textsuperscript{430} of the benefit corporation; and

(2) transparent because of the following information about the standard is publicly available or accessible:

(a) the factors considered when measuring the performance of a business;
(b) the relative weightings of those factors; and
(c) the identity of the persons who develop and control changes to the standard and the process by which those changes were made.\textsuperscript{431}

Unlike B Lab’s certification, there are no specific criteria to qualify as a Maryland or Vermont benefit corporation so long as proper company approvals have been met. Both states refer to their existing state corporate laws to fill any holes in the benefit corporation

\begin{itemize}
\item \textsuperscript{427} B Corporation, supra note 426.
\item \textsuperscript{428} Maryland Act, Subtitle 6C(6)(A); Subtitle 6C(1)(C); Vermont Act, Section 21.08.
\item \textsuperscript{429} Maryland Act, Subtitle 6C(E); Vermont Act, 21.03(8).
\item \textsuperscript{430} Vermont has specifically defined “independent” to mean a person that has no material relationship with the benefit corporation or any of its subsidiaries. A material relationship between a person and the benefit corporation is presumed if the person is, or has been within the last three years, an employee of the benefit corporation, an immediate family member of an executive officer, or the person owns (or is a manager of an entity that owns) beneficially or of record five percent or more of the equity interests or shares of the benefit corporation. See Vermont Act, Section 21.03(5).
\item \textsuperscript{431} Maryland Act, Subtitle 6C(1)(E) of the Act; Vermont Act, Section 21.03(8).
\end{itemize}
laws. New and existing corporations are allowed to obtain benefit corporation status. For existing entities, the benefit corporation status must be approved by the shareholders according to the usual state corporate laws governing amendments or restatements, which for both states means a two-thirds majority (or the majority as required by the company’s articles, if higher). In Vermont, a statement from the board of directors is required to be sent to shareholders stating (1) why the board is proposing the amendment and (2) what the anticipated effect of becoming a benefit corporation will have on its shareholders. Once approved, a corporation seeking benefit corporation status must include or make a clear and prominent statement in its articles of incorporation that it is a “benefit corporation.” If a corporation elects to withdraw from its benefit corporation status, it may obtain two-thirds shareholder approval to amend its articles and delete the “benefit corporation” statement. Again in Vermont, a statement from the board is required to explain the reasons why status is being termination and the effect such termination will have on its shareholders.

A benefit corporation can also identify in its articles the creation of certain specific public benefits as one of its purposes. This identification does not, however, remove its obligation to create a general public benefit purpose. A “specific public benefit” is broadly defined to include:

1. providing individuals or communities (in Vermont, this definition is narrowed to

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Footnotes:

432 For clarity, Maryland uses the term “stockholders” and Vermont, “shareholders.” I have elected to use the term “shareholders” throughout.
433 Maryland Act, Subtitle 6C(3)(A),(B), Maryland Corporation and Associations Code, Title 2, Subtitle 6. (e.g., Section 2-604 requires a two-thirds affirmative vote if there are stockholders); Vermont Act, Section 21.05.
434 Vermont Act, Section 21.05.
435 Maryland Act, Subtitle 6C(3)(A), Subtitle 6C(5); Vermont Act, Section 21.05.
436 Maryland Act, Subtitle 6C(4)(A),(B); Vermont Act, 21.07.
“low income or underserved” individuals or communities) with beneficial products or services;
(2) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;
(3) preserving the environment;
(4) improving human health;
(5) promoting the arts, sciences, or advancement of knowledge;
(6) increasing the flow of capital to entities with a public benefit purpose; or
(7) the accomplishment of any other particular benefit for society or the environment.\textsuperscript{437}

The creation of any public benefit purpose, general or specific, must be in the best interest of the benefit corporation.

A significant aspect of the benefit corporation laws is the codification of stakeholder interests in directorial decision-making. Both Maryland and Vermont outline factors that are to be considered by a director in determining what the director reasonably believes to be in the best interests of the benefit corporation, which in traditional corporate law and practice has meant how decisions affect shareholders only. In Maryland, a director is required to consider the effects of any action or inaction upon:

(1) the shareholders of the benefit corporation;
(2) the employees and workforce of the benefit corporation and the subsidiaries and suppliers of the benefit corporation;
(3) the interests of customers to the extent they are beneficiaries of the general or specific public benefit purposes of the benefit corporation;
(4) community and societal considerations, including those of any community in which offices or facilities of the benefit corporation or the subsidiaries or supplies of the benefit corporation are located; and
(5) the local and global environment.\textsuperscript{438}

Vermont has an additional sixth factor, being “the long-term and short-term interests of the benefit corporation, including the possibility that those interests may be best served

\textsuperscript{437} Maryland Act, Subtitle 6C(1)(D); Vermont Act, 21.03(6).
\textsuperscript{438} Maryland Act, Subtitle 6C(7)(A). Vermont has similar provisions with some de minimus differences in wording, see Vermont Act, Section 21.09.
by the continued independence of the benefit corporation.

This addition provides substantially the same protection as a similar provision offered by B Corporation by carving out the Revlon duties requiring directors to maximize shareholder value in a takeover situation, regardless of nonshareholder interests. The explicit inclusion may offer some symbolic vindication for the state of Vermont, home of the socially-minded ice cream business, Ben and Jerry’s, whose board in 2000 had multiple offers to purchase the company but had no choice but to sell to the highest offer or risk a lawsuit. The much publicized takeover by the British-Dutch based conglomerate Unilever hit a nerve for many in Vermont, and the social enterprise sector in general.

Both states permit directors to consider any other pertinent factors or interests of other groups the director deems appropriate to consider. Thus, board members are generally not liable for actions they take in the course of their duties in seeking to achieve the purposes of the benefit corporation, unless those acts constitute fraud, negligence, or other violations under their traditional state corporate laws. Courts are unlikely to intrude upon a director’s business judgment.

In Maryland, the director has no duty (fiduciary or otherwise) to a person who is a beneficiary of the public benefit purposes of the benefit corporation. Vermont, however, has actually gone a step further in expanding the definition of fiduciary duties for their

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439 Vermont Act, Section 21.09(1)(F).
440 Supra note 412.
442 Maryland Act, Subtitle 6C(7)(A)(2); Vermont Act, Section 21.09(a)(2).
Vermont directors have fiduciary duties only to those persons entitled to bring about enforcement proceedings against the benefit corporation, who have specifically been identified as:

1. a shareholder that would otherwise be entitled to commence or maintain a proceeding in the right of the benefit corporation on any basis;
2. a director of the corporation;
3. a person or group of persons that owns beneficially or of record 10 percent or more of the equity interests in an entity of which the benefit corporation is a subsidiary; or
4. such other persons as may be specified in the articles of incorporation of the benefit corporation.

A “benefit enforcement proceeding” means a claim or action against a director or officer for failing to pursue the general public benefit purpose, or any specific public benefit purpose set forth in its articles of incorporation, or violating any duty or standard of conduct in the statute. While the expansion may seem slight, it is important. Shareholders, and shareholders of any parent company, can bring proceedings against the benefit corporation for violating the broader codified stakeholder interests. Furthermore, a benefit corporation also has the freedom to specifically include any other persons with rights to bring proceedings in their articles.

Vermont’s expansion of duties thus has required several additional provisions to properly address the parameters of the directors’ duties. Directors are not required to give priority to the interest of any particular person or group over the interests of any other person or group unless the benefit corporation has stated its intention of giving priority in its articles. Directors are also not subject to a different or higher standard of care when

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443 Vermont Act, Section 21.09(e).
444 Vermont Act, Section 21.13.
445 Vermont Act, Section 21.09(a)(3).
decisions may affect the control of the benefit corporation.\textsuperscript{446} As well, a director is not liable for the failure of a benefit corporation to create general or specific public benefit. In both states, directors have the same immunity from liability as directors of those state’s corporations generally.

Vermont has gone another step further by codifying standards of conduct for officers, and in doing so, has created a new fiduciary duty. According to the Vermont Act, officers now have a fiduciary duty to consider the same six stakeholder interests and factors required to be considered by directors\textsuperscript{447} when: (1) the officer has discretion in how to act or not act with respect to a matter; and (2) it reasonably appears to the officer that the matter may have a material effect on: (A) the creation of general or specific public benefit by the benefit corporation; or (B) any of those six interests or factors. Accompanying provisions regarding carve outs, liability and indemnity protections are identical to those of directors.\textsuperscript{448}

Vermont has also created the requirement for one member of the board of directors to be designated as a “benefit director.”\textsuperscript{449} Maryland does not have any such position. This director is required to be independent, and the corporation’s constating documents may prescribe any additional requirements. The benefit director is required prepare an annual statement (which is required to be included in any benefit report) detailing whether, in the opinion of the director, the company acted in accordance with its benefit purpose in all material respects during the period covered by the report. If the benefit director believes

\textsuperscript{446} Vermont Act, Section 21.09(a)(4).
\textsuperscript{447} See Vermont Act, supra notes 438-439
\textsuperscript{448} Vermont Act, Section 21.11.
\textsuperscript{449} Vermont Act, Section 21.10.
the corporation or its directors or officers failed in its mission, then the statement should include a description of the ways in which the corporation or its directors or officers failed to so act. Vermont has also provided for the optional appointment of a “benefit officer” that has duties relating to the benefit purposes of the corporation, including the drafting of the annual benefit report.\textsuperscript{450} The benefit director may act in a dual role as the benefit officer.

Both Maryland and Vermont require benefit corporations to be responsible for creating an annual benefit report, with Vermont requiring board approval prior to the report being sent out to shareholders.\textsuperscript{451} Each state lists specific terms that must be included (with Vermont’s language being a bit more stringent), and Vermont has included provisions that significantly increase transparency. The benefit report in both states is required to include a description of how the benefit corporation pursued a general (and if applicable, specific) public benefit during the year and the extent to which the public benefit was created; any circumstances that hindered the creation of the public benefit; and an assessment of the societal and environmental performance of the benefit corporation prepared in accordance with a third-party standard. Vermont has also required a statement of the specific goals or outcomes, and specific actions that can be taken to improve its social and environmental performance and attain the goals or outcomes. More importantly, Vermont requires the inclusion of contact information for the benefit director and the benefit officer, if any; the amount of compensation paid to each director; the name of each shareholder owning beneficially or of record five percent or more of the shares of the benefit corporation; and the statement of the benefit director as previously

\textsuperscript{450} Vermont Act, Section 21.12.
\textsuperscript{451} Maryland Act, Subtitle 6C(8)(A); Vermont Act, Section 21.14.
mentioned. These additions in Vermont’s legislation add a heightened level of transparency to governance, holding benefit corporations to a standard of disclosure similar to those of public corporations operating in the financial markets.

This annual benefit report is to be delivered to each shareholder within 120 days following the end of the benefit corporation’s fiscal year. Vermont’s legislation also states that, after reasonable opportunity for review, the shareholders of the benefit corporation must either approve or reject the annual benefit report by majority vote at the annual meeting of shareholders or at a special meeting held for that purpose. In both states, if the benefit corporation has a public website, the benefit corporation is required to post its most recent benefit report (in Vermont, this report must have been shareholder approved) on the public portion of its website. If the benefit corporation does not have a website, it is required to provide a copy of its most recent benefit report on demand and without charge to any person who requests a copy.

The development of benefit corporation laws in the U.S. promote a more stakeholder-based and director-controlled model, in which corporations are obligated to expand beyond traditional just shareholder value, and legal infrastructure to encourage an active level of social responsibility. In combination with the B Corporation certification, which provides a valuable normative standard through its rating system that the laws are unable (and should not) provide, a powerful solution has been created to combat the corporate behaviour we have seen in the past. The B Corporation and these state benefit

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452 Vermont Act, Section 21.14(a)(4), (5), (6), and (7).
453 Maryland Act, Subtitle 6C(8)(B); Vermont Act, Section 21.14(b) (Vermont also allows delivery to be at the same time that the benefit corporation delivers any other annual report to its shareholders.)
454 Maryland Act, Subtitle 6C(8)(C); Vermont Act, Section 21.14(d).
corporations are on to something very significant. They have accomplished what years of infighting between scholars on shareholders v. stakeholders could not do – which is to come up with a practical solution that is taking shape in corporate practice.

It is extremely early in the process, as the laws still have not taken effect, and so it is unclear how corporations will react to the new laws. One can foresee an initial wave of leader companies signing up to be benefit corporations that have already made it a point of ingraining social responsibility in their business and advertising – I suspect most of those companies will already have been certified as B Corporations. But following the initial wave, how many corporations will end up choosing to be guided by benefit corporation laws? Will additional laws and reporting requirements\(^{455}\) dissuade the larger mass of businesses? This remains to be determined. But demand is not the driver behind these laws. New corporate laws do not always have to be a function of high demand or necessity following some financial calamity. Nor do they have to be utilized immediately to prove their value, as the “other constituency” statutes have shown. On some rare occasions, corporate laws can be created to promote opportunities to citizens, to provide infrastructure for inspirational and aspirational goals, and to improve the functioning of society. Pessimism is a frequent theme among corporate scholarship, and usually with good reason. There may be some unforeseeable problems in the future for these benefit corporate laws, or, minus some eager adopters, the level of corporate participation may be disappointing. On the other hand, these laws may one day form the standard under

\(^{455}\) There may also be slightly higher internal administrative costs, although I believe the costs of becoming a benefit corporation tend to be negligible. A company may elect to spend more to adhere to the standards of the benefit corporation laws (such as hiring a benefit officer, bringing in a professional social auditor to act as their third-party standard, etc.), but these actions are optional. Also, in connection with an earlier point I made in Section 4.4.1 regarding CSR and economic viability (see supra note 351), I note that since it is assumed that new and existing corporations will factor in any additional costs prior to becoming a benefit corporation, economic viability should not be a concern.
which corporations operate, changing the way we harness corporate power and influence to produce socially positive outcomes.
6. Governing Financial Institutions

On November 4, 2009, 51 prominent men and women from international financial institutions, major accounting and law firms, academia, media, and research and policy institutions gathered in New York for a colloquium (the “Colloquium”) to discuss the governance of financial institutions in the wake of the global financial crisis.\footnote{Report from the Colloquium, “Governance of Financial Institutions” (held on 4 November 2009 by the Institute of International Finance, the Hills Program on Governance, and The American Assembly), online: Centre for Strategic and International Studies <http://csis.org/files/publication/100331_governance.pdf> [hereinafter, “Colloquium”].} A report produced from the Colloquium, where both Volcker and Posner made formal addresses, identified several voices within the group that pinpoint issues which resonate with the premise of this Chapter. Some of these voiced concerns are reproduced here:

Speaker #1: Beneficial changes in regulation will no doubt yield beneficial outcomes. Nevertheless, the primary responsibility for the failure of financial institutions rests with their management and with boards of directors.\footnote{Ibid. at 5.}

Speaker #2: Directors of the largest financial institutions need to understand that apart from their responsibility to stockholders, they have an obligation to society, to our capitalistic system, and to avoid risks that could cause their institutions to fail.\footnote{Ibid. at 7.}

The particularities of the financial services industry have meant that most financial institutions are more regulated and supervised than the average corporate institution. The business of financial institutions has grown increasingly complex within the global capital markets. The industry itself poses the greatest governance risks, as the present day financial events have shown.\footnote{The International Finance Corporation put it this way: “first, since banks take large amounts of risk-bearing obligations on their books, weak internal controls and accountability can cause urgent and rapid crises; second, the collapse of a bank will usually destroy value for its public depositors, not just shareholders, and may even require a costly bail-out by the fiscal authorities; and, third, there is the systemic risk that the collapse of a single bank can undermine the entire banking system.” International Finance Corporation, “The Global Financial Crisis and the Governance of Financial Institutions” (March 2010), online: Centre for Strategic and International Studies <http://csis.org/programs/financial-crisis-governance> [hereinafter, “Global Financial Crisis”].} The internal governance of financial institutions, which
may be more committed to shareholder wealth maximization than any other institution, is also substantially more complicated. Consequently, “the rules of corporate governance within financial institutions must be adapted to take account of the specific nature of these companies” and regulatory authorities have an important role to play in shaping best practices for governance in financial institutions.

As discussed in Chapter 3, the U.S. government’s response in the wake of the global financial crisis has largely been to ignore issues of corporate governance reform, with the exception of issues relating to executive compensation. This is despite the fact that the crisis has caused “a great deal of franchise disruption and turnover in bank management,” while boards have clearly been under increased pressure to be on top of management decisions, particularly with respect to risk-taking activity. Boards themselves have struggled with the burden of overseeing complex financial matters. Recent discourse from prominent leaders in the financial services industry suggest that despite the lack of governmental initiative, private bodies are keenly aware of the serious governance concerns in the wake of the crisis. Volcker, as well, has been an active participant in

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460 This is evident in corporate practice, see e.g. NYSSA, “The New Governance Environment for Financial Institutions” (event occurred on 24 March 2010), online: New York Society of Security Analysts <http://www.nyssa.org/AM/Template.cfm?Section=calendar&template=/CM/ContentDisplay.cfm&ContentID=15808> (stating the obligations of the board to “maximize shareholder value”).


462 See infra notes 184-186.

463 NYSSA, supra note 460.
some key governance discussions that have occurred in corporate practice. Perhaps in the near future, the U.S. government may follow up on the Dodd-Frank Act with additional initiatives to address governance reform. It is possible, but the political atmosphere in the U.S. makes it seem unlikely the Obama administration will be interested in addressing these issues anytime soon.\footnote{The political climate in the U.S. seems particularly sensitive in the aftermath of the DFA. See e.g. David Herszenhorn, “Financial Reform Bill Limpns Toward Passage” The New York Times (13 July 2010), online: <http://www.nytimes.com/2010/07/14/business/14regulate.html?_r=1&scp=7&sq=financial%20regulatory%20overhaul&st=cse>.
}

This Chapter outlines some of the important high-level governance issues that are currently being addressed outside the U.S. legislature, including important discussions that have been occurring within the EU Commission. I briefly focus on two areas to provide a jumping off point for future governance reform efforts: risk management and board competence. I show how suggested improvements in the governance of financial institutions can encapsulate a few of my structure-altering recommendations from Chapter 4. Since U.S. legislators do not presently seem keen on addressing these concerns, it may optimistic to hope that others – either the financial institutions themselves, the bodies that advise them, or other stakeholders and groups with particular interest in their reform – will push these ideas forward so they may reach a level of normative fruition, until statutory reform appears one day to support it.

6.1. Risk Management and Stakeholder Interests

It is not surprising that the fallout from the crisis has led to a severe backlash in American public sentiment towards risk-taking by financial firms. The need for recognition of stakeholder interests in this regard is extremely apparent. The EU Commission has
recently noted that “financial institutions have too often failed to take a holistic approach to risk management.” \textsuperscript{465} It has summarized the main failures and shortcomings of financial institutions in terms of risk management as follows:

(1) a lack of understanding of the risks on the part of those involved in the risk management chain and insufficient training for those employees responsible for distributing risk products;

(2) a lack of authority on the part of the risk management function. Financial institutions have not always granted their risk management function sufficient powers and authority to be able to curb the activities of risk-takers and traders;

(3) a lack of expertise or insufficiently wide-ranging experience in risk management. Too often, the expertise considered necessary for the risk management function was limited to those categories of risk considered priorities and did not cover the entire range of risks to be monitored;

(4) a lack of real-time information on risks. To allow those involved to react quickly to changes in risk exposures, clear and correct information on risk should be available rapidly at all relevant levels of the financial institution. Unfortunately, the procedures for getting information to the appropriate level have not always functioned. \textsuperscript{466}

Addressing the practical aspects of solving these problems requires a level of expertise from leaders in the industry familiar with implementing sound risk management policies. The multiple issues do, however, call for a high-level view on the governance model that dictates the motivations behind risk management.

Perhaps the most radical idea for addressing the broader, stakeholder-oriented view of risk-taking policies has come from a welcomed source. Volcker, following his appointment by President Obama as the head of the Economic Recovery Advisory Board, has been a major proponent in arguing for reform that is more far-reaching than what one typically expects from government. In addition to his contributions which appeared in the DFA, Volcker has made several comments addressing corporate governance issues. One


\textsuperscript{466} Ibid.
of these comments in particular is Volcker’s contention that certain financial institutions should be given a fiduciary responsibility to regard stakeholders in their business model. He states:

We ought to have some very large institutions whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit…They ought to be the core of the credit and financial system. Those institutions should not engage in highly risky entrepreneurial activity.467

Volcker’s proposals for expanding directorial duties to include stakeholder interests are important in curtailing conflicts of interest and, purely in terms of outcomes for consumers and taxpayers, in protecting them from the risks associated with speculative trading.468 The concepts behind his proposal are also not unheard of. The EU Commission has recently stated that it is considering whether, “in addition to shareholders’ interests, which are essential in the traditional view of corporate governance, financial institutions also need to take better account of other stakeholders’ interests.”469 The Commission has asked for comments from the industry on the idea of imposing a new duty of care on directors of financial institutions to take account of depositors’ and other stakeholders’ interests. It notes that the interests of creditors are potentially at odds with the financial institution’s shareholders. Shareholders benefit from an increase in share price and maximization of profits in the short term and are potentially less interested in a certain low level of risk. On the other hand, depositors and other creditors “are focused only on a financial institution’s ability to repay their deposits and other mature debts, and thus on its long-term viability…As a result, depositors can be

467 Cho & Appelbaum, supra note 116.
468 Cristie Ford and I have considered his plan further, see Ford & Liao, supra note 94 at 915-916.
469 EU Commission Green Paper #1, supra note 90 at 12.
expected to favour a very low level of risk.”

Accordingly, the Commission states that

the creation of a specific duty for the board of directors to take account of the interests of depositors and other creditors in their decision-making (‘duty of care’) could help encourage the board of directors to adopt less risky strategies and improve the quality of the financial institution’s long-term risk management.

Changes in this regard, if adopted in the U.S., could translate into a more stakeholder-based approach in management and any expansion, legally or normatively, of the corporate purpose behind certain large commercial banks could potentially remake the actions and behaviour of its management. If directors are cognisant of the fact that they may be held liable to a broader range of stakeholders when exercising their fiduciary duties, then they will be more stringent in their oversight, and pay closer attention to the effects of management decisions. Embedding public obligations into the private institution, a belief supported by progressive corporate law scholars, would remind large financial institutions not to operate under the singular objective of generating shareholder wealth, and also better understand the role and responsibility they carry within society.

Nevertheless, this proposal should be considered alongside the multifaceted environment in which large financial institutions have to operate, and the global regulatory schematics that go along with it. In general, the risks of financial institutions are far more complex than in other industries, mainly because of the way the institutions relate to one another and the various markets in which they operate, as well as the complexity of their products.

One speaker at the Colloquium noted:

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472 Colloquium, *supra* note 456 at 16.
...while we can get lost in the question of how to define the risk of [an investment] and who within the bank is responsible for monitoring such things...we won’t come close to addressing the incentives that drive risk maximization until we deal with the purpose of the business and recognize the environment within which we are operating...I don’t think we’ve come close to addressing the incentives that drive risk maximization.\textsuperscript{473}

The trouble is that coherent and consistent group governance, including well-integrated risk management, “needs to be balanced with meeting the formal needs of local entity governance and the expectations of host regulators for the management and governance of local entities.”\textsuperscript{474} Therefore, the fact that in the regulation of banks there is an enormous “disparity in national practices” may cause significant trouble.\textsuperscript{475} Members of the Colloquium found that there is a “lack of thinking on what should be the architecture of the financial world” and the legislative actions by the governmental authorities are “just regulatory bodies…rushing into solutions – quick fix – without…true coordination.”\textsuperscript{476} Thus, I regard Volcker’s proposal as one small but very significant step to reforming risk-taking activity, but there need to be others given the mega-proportions in which this industry operates.\textsuperscript{477}

These concerns on a risk management level are important to address in the wake of the crisis. As mentioned in Chapter 3, the DFA, following much partisan politics, has had lukewarm reception from reformists on how effective it will be in changing the way financial institutions handle risk.\textsuperscript{478} Volcker’s suggestion for an expansion of fiduciary

\textsuperscript{473} Ibid. at 24.
\textsuperscript{474} Ibid.
\textsuperscript{475} Ibid.
\textsuperscript{476} Ibid.
\textsuperscript{477} Ibid.
\textsuperscript{478} Some suggestions have included improved measures of systemic risk and more adaptive regulations and including counter-cyclical leverage constraints. Andrew Lo, “Regulatory Reform in the Wake of the Financial Crisis of 2007-2008” (10 March 2009), online: Social Science Research Network <http://ssrn.com/abstract=1398207>.
\textsuperscript{478} See supra note 198 for examples.
duties is innovative and should be seriously considered by regulatory authorities as an additional supporting initiative to help prevent future crises. It seems clear that more needs to occur to challenge the existing governance structures in the treatment of risk and how such risk affects a financial institution’s broader community of stakeholders. When addressing the relationship between governance and risk management in large financial institutions, it is also imperative to extend this analysis beyond a national scope and bring it to a global, comparative level.

6.2. Board Competency and Control

At the Colloquium, participants “fully understood that responsibility for the current financial crisis lies with many, including regulators, but they accepted that the [boards] of many financial institutions deserve a significant part of the blame.”\(^479\) The EU Commission has stated that the crisis clearly shows that directors “did not fulfill their key role as a principal decision-making body” and consequently, “were unable to exercise effective control over senior management and to challenge the measures and strategic guidelines that were submitted to them for approval.”\(^480\) These directorial failures to “identify, understand and ultimately control the risks” lie “at the heart of the origins of the crisis.”\(^481\) In addition to expanding fiduciary duties to stakeholders, there have also been calls for directors of these financial institutions to have increased “muscular board oversight.”\(^482\) Others have argued that these directors need to carry “moral capacity,” hinting that the crisis has caused many to consider the lack of moral undertones within the financial world, and seek out the players that should responsible for changing this

\(^{479}\) Colloquium, supra note 456 at 6-7.
\(^{480}\) EU Commission Green Paper #1, supra note 90 at 6.
\(^{481}\) Ibid.
\(^{482}\) Colloquium, supra note 456 at 21.
deficiency.483

In reasserting the control of the board, it is important to pinpoint the reasons why the boards of several financial institutions failed as internal governing bodies during the lead-up to the crisis. Some could suggest that boards in general meet too infrequently with management, making it almost impossible for there to be adequate oversight from boards of financial institutions operating in the complicated and fast-moving industry. While there is theoretical merit in this argument, Jay Lorsch has pointed out that “in 2007, the boards of the large Wall Street institutions did meet much more often than the average American company’s board – on average 10 times a year for the Wall Street firms, and six times for the typical company.”484 And even more telling, the audit committees on these boards met on average an additional 11 times in 2007.485 Lorsch thus describes the issue this way:

[W]hat directors understand about [their financial] institutions is obviously the result of more than just how much time they spend together. Another significant factor is the depth of knowledge directors bring to the boardroom about financial markets, products, and institutions from prior career experience. Unfortunately, current rules and best practices make such transfer of knowledge unlikely. The emphasis in selecting board members in the United States is on finding individuals who are ‘independent.’486

The general understanding among attendees at the Colloquium echoed Lorsch’s argument. While recognizing the corporate and accounting scandals of 2001-2002 largely involved issues of board independence, the consensus from the Colloquium was that failures in directorial oversight during the crisis related more to issues of board

483 Ibid. at 8.
485 Ibid.
486 Ibid.
Increasing board responsibility and control in a governance model inevitably creates the strong preference for active and knowledgeable directors. Participants at the Colloquium agreed that implanting personal obligation in the mind of a director was necessary. To create more individual director accountability, one participant suggested that firms should prominently display directors’ names so that the public would “know exactly who had oversight responsibility.” Others spoke of the need to judge character when selecting board candidates, and another offered the suggestion of “motivational training…to impart an ethic of ‘servant leadership.’” Several other suggestions by non-governmental organizations and scholars, the EU Commission, and others offered at the Colloquium include: keeping boards small so that directors feel more personal responsibility;

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487 Colloquium, supra note 456 at 7. While board independence has been less of a focus in the wake of the crisis (and indeed, Enron has taught us that a regime based on disclosure can only take us so far), there nevertheless have been some heated discussions on how to improve the board through greater independence. Specifically, many have suggested splitting the role of CEO and board chair, as they require in the U.K. Financial Reporting Council, “UK Corporate Governance Code” (effective as of 21 June 2010), online: Financial Reporting Council <http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf> (It should be noted that the prevalent practice seems to be that former CEOs of larger banks in UK continue as non-executive chairs. The success of this practice suggests that competence is more important than independence. But on other hand, the practice is a derivation from norm – UK regulation requires “comply or explain” justification by firms that choose former CEOs as chairmen, which some have noted may not translate well in the U.S.). Those opposed to disallowing the CEO from the chair position generally believe there would be serious difficulty in finding someone with sufficient experience to chair the board of the larger institutions. Colloquium, supra note 456 at 8-9; but see Lorsch, supra note 484. Nevertheless, several at the Colloquium argued that “the loss of faith in large financial institutions demands a non-executive board chair to reassure the public that the board will effectively monitor risk.” Ibid. at 8. Volcker supported this position at the Colloquium. The EU Commission as well has stated that several studies have clearly demonstrated how “faced with a chief executive officer who is omnipresent and in some cases authoritarian, non-executive directors felt unable to raise objections to, or even question, the proposed guidelines or conclusions due to a lack of technical expertise and/or confidence.” EU Commission Green Paper #1, supra note 90 at 6. Many have also pointed out that the CEO should not be the normal source of identifying potential candidates for the board. Ibid. at 10.

488 Ibid. at 8.

489 Ibid.

490 Ibid. at 12. The suggested number at the Colloquium was no more than 15 members.
shortening the tenure of board membership; raising standards regarding director and manager experience, such as certifications for expertise in financial engineering for the senior management and directors of all financial institutions and/or using regulatory law to require a level of “competence” of these directors (similar to provisions in the SOX Act regarding members of audit committees); and reinforcing civil and criminal liabilities of directors.

Lorsch points out that however capable and experienced a board is, the board will always have to rely on management as “the most important source of information for future plans and current company activities, risks and results.” Management must provide information in a way that directors can effectively understand what is happening within the institutions they are governing. Thus, while the formation of a risk management committee may increase board competence, there need to be other ways that address unlocking information from the executives of the institution.

A plausible solution would be to provide board members with a small staff of professionals to support the board with analysis and interpretation of data, in order to aid the board in their oversight of risk-taking activity. Lorsch believes this idea is one “whose time has come for complex financial institutions.” Special knowledge and expertise becomes of particular concern when an industry is increasingly complex and

491 Ibid.
492 Lo, supra note 477.
493 Lorsch, supra note 484.
494 Ibid.
495 According to Lorsch, this idea was first proposed in 1972 by the late Justice Arthur Goldberg, who was on the board of Trans World Airlines. Goldberg suggested that the board create a small staff of professionals with relevant expertise to support the board with its analysis and interpretation of data. The proposal was rejected. Ibid.
496 Ibid.
dynamic and the pool of potential directors shrinks. The level of complexity requires the board to be a step ahead of new financial product innovations. In this day and age, “there is simply too much complicated data about performance and risks for independent directors to understand, even if boards do meet monthly and consist of more members with deep financial expertise.”\footnote{497} A relatively small “staff” of young professionals with the relevant expertise at the service of the board would go a long way in deepening board oversight.

There seems to be recognition among many prominent leaders in the industry that greater board responsibility and control, as opposed to greater shareholder control, is critical to preventing similar crises in the future. For example, when questioned about the prospect of shareholders being given a greater voice in governance, Volcker believed that a greater shareholder voice was not necessary or even desirable. He stated:

\begin{quote}
I think yes, some stockholder activism may be useful but if it is too much and if it’s too easy you will get a lack of congeniality on the board and is destructive and not recognizing any common purpose of the organization. So I think you’ll see some changes there; some stockholder votes may be useful on an advisory basis, but I myself don’t think you can go much beyond that.\footnote{498}
\end{quote}

Board competency, independence, and accountability are all contributing factors that need to be continually fostered for the proper maintenance of good board control. Several participants in the Colloquium noted that a diligent, non-executive director of a financial institution will need to dedicate at least 30 to 60 days per year to his or her task,

\footnote{497} \textit{Ibid.}  
\footnote{498} Colloquium, \textit{supra} note 456 at 11.
referencing the recommendation by Sir David Walker in his report. In many ways there may be a shifting of view from once when directors played a passive role in contrast to institutional shareholders’ control, to now where directors are expected, even demanded, to take responsibility for the actions of the company.

The EU Commission as well has questioned the viability of shareholder control in the financial sector. One Green Report states:

The growing importance of financial markets in the economy, due in particular to the multiplication of sources of financing/capital injections, has created new categories of shareholders. Such shareholders sometimes seem to show little interest in the long-term governance objectives of the businesses/financial institutions in which they invest and may be responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizons. In this respect, the sought-after alignment of directors’ interests with those of these new categories of shareholder has amplified risk-taking and, in many cases, contributed to excessive remuneration for directors, based on the short-term share value of the company/financial institution as the only performance criterion.

The EU Commission has gone on to point out several factors to explain the disinterest or passivity of shareholders with regard to the governance the financial institutions. In addition to familiar arguments leveled against the prescriptive and practical aspects of shareholder control, the EU Commission has noted that the concept of ownership normally associated with holding shares is disappearing. As well, institutional investors would face additional costs if they wanted to actively engage in governance of a financial institution, which would likely dissuade them.

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500 EU Commission Green Paper #1, supra note 90 at 8.
501 See Hu & Black, supra note 271.
502 EU Commission Green Paper #1, supra note 90 at 8.
On an extremely positive note for corporate governance reformists across the Atlantic, the Commission ends this topic by stating the following:

The Commission is aware that this problem does not affect only financial institutions. More generally, it raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders. As a result of this situation, the Commission will launch a broader review covering listed companies in general.\footnote{Ibid.}

Thus it does seem that, at least in Europe, the global financial crisis has created a window of opportunity to revisit alternative models of corporate governance.

It may be alright for now if the U.S. government is slow to reform the governance of its financial institutions. Those pushing for governance reforms may be able to gain some normative traction in practice. Groups like the IFC, for example, have established measured ways for financial institutions to improve their corporate governance without the need for governmental regulation.\footnote{International Finance Corporation, “The Corporate Governance Review – Report Generator” and “Sample Improvement Program” (as of July 2010), online: International Finance Corporation <http://www.ifc.org/ifcext/corporategovernance.nsf>.} One hopes, however, that with time legal support for these practices will follow.

\footnote{Ibid.}
7. Conclusion

Corporate governance is a heavily debated topic in legal discussion, and it is no wonder. The obvious influence of corporations in everyday culture, the daily clash of interests between and among corporate bodies, the ease with which a person can quickly turn into an investor – all these factors have made the body of law governing how corporations are regulated and managed a pertinent issue for everyone. Now, in the wake of the global financial crisis, while many continue to recover from the effects of Wall Street’s cataclysmic fall from grace, there should be a renewed focus on corporate governance reform.

Chapters 2 and 3 of this thesis looked back in recent corporate history to two events that had the potential to destabilize the ideological support of the shareholder primacy model in the United States: the corporate and accounting scandals of 2001-2002 and the global financial crisis. American confidence in the shareholder primacy model of governance and neoclassical law and economics was at its peak in 2000, leading some scholars to even declare an end of history for corporate law. Shortly following the scandals of 2001-2002, three different perspectives emerged from corporate legal scholarship. The first believed that market sanctions alone were effective disciplinary devices for addressing negative corporate behaviour. The second argued for greater transparency and accountability of directors and managers, and stricter regulation following the scandals to support the shareholder primacy model. The third perspective, which this thesis builds upon, believed that in addition to stronger regulation, a fundamental rethinking of corporate governance practices and procedures was required. With time, it became evident that the ideological support of the shareholder primacy model was deeply
entrenched in American corporate culture. The third perspective did not gain traction following the scandals. The mainstream desire for reform focused on the effectiveness of the SOX Act and using behavioural law and economics approaches to lessen negative corporate behaviour within existing governance structures, rather than altering current corporate form.

The recent global financial crisis has again called into question the merits of the shareholder primacy model. Examining two main, interrelated causes of the global financial crisis, the repeal of the Glass-Steagall Act and the originate-to-distribute model of lending in the OTC derivatives market, this thesis reveals how corporate institutions have played a major role in hindering the development of regulations that govern corporate actions. When comparing the three perspectives that developed following the scandals to those in the wake of the crisis, important observations are made. The $700 billion bailout by the U.S. government has made the first perspective, which held that \textit{laissez-faire} market principles are sufficient, no longer plausible. It seems that reform following the crisis has again focused on strengthening the shareholder primacy model. The Dodd-Frank Act has put a great deal of faith on regulators preventing another financial crisis by imposing limits on risky activities, but corporate governance issues have failed to garner the attention of policy makers in the U.S. to date. Without addressing the legal and normative prescriptions found within the existing governance model, there will be significant opportunities for crises to continue to occur in the future.

Regulatory reform efforts going forward should include structure-altering proposals that redesign the underlying governance model and its singular business objective of wealth maximization. In Chapter 4, I build upon theoretical approaches in corporate legal
scholarship to construct a framework of four structure-altering recommendations for reforming the existing model. These recommendations, when combined together, provide a powerful foundation for establishing a new type of corporate existence and behaviour. First, using the tenets from stakeholder theory and progressive corporate law, I recommend that corporate governance reform efforts should seek to deeply entrench stakeholder interests in corporate decision-making and actions. I contend that stakeholder interests should be both legally and normatively supported for effective integration into the corporate form. Next, board responsibility and control should be increased. Using team production theory, I argue that a “mediating hierarch” approach is more effective than shareholder primacy to ensure that various stakeholder interests are adequately addressed. Individual director accountability is offered as a method of heightening director accountability in light of the increased levels of control. The third recommendation, expand beyond traditional shareholder value, borrows upon the enlightened shareholder value concept developed in the U.K. while challenging the neoclassical notion of efficiency using institutional law and economics. Enlightened shareholder value encourages corporate institutions to pursue shareholder wealth with a long-run view based on the consideration of a full range of stakeholder interests. Institutional law and economics then points out how the government has the capability of recalibrating measures of efficiency. This approach shows how institutional reform can allow for significant change to how corporate institutions perceive success. Finally, I recommend that social responsibility be normatively embedded into corporate culture. While legal infrastructure has an important role to play in corporate governance reform, it is critical that a normative cultural shift of social responsibility permeates into day-to-day
management and operations.

It is easy for skeptics to dismiss alternative governance modelling as idealized theorizing, and to rebuff the notion that reform of this manner will ever occur. But for supporters, Chapter 5 of this thesis shows that there is reason to be optimistic. Recent grassroots and legislative initiatives in the U.S. have indicated the public demand for reform exists. The privately regulated B Corporation has been gaining notoriety for its novel way of utilizing corporate power to address social and environmental problems using existing state “other constituency” laws. As well, the recent innovative development of state “benefit” corporations in Maryland and Vermont has shown how state governments can design governance structures that are able to facilitate the dual corporate purpose of creating social benefit and shareholder value. These initiatives provide real examples of how the four structure-altering recommendations can be exhibited in corporate practice.

Chapter 6 then rounds out the discussion by turning back to issues surrounding the governance of financial institutions at the core of the crisis. Governing of financial institutions is substantially more complicated than general corporate governance reform due to the global interconnectedness of large banks and complex regulatory schematics. I briefly focus on two areas: risk management and board competence. I capitalize on Volcker’s comment that certain financial institutions should consider creating fiduciary duties to stakeholders, and promote his suggestion as an effective way to implement a stakeholder-oriented view of risk-taking policies within these institutions. Next I contend that, given the complexities surrounding the financial sector, improving board competency would go a long way in allowing better governance under increased board responsibility and control. These high-level suggestions provide a starting point for future
governance reform efforts in the financial sector.

7.1 The Way Forward

Corporate institutions have become the most powerful legal structure in American society. Testy provides a commanding description of this phenomenon. She states:

Start with a pervasive distrust of regulatory solutions to economic problems, together with a concomitant faith in the righteousness of private ordering. Add to that the privileged status of financial capital in corporate governance, which is reinforced by an obsessive focus by corporate managers and investment communities on short-term share price. All of that, combined with exponential growth in the transfer of technology and other products across national borders, have paved the way for corporations to rival the state, and certainly the church, in institutional power and influence.\(^{505}\)

The crisis has been a stark reminder of this development and should change the state of play for corporate legal scholars. Let there be little doubt that there is something wrong with the way we have designed the existing governance model of public corporate institutions. The model we have accepted as the norm has justified selfish human behaviour and privileged the basest human vices.

Volcker, when referring to financial regulatory reform, put it this way: “We need to face up to needed structural changes, and place them into law. To do less will simply mean ultimate failure – failure to accept responsibility for learning from the lessons of the past and anticipating the needs of the future.”\(^{506}\) His words should inspire corporate governance reformists and translate into governance initiatives that recalibrate the shareholder primacy model. An alternative movement in corporate law is nascent. It is also disorganized, and it is unclear what will come about from recent reform efforts. For

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\(^{505}\) Testy, supra note 6 at 1128.

\(^{506}\) Volcker, supra note 183.
now, scholars should capitalize on the fact that “good ideas eventually prevail” and begin contributing to the expansion of counter-hegemonic discourse. This thesis attempts to provide important tools for the pursuit and development of an alternative model of corporate governance. There is now the opportunity to reassess long-held beliefs in corporate law; indeed, reconsidering the existing corporate governance model may never be as timely as now.

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