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Author
Eisenberg, Melvin

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Corporate Law, Social Norms, and Belief-Systems

by

Melvin A. Eisenberg

Introduction

Corporate law serves both to facilitate and to regulate the conduct of the corporate enterprise. Insofar as corporate law is regulatory, it provides incentives and disincentives to the major actors in the corporate enterprise -- directors, officers, and significant shareholders -- through the threat of liability. In significant part, however, these actors are motivated not by the desire to avoid liability, but by the prospect of financial gain, on the one hand, and by social norms, on the other. Much work has been done on the way in which these actors are motivated on the threat of liability and the prospect of financial gain, but relatively little work has been done on the operation of social norms.

The neglect of the operation of social norms in the field of corporate law parallels the neglect of the operation of social norms in the law generally.[1] In recent years, a small but important group of scholars has begun to remedy this neglect.[2] However, relatively

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[1] See Eric A. Posner, Efficient Norms, in 2 *New Palgrave Encyclopedia of Law and Economics* 19, 20 (1998).

[2] See, e.g., Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes* (1991); Lisa Bernstein, Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms, 144 U.Pa.L.Rev. 1765 (1996); Lisa Bernstein, Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, 21 J. Leg. Stud. 115 (1992); Robert D. Cooter, Expressive Law and Economics, 27(2) J.Leg.Stud. 585 (1998); Robert D. Cooter, A Normative Failure Theory of

little work has been done on the interrelation of law and social norms in specific fields of law. Instead, most of this work has either concerned the operation of social norms in a general way, using random illustrations from various fields to illustrate the general points, or has concerned occupational communities whose members choose to be governed by their own social norms rather than law in their dealings with each other.[3] Furthermore, much of this work has concerned only those social norms that impose obligations, and little of the work has concerned the role of belief-systems in the origin and acceptance of social norms.

In this Article, I examine the interrelation of social norms and law in a given field of law -- corporations. The purpose of this examination is to illuminate both corporation law specifically, and the interrelation of social norms and law generally, by studying ways in which that interrelation operates in a specific field. I will focus on three kinds of social norms, which I call descriptive norms, conventions, and obligational norms. In the course of this Article, I will show that even social norms that do not impose obligations

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Law, 82 Cornell L.Rev. 947 (1997); Robert D. Cooter, Decentralized Law in a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant, 144 U.Pa.L.Rev. 1643 (1996); Jody S. Kraus, Legal Design and the Evolution of Commercial Norms, 26 Leg. Stud. 377 (1997); Lawrence Lessig, The Regulation of Social Meaning, 62 U.Chi.L.Rev. 943 (1995); Richard H. McAdams, The Origin, Development, and Regulation of Norms, 96 Mich.L.Rev. 338, 341 (1997); Eric A. Posner, Symbols, Signals, and Social Norms in Politics and the Law, 27(2) J. Leg. Stud. 765 (1998); Eric A. Posner, The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action, 63 U.Chi.L.Rev. 133 (1996); Eric A. Posner, Law, Economics, and Inefficient Norms, 144 U.Pa.L.Rev. 1697 (1996); Cass R. Sunstein, On the Expressive Function of Law, 144 U.Pa.L.Rev. 2021 (1996); Cass R. Sunstein, Social Norms and Social Roles, 96 Colum.L.Rev. 903 (1996).

[3] See, e.g.,, Bernstein, Opting Out, supra note 2.

play important roles in the law, and that belief-systems that result from information and reasoned persuasion play a fundamental role in the origin and adoption of social norms.

The organization of this Article is as follows: I begin by describing and defining the kinds of social norms that are relevant to law (Part I). I then consider, in a preliminary way, the effects and origins of social norms (Part II). Finally, I examine the role of social norms in three central areas of corporate law: fiduciary duties, corporate governance, and takeovers (Part III). In the course of that examination, I apply and elaborate the analysis in Parts I and II concerning the kinds, origins, and effects of social norms, and consider some of the kinds of interrelations between social norms and law.

I. Descriptions and Definitions

An analysis of the operation of social norms in the law presents severe problems of terminology. To begin with, as a matter of ordinary language the term *norm* encompasses both rules and regularities. Because rules and regularities are very different kinds of phenomena, a single canonical definition of the term norm is not within reach. Furthermore, rules and regularities each include various types of norms, and the typology that is employed in a given inquiry will depend in part on the purpose of the inquiry. I therefore begin by describing and defining the major types of norms that are salient to law. These descriptions and definitions, in turn, will set the stage for an inquiry into the manner in which different types of norms operate in areas that are within the scope of law.

A. Social Norms, Legal Rules, and Organizational Rules

To begin with, I use the term *social norm* to mean all rules and regularities concerning human conduct other than legal rules and organizational rules. By *legal rules*, I mean the principles and rules of a legal system. By *organizational rules*, I mean formal rules adopted by private organizations. Such rules often have the effect of legal rules, because they are directly or indirectly backed by legal sanctions.[4] Even organizational rules that are not backed by legal sanctions are often backed by formal sanctions, because many private organizations have monopoly power over important parts of the lives of persons who are members or want to become members. Consider, for example, the rules of professional- and amateur-sport organizations, HMOs, and the Boy Scouts and Girl Scouts.

I exclude legal rules from the definition of social norm that I use in this Article because the purpose of this Article is to investigate the effect of nonlegal rules and regularities. I exclude organizational rules because such rules tend to operate in a much different way than other nonlegal norms; in fact, they tend to operate in many ways like legal rules. Of course, organizational rules can be and often are considered to be social norms. For that matter, legal rules can be and often are considered to be social norms. I exclude those categories from the definition of social norm that I use in this Article not

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[4] For example, a broker-dealer who violates the rules of the National Association of Securities Dealers may be expelled from that organization, and under the Securities Act, a broker-dealer who is not a member of the NASD cannot effect any transaction in a manner other than an exempted security. See Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 629-48 (3d ed. 1995).

because doing so is required as a matter of ordinary language, but for clarity in analysis and convenience in exposition.

B. Three Categories of Social Norms

Social norms can be divided into three categories according to the degree of self-consciousness and obligation that they involve. The first category consists of regularities in human conduct that neither involve a sense of obligation nor are self-consciously engaged in. One such type of norm consists of functional responses to the facts of the natural world, like putting on warm clothes when it's cold. Another consists of average patterns in a given social population, like the distribution of wealth. Still another consists of statistical regularities, like the fact that automobile accidents peak during holidays.

The second category consists of rules and regularities that are self-consciously adhered to or engaged in, but do not entail a sense of obligation. For example, it is a practice in some law schools to begin "one-hour" classes on the hour and finish at ten minutes of, and in others to begin at ten minutes after the hour and finish on the hour. These practices are self-consciously engaged in, and indeed have the look and feel of rules, but they do not involve a sense of obligation. A law school would normally not be criticized for changing from one practice to the other, or to a third practice entirely. A faculty member could normally depart from the practice -- make an exception to the rule -- without criticism, as long as he could comfortably fit the schedule of his class into the schedules of others.

Another norm of this type consists of usages that attach meanings to words, symbols, or stylized conduct. Here is an example from the *Restatement Second of Contracts*.

> *A* contracts to sell *B* 1,000 feet of San Domingo mahogany. By usage of dealers in mahogany, known to *A* and *B*, good figured mahogany of a certain density is known as San Domingo mahogany, though it does not come from San Domingo. Unless otherwise agreed, the usage is part of the contract.[5]

A different kind of example is the posture and hand-signal used to hitchhike: As a matter of usage, standing in a certain posture by the side of a road and holding up your hand in a certain way means that you want a lift.

The third category consists of social norms that take the form of rules or practices that actors not only self-consciously adhere to or engage in, but feel obliged in some sense to adhere to or engage in, although (by hypothesis) the rule or practice is neither a legal nor an organizational rule. I will call social norms in the first two categories -- norms that, whether or not self-consciously adhered to or engaged in, do not carry a sense of obligation -- *nonobligational norms*. I will call social norms in the third category -- norms that do carry a sense of obligation -- *obligational norms*. An operational test of whether a social norm is obligational is whether a departure from the norm is likely to involve either self-criticism or criticism by others.

[5] Restatement (Second) of Contracts § 222, Ill. 2.

Moral norms are one extremely important type of obligational norm. However, a social norm may be obligational without being moral. For example, if it is a practice to wear formal dress to Metropolitan Opera premieres, then regular Metropolitan Opera goers will probably believe there is an obligation, although not a moral obligation, to follow along. Correspondingly, those who attend a premiere in informal dress will be criticized. Similarly, the social norms concerning what kinds of foods should be eaten with implements, rather than with one's hands, are not moral norms, but they are obligational norms.

II. The Effects and Origins of Social Norms

I turn now to a preliminary consideration of the effects of social norms on human conduct, and the origins of social norms. The effects of social norms depend on two basic variables: (1) whether or not the norm is obligational and, (2) if it is obligational, whether or not it has been internalized by the relevant actor. These issues are discussed in Sections A (obligational norms) and B (nonobligational norms).

Social norms may originate in a variety of ways. In this Article I will focus on one way in which social norms originate, which is particularly relevant to corporate law: the formation of belief-systems based on information, reasoned persuasion, or both.. This and related issues are discussed in Section C and D.

A. Obligational Norms

Legal rules provide a reason for acting in a certain way. So do obligational norms. A legal rule may provide a reason for acting in a certain way because the actor has

internalized the moral norm of obedience to law; because the actor either fears legal sanctions or desires a legal benefit, or because the actor fears nonlegal sanctions, like reputational sanctions, or desires nonlegal benefits, like reputational gains. Similarly, an obligational norm may provide a reason for acting in a certain way either because the actor has internalized the norm or because the actor fears external sanctions that result from noncompliance with the norm or desires external benefits that can be obtained by compliance with the norm.

1. *Internalized obligational norms*. Begin with internalized obligational norms. The economist Kaushik Basu usefully describes the operation of such norms in his discussion of what he calls rationality-limiting norms:

> A "rationality-limiting norm" means a norm which stops us from doing certain things or choosing certain options, irrespective of how much utility that thing or option gives us. Thus most individuals would not consider picking another person's wallet in a crowded bus. This they would do not by speculating about the amount the wallet is likely to contain, the chances of getting caught, the severity of the law and so on, but because they consider picking wallets as something that is *simply not done*.
>
> In traditional economics the 'feasible set' of alternatives facing an individual (from which the person makes his or her choice) is defined in terms of technological or budgetary feasibility. Thus a consumer's feasible set is the collection of all the combinations of goods and services that the consumer can purchase given his or her income. From the above discussion it should be evident that a rationality-limiting norm further limits the feasible set, because now certain alternatives may be infeasible to an individual not just because they are technologically infeasible "(like

walking on water) or budgetarily infeasible (like buying a Jaguar car) but because they are ruled out by the person's norms."[6]

Although Basu's description is apt, his nomenclature might be questioned. Basu employs the term *rationality-limiting norms* on the ground that "a person endowed with norms may forgo options which could have enhanced his utility and thus such a person would be considered less rational in terms of mainstream economics. Basically, such norms limit the domain over which the rationality calculus is applied."[7] Here Basu, like many economists, uses *rationality* to mean wealth-maximization, and seems to use *utility* in the same way. These meanings are unduly restrictive. Rationality is not equivalent to wealth-maximization, and utility is not equivalent to wealth. It is perfectly rational to forgo an increase in wealth by adhering to an internalized social norm or, for that matter, by engaging in conduct that is intellectually, creatively, or socially gratifying. Furthermore, as Cass Sunstein has pointed out, "[i]ndividual rationality is a function of social norms. The costs and benefits of action, from the standpoint of individual agents, include the consequences of acting inconsistently with social norms."[8] Because utility is not solely a function of wealth, actors often maximize their utility by taking actions that do not maximize their wealth. So, for example, an actor may maximize his utility by

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[6] Kaushik Basu, Social Norms and the Law, 3 *New Palgrave Encyclopedia of Law and Economics* 476, 477 (1998) (emphasis in original).

[7] Id. at 477.

[8] Sunstein, Social Norms and Social Roles, supra note 2.

keeping his promises or telling the truth, even in cases where breaking a promise or lying would maximize the actor's wealth.

Basu also doesn't address just why some things are simply not done. It's tempting to answer that question, even insofar as it applies to internalized norms, solely in cost-benefit terms -- specifically, internal costs and benefits. In the case of moral norms, the internal cost is the pain of guilt -- what Robert Cooter refers to as the "guilt penalty."[9] The internal benefit is the satisfaction an actor obtains from doing the right thing – the pleasure of rectitude.

However, an analysis in cost-benefit terms, although important, is insufficient. Moral norms, in particular, may operate by affecting an actor's *moral character*, so that his action follows from sympathy and commitment, to which psychological and external costs and benefits are not relevant or only marginally relevant. Martha Nussbaum has captured this point especially well:

> [Under a cost-benefit analysis, altruism] tends to be reduced to a type of egoism, in which people get reputational or psychic goods for themselves. For some time it has been influentially argued within economics that this approach is inadequate, even for predictive purposes: we need to recognize sympathy and commitment as independent sources of motivation. This is hardly a surprising claim, because it is one that has been argued throughout the history of Western philosophy -- starting . . . with Aristotle, who argued that people who die for their friends or family cannot plausibly be said to do so for satisfaction, because they are risking or forfeiting, in the process, all prospect of future satisfaction. A theory that focuses on satisfaction will therefore make bad predictions about what they will do. Recently these ideas have been receiving striking empirical confirmation: it has been

[9] See Cooter, Decentralized Law, supra note 2, at 1162.

> powerfully argued that economic theories could not have predicted that anyone would risk life, family, comfort, and reputation to rescue Jews during the Holocaust. And yet a significant number of people did.[10]

More generally, as Basu points out, for many or most actors in many or most situations internalized moral norms operate without a cost-benefit calculation, simply because that for those actors certain things (like picking pockets) are simply not done, while other things (like assisting the unsighted across the street) simply are done.

Obligational norms that are not moral norms may also be internalized, and the effects of such norms may be comparable to those of internalized moral norms. A major effect of internalized obligational but not moral norms is the way in which they shape an actor's *social character*. For regular Metropolitan Opera goers, not dressing formally for a premiere might be no more of an option than picking pockets.

This doesn't mean that cost-benefit analyses don't figure in the effect of internalized norms. They often do. In deciding whether to adhere to an internalized moral norm, an actor may weigh the pain of guilt and the pleasure of rectitude against the gain from nonadherence. In deciding whether to adhere to an internalized nonmoral norm, an actor may weigh the pain of shame and the pleasure of conformity against the gain from nonadherence. Thus, character may explain adherence to internalized norms by some actors, while the weighing of internal and external costs and benefits may explain adherence by others. Or, internal and external costs and benefits may figure for

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[10] Nussbaum, Flawed Foundations: The Philosophical Critique of (a Particular Type of) Economics, 64 U. Chi. L. Rev. 1197, 1211 (1997).

some actors some of the time. Having said that, however, it seems likely that most actors who have internalized an obligational norm will usually apply the norm naturally, as an expression of their character, rather than calculatingly, on the basis of a cost-benefit analysis.

2. *Obligational norms that are not internalized.* In contrast to internalized obligational norms, non-internalized obligational norms will be adhered to, if at all, only for instrumental reasons. Thus the effect of such norms in any given case will depend on a comparison of the immediate gains from nonadherence, on the one hand, with the long-term benefits of adherence and costs of nonadherence, on the other. The long-term costs of nonadherence involve loss of reputation, diminished esteem, public shame (as opposed to feeling ashamed), and disdain. The long-term benefits of adherence involve enhanced reputation, increased esteem, public recognition, and social acceptance. As shown by Eric Posner, adherence and nonadherence to obligational norms have signaling effects. Adherence to norms signal that one is a cooperator. Non-adherence signal that one isn't. An actor who develops a reputation as a cooperator may derive substantial benefits from the cooperation of others. An actor who develops a reputation as a noncooperator may not.[11]

3. *Oneness*. Often, the effect of obligational norms derives not, or not only, from an actor's internalization of a given norm on its own merits, or from the prospects of

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[11] See the work by Eric Posner cited supra in footnotes 1 and 2.

external benefits and costs, but from the actor's internalization of a metanorm that calls for adherence to the norms of a special group with which he feels at one. For example, an actor may derive great gratification and self-worth from membership in a special group that is working toward a shared end, or that shares a special ethos, that the actor believes to be important. In certain respects, membership in such groups simply sharpens some of the characteristic incentives to adhere to norms -- in this case, the norms of the special group. For example, the sanction of disapproval may be especially salient and effective in such a group. However, there is also a special internal benefit in adhering to the norms of such a group, just because they are the norms of the group -- the pleasures of belongingness, of acting in a special and good endeavor, and of surrendering narrow individuality to a larger cause.

B. Nonobligational Norms

There is a tendency in the legal and economics literature concerning social norms to focus on obligational norms.[12] It's easy to see why this should be so. In their work on legal rules, legal and economics scholars characteristically emphasize incentives and disincentives, and obligational norms, like legal rules, provide incentives and disincentives. However, obligational norms are not the only kind of social norms that can affect human conduct. Nonobligational norms can have this effect as well. In a

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[12] See, e.g., Sunstein, Social Norms and Social Roles, supra note 2, at 350. An important exception is Kraus, supra note 2.

memorable phrase, E.M. Jellinek referred to “the normative power of the actual.”[13] Jellinek here used “normative” in its obligational sense. What he meant is that regularities of practice take on a certain oughtness. Partly this phenomenon results from a respect for tradition. That respect need not be irrational. Traditional practices may be ways that have worked, that have stood the test of time, even if we are not entirely sure why any given traditional practice works.[14] There are other reasons for this phenomenon. Many regularities of practice give rise to expectations that they will continue to be followed. If these expectations seem justified to those who hold them, then a failure to follow the practice will be treated as a defeat of justified expectations. If a regularity of practice has been relied upon, then a failure to follow the practice will be treated as a defeat of justified reliance. Thus *is* easily becomes *ought*, and what begins as a practice may easily end as an obligation.[15]

Then too, many social norms have both nonobligational and obligational faces. For example, social scientists may treat the average age at marriage in a given group as a statistical regularity, while members of the group may feel obliged to marry before reaching that age. The posture and hand-signal used to hitchhike is a usage, but the usage may have an obligational effect if would-be hitchhikers find that if they try to hitch rides

[13] See Morris Cohen, The Basis of Contract, 46 Harv. L. Rev. 553, 582-83 (1933).

[14] See Robert Clark, Contracts, Elites, and Traditions in the Making of Corporate Law, 89 Colum.L.Rev. 1703 (1989).

[15] See Robert Axelrod, An Evolutionary Approach to Norms, 80 Am.Pol.Sci.Rev. 1095, 1107 (1986).

in other ways they won't get rides, either because they are misunderstood or because drivers don't want to give rides to unconventional people.

Finally, a focus on obligational norms overlooks that nonobligational norms may have an important effect on conduct by *permitting* certain behavior. For example, the norm of racial discrimination in the Jim Crow South might be conceived of as either an obligational norm, to the extent that it obliged even those whites who did not want to discriminate to do so, or as a nonobligational norm that (among other things) insulated those who engaged in discrimination from both outside criticism and self-criticism. Similarly, when smoking is a prevailing practice it will be socially permissible. When smoking is no longer a prevailing practice it may no longer be socially permissible.

C. Belief-Systems and Social Norms

Most legal and economic accounts of social norms are directed toward the dynamics that govern the adoption of social norms. Most of the models focus on external reasons for adhering to social norms, rather than on internal beliefs. Correspondingly, very little work has been done by legal and economics scholars on why particular social norms (other than rudimentary norms of cooperation, which are often in actors' self-interest) originate.

A major exception is the work of Robert Cooter, who focuses on three processes by which social norms are internalized: a Freudian process, in which the repressed memory of parental sanctions for childhood transgressions becomes transmuted into an adult superego; a Piagetian process, in which children perfect their ability to internalize

norms as they acquire a capacity for general reasoning; and a Weberian process, in which actors internalize the norms associated with occupational roles.[16] Cooter's emphasis on the processes by which norms are internalized is relatively unusual in the legal and economic literature on norms, and extremely important. However, each of these processes assumes the prior existence of the norms that are internalized through these processes, rather than explaining how and why particular social norms originate, or why adults internalize new social norms other than occupational role norms.

There is no simple, or at least no single, answer to these questions. Undoubtedly, some social norms, like the prohibitions on murder, theft, and incest, originate because they are necessary for societies to become viable. Others originate because they prove to be efficient and are therefore imitated.

Still other social norms originate because actors adopt a new belief-system that involves new views or new values, on the basis of new information, reasoned persuasion by other actors, or both. The process by which norms are originated and adopted through changes in actors' belief-systems is extremely important generally -- Isaac Berlin is reported to have said that what philosophers do in the privacy of their studies can change the course of history.[17] More to the point, the effect of belief-systems on social norms is of special importance in explaining the origin and adoption of many norms that are

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[16] See Cooter, Decentralized Law, supra note 2, at 1657-64.

[17] A.C. Grayling, Book Review [of Randall Collins, *The Sociology of Philosophies* (1998)], N.Y. Times Book Review, Sept. 27, 1998, at 20.

significant in corporate law.[18] Both for that reason and because this process has been little studied by scholars who have analyzed the role of social norms in the law, in this Article I will place heavy emphasis on the role of belief-systems in the origin and adoption of social norms.[19]

D. Tipping-Points and Equilibria

The behavior of actors often depends on their expectations of what other actors will do. In his book *Micromotives and Macrobehavior*,[20] Thomas Schelling gives a number of examples. A faculty seminar is begun. Whether it will succeed or die depends on whether the participants expect that enough other participants will continue to come. Pedestrians gather at a busy intersection, anxious to cross against the light. Whether they do so depends on whether each believes that enough additional pedestrians will cross so that a group sufficiently large to stop traffic will be formed. "The generic name for behaviors like this," Schelling notes, is "*critical mass*."[21] He continues, "What all of the critical mass models involves is some activity that is self-sustaining once the measure of that activity passes a certain minimum level."[22]

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[18] See text at notes xxx-xxx, infra.

[19] An exception, again, is Cooter, whose analysis includes a passage that points out that a smoker may be persuaded to quit smoking. See Cooter, supra note 2, at xxxx.

[20] Thomas C. Schelling, *Micromotives and Macrobehavior* (1978).

[21] *Id.* at 94 (emphasis in original).

[22] *Id.* at 95.

A special case of the critical-mass phenomenon is known as *tipping*. Tipping occurs when the success of a social activity depends on the formation of a critical mass, and enough actors sign on or sign off that the activity succeeds or fails. If enough actors sign on, the activity is tipped in. If enough actors sign off, the activity is tipped out. A consequence of the critical-mass and tipping phenomena is that the behavior of a relatively small number of actors can cause an activity to succeed or fail because the addition or subtraction of a few actors results in the crossing of a tipping-point.

What is true of social activities in general is often true of social norms in particular. Social norms may shift when, and because, enough actors change their behavior that a tipping-point is crossed. And because a relatively small number of crossover actors may cause a norm to tip in or out, social norms may shift relatively suddenly. The tipping-point for a social norm may be crossed for various reasons. For example, it may be crossed because some actors change their belief-systems about the desirability of adhering to a norm. Or, it may be crossed because actors who adhere to a norm increase their readiness to sanction actors who don't, and previously some nonconforming actors change their behavior to avoid these sanctions.

A phenomenon that resembles tipping-points occurs where a social norm is or can be radically changed by the defection of a very small number of actors -- perhaps even one or two. This phenomenon may occur because the norm reflects an equilibrium that depends on the fear of the consequences of departing from the norm, and a successful defection allays those fears. Or, it may occur because a successful defection shows that

departure from the norm opens up valuable opportunities. More generally, it is a familiar phenomenon that actors may be willing to change their course of conduct if, but only if, others act first. This phenomenon is not limited to shifts in social norms. In the common law, for example, the first overruling of an undesirable doctrine is often followed by a wave of additional overrulings.

E. Good and Bad Norms and Belief-Systems

As shown by the norm of racial discrimination in the Jim Crow South, it's crucial not to idealize social norms. There is an occasional tendency to view social norms as good, efficient, or both; in particular, to view social norms as a form of private action that does a better job of regulating conduct, just because it is private action, than governmental action. But social norms are not necessarily either good or efficient. They may be morally bad or at least insulate morally bad conduct from criticism, and they may promote inefficient behavior or at least insulate inefficient behavior from criticism.[23] Bad or inefficient norms may result from a variety of causes, including self-interest, inertia, and bad or inefficient belief-systems. Bad or inefficient belief-systems, in turn, may result from bad information or from persuasion that is founded on false premises or developed by fallacious or incomplete reasoning.

In short, it is important that social norms not be treated as intrinsically more desirable than legal regulation in governing conduct. Rather, the issues raised by social

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[23] See text at notes xxx-xxx, infra.

norms, for those interested in the law, are how social norms operate in a field that is within the scope of law; whether, in any given area, social norms potentially have advantages over legal rules in regulating conduct; and whether the actual social norms that prevail in an area are good or bad, efficient or inefficient.[24]

III. The Role of Social Norms in Corporate Law

I now turn now to the role of social norms in corporate law. I use the term *corporate law* here in a broad but standard sense to mean those areas of conduct that are within the scope of corporate law, and more generally those areas of conduct that are of ongoing concern to the corporate bar and to students of corporate law, including areas that are regulated only loosely or not at all by legal rules, such as the structure of the board and the role of institutional investors in corporate governance.

Often, the operation of social norms is at or near the surface of corporate law. For example, some corporate-law doctrines explicitly incorporate social norms. Thus the ALI's *Principles of Corporate Governance* provides that a corporation may take into account ethical considerations that are reasonably regarded as appropriate to the conduct of business, even if corporate profit and shareholder gain are not thereby enhanced.[25] My focus here, however, is on social norms that are not explicitly incorporated into legal

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[24] See Cooter, Decentralized Law, supra note 2; Posner, Law, Economics, and Inefficient Norms, supra note 2.

[25] ALI, Principles of Corporate Governance: Analysis and Recommendations § 2.01 (1992).

rules. I consider three central areas of corporate law: fiduciary duties (Section A), corporate governance (Section B), and takeover bids (Section C).

A. Fiduciary Duties

The major fiduciary duties of corporate actors are the duty of care and the duty of loyalty. The duty of care concerns the standards that apply to the conduct of corporate actors who are free of self-interest. My theses concerning the duty of care are as follows: The level of directorial care is largely driven by social norms, rather than by the threat of liability or the prospect of gain. Within the last ten years, an inefficient norm that licensed and insulated a low level of directorial care has been replaced by a more efficient norm that requires a higher level of care. This norm-shift was in significant part the result of belief-systems. The change in belief-systems, in turn, was partly induced by the expressive effect of legal authorities, which clarified and added moral force to the social norm of care.

The duty of loyalty concerns the standards that apply to the conduct of corporate actors who are not free of self-interest. My theses concerning the duty of loyalty are as follows: Adherence to the duty of loyalty is driven by both the threat of liability and moral norms. The legal rules in this area serve both regulatory and norm-supporting and -defining functions. Although the regulatory function of these legal rules is important, the moral norm of loyalty that the legal rules support and define is critical to the efficient operation of the duty of loyalty.

Standards of care and loyalty potentially apply to all major types of corporate actors, although often in somewhat different ways. I will focus on the application of the duty of care to directors and the application of the duty of loyalty to directors and officers.

I. The duty of care. Most observers of the corporate scene believe that the level of directorial care has risen significantly in the last ten years or so: that directors today are more attentive to their responsibilities, more ready to displace inefficient CEOs, more concerned about corporate structure, more active in setting agendas and determining corporate strategy, and so forth.

What has caused this shift to a greater level of care? Pretty clearly, it's not an increased threat of liability. It's true that during this period the meaning of the duty of care was greatly clarified and elaborated. *Smith v. Van Gorkom*[26] made clear that reasonable inquiry by a director was a condition to the invocation of the business judgment rule. The ALI's *Principles of Corporate Governance* formulated the first clear statement of the business judgment rule, as a special standard of review – that is, a rationality standard – and the conditions that had to be satisfied, including reasonable inquiry, before the special business judgment standard of review was applied.[27] *Cede v. Technicolor*[28] made clear that if the conditions to invoking the business judgment

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[26] 488 A.2d 858 (Del. 1985).

[27] ALI, Principles of Corporate Governance, supra note xxx, § 4.01.

[28] 634 A.2d 956 (Del. 1994).

standard of review were not satisfied, the standard of review is reasonability or some equivalent. The monitoring duty of the board was made explicit and strongly supported, first in *Francis v. United Jersey Bank*[29] and later and more comprehensively in the *Caremark* case.[30]

From a liability perspective, however, the developments during this period were overshadowed, if not overwhelmed, by the adoption of director-shield statutes that permit a corporation's certificate of incorporation to eliminate the liability of directors for violation of the duty of care. Delaware Section 102(b)(7) is typical. This section provides that the certificate of incorporation may include:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith which involve intentional misconduct or a knowing violation of law, (iii) [for improper distributions], or (iv) for any transaction from which the director derived an improper personal benefit.

It's true that the shield statutes have important exceptions. For example, the statutes typically don't apply to officers acting in that capacity. This exception, however, doesn't affect directors. In addition, the statutes generally concern only liability, not the validity of directorial action. There are many important validity contexts in which liability may not be at issue, but the standard of care will be; among the most important

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[29] 87 N.J. 15, 482 A.2d 814 (1981).

[30] In re Caremark International, Inc. Derivative Litigation, 698A.2d 959 (Del.Ch. 1796).

are the validity of decisions by disinterested directors to approve interested-director transactions or to take defensive actions against a takeover bid. The validity exception, however, doesn't reduce the statutes' protection against liability.

The statutes also typically have exceptions, like those in Delaware § 102(b)(7), for acts or omissions not "in good faith," or which involve "intentional misconduct," or the like. The meaning of these terms in this context will have to be developed by judicial interpretation, but a lot can be packed into the concept of good faith. In *In re RJR Nabisco,*[31] Chancellor Allen stated that an action by a director is not in good faith if it is based on "any human emotion [that] may cause a director to place his own interests, preferences or appetites before the welfare of the corporation" including "hatred, lust, envy, revenge, . . . shame or pride." In *Gagliardi v. Trifoods International Inc.*,[32] Chancellor Allen stated: "I include within the category of improper motivation those cases in which particularised claims of director entrenchment are made or in which, relatedly, transfers of corporate control by the board . . . are involved." In *Caremark,* Chancellor Allen stated that "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition

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[31] In re RJR Nabisco, Inc. Shareholders Litigation, (CCH) Fed.Sec.L.Rep. ¶ 94, 194, 1989 WL 7036 (1989).

[32] 683 A.2d at 1049 (199x).

to liability."[33] The meaning of "intentional misconduct" is also unclear. For example, a complete failure to act might be construed as "intentional misconduct" within the meaning of the statutes. The not-in-good-faith and intentional misconduct exceptions therefore somewhat diminish the protection the shield statutes afford against directorial liability for breach of the duty of care. Even when these exceptions are taken into account, however, the result of the shield statutes is to drastically reduce the threat of such liability. Accordingly, if directorial care was based solely on the threat of liability we would expect the level of care to have gone drastically down in the last ten years, rather than significantly up.

A possible incentive for care, even when there is no significant threat of liability, is the prospect of individual gain. However, directors' fees are normally unrelated to performance. Such fees are invariably uniform for all directors on a given board (subject, sometimes, to extra compensation for committee service), and indeed are relatively uniform among all corporations of given kinds. Extra care by a particular director is therefore unlikely to lead to increased compensation. In theory, extra care might lead to a greater number of directorships, but there is little or no data to suggest that most directors want to or do hold a number of directorships, or that there is a market for directors in which directorial care is appraised.

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[33] *Caremark*, at xxx.

Since the increased level of directorial care in recent years cannot be accounted for either by an increase in the threat of liability or by the prospect of gain, and since, indeed, the threat of liability has been substantially reduced if not virtually eliminated, it's difficult to avoid the conclusion that the level of directorial care is determined in significant part not by the threat of liability or the prospect of gain, but by social norms concerning the directorial role, and that the increased level of care is due to a shift in social norms concerning the directorial role.

What has led to this shift?

One factor may be the role of the media. The business press, like the general press, has become increasingly willing, and indeed eager, to report on the shortcomings of directors and officers. A juicy story about feckless directors on page one of the *Wall Street Journal* is the equivalent of a picture of Brad Pitt on the cover of *Vanity Fair*. The increased likelihood of such stories, with their consequence of shaming and the loss of esteem, may have been one factor in making directors more attentive.

Another factor is that directorial performance has come under closer scrutiny from institutional investors, who may either put direct pressure on directors or present another possible source of bad publicity.

But something else seems to be operating; that is, a change in the belief-system of the business community concerning the obligations associated with the directorial role. The issue then is what elements may have led to this change in the belief-system. One possible element was new information. Some of this information was provided by the

rise of the takeover-bid institution. The enormous discrepancy between takeover-bid prices and market prices conveyed the information that there was a lot of managerial inefficiency, and that something in addition to takeover bids needed to be done about it. The decline of such corporate giants as GM and Sears conveyed the same information.

The law may also have contributed to the change in directors' belief-systems. Recall that at the same time the shield statutes virtually eliminated liability for the director's breach of the duty of care, the courts were greatly clarifying the meaning of that duty. To understand the impact of this clarification, a distinction must be drawn between standards of conduct and standards of review. A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* is the test a court applies when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.

Typically, the elements of a standard of conduct and a correlative standard of review are the same. For example, the standard of conduct for an actor in driving a car is to drive carefully, and the correlative standard of review to determine whether liability should be imposed is whether the actor has driven carefully. In corporation law, however, the standards of conduct and review pervasively diverge. For example, in the area of duty of care the standard of *conduct* is "act reasonably," but the standard of *review* is often the much looser business judgment standard of rationality. Similarly, the elimination of liability under the shield statutes did not affect the director's standard of *conduct*, but only the *liability* for failure to adhere to that standard.

Although legal standards of conduct are characteristically accompanied by liability rules or other enforcement regimes, even a legal standard of conduct that is unaccompanied by such a regime may be effective because of its impact on social norms. While social norms differ from legal rules, there is often a symbiotic relationship between law and norms. On the one hand, legal rules are often based on social norms. On the other hand, many legal norms have an *expressive* effect -- that is, in addition to their regulatory effects, legal norms send messages of various kinds.[34] Adoption of a legal rule that is based on a social norm sends a message that the community regards the norm as especially important. Furthermore, legal rules add, to the force of a specific obligational norm, the force of the general norm of obedience to law, which is one of the most powerful social norms of our society.

Legal rules may also serve to clarify a social norm.[35] This has obvious relevance to the duty of care, because one function of the cases that clarify the meaning of that duty, especially in a directorial context, is to tell directors how to play their directorial role. Thus one way of looking at the change in the social norm concerning directorial care is that directors who once believed, as a result of an earlier prevailing practice, that they could properly satisfy the demands of the directorial role with minimal care, have been instructed by the courts -- or perhaps more accurately, by their lawyers -- that this1

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[34] See Sunstein, On The Expressive Function of Law, supra note 2.

[35] See Cooter, supra note 2.

view is wrong. Having been so instructed, directors who wanted to perform their role properly made appropriate adjustments in their conduct -- not necessarily to avoid liability, but just because they wanted to play their roles properly. Ed Rock, in a notable article,[36] shows how much of the Delaware case law on takeovers, and by extension the duty of care generally, can be understood as directed in significant part toward instructing directors on how to play their role in that context, and publicly admonishing those directors who failed to properly play that role.

Legal rules may also be effective, even without an enforcement strategy, because they facilitate the effectiveness of informal sanctions by norm-compliers against norm-violators. For example, Cooter points out that if smoking in public places like airports violates a social norm but not a legal norm, some norm-compliers will sanction smokers with words or looks, but others won't. If a legal rule is adopted to ban smoking in such places, many of the norm-compliers who previously had kept silent will now speak out. This effect may be especially important where a relatively small number of additional informal norm-enforcers may tip the balance in a way that makes norm violations too uncomfortable to be worth the trouble. (Correspondingly, the adoption of a legal rule, even without formal enforcement, can cause actors to correctly believe that there will be more social enforcement of the norm.[37]) This aspect of the effect of legal rules on social

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[36] Edward Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 U.C.L.A. L.Rev. 1009 (1997).

[37] Cooter, Decentralized Law, supra note 2, at 1673-74. See also Cooter, Expressive Law and Economics, supra note 2, at 595:

norms is particularly salient to the duty of care, because the development of the meaning of that duty in the case law gave institutional investors, the media, and, for that matter, fellow directors a better purchase for criticism of laggard directors.

The developments in the area of the duty of care illustrates both that descriptive norms can have significant consequences and that norms may be inefficient. Whether or not directors today are exercising maximum diligence, it's clear that they are exercising significantly more diligence than they were exercising twenty years ago. The prior social norm concerning the director's role was essentially the descriptive norm that directors don't do much. The effect of this norm was to permit a low level of directorial diligence by insulating directors who didn't do much from both external criticism and self-criticism.

B. The Duty of Loyalty

The duty of loyalty is a shorthand expression for the duty of fair dealing by, and the trustworthiness of, directors, officers, and controlling shareholders when they are financially interested in a matter affecting the corporation. A useful entry point into the

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> Perhaps enacting a law forbidding wrongdoing, without enforcing the law, can induce 76 percent of the actors to do right. If most citizens obey the law from respect, enacting the law without enforcing it can probably achieve the desired result. I have suggested that prohibiting smoking in American airports and requiring dog owners to clean up after their animals ("pooper-scooper" laws) work this way. Most people began to obey these laws as soon as they became aware of them. For the small recalcitrant group of lawbreakers, rude remarks by citizens and other informal punishments deter without state coercion.

relationship between law and social norms in this area is provided by an important article by Jonathan Macey and Geoffrey Miller.[38] This article was triggered by the Supreme Court's decision in *Basic, Inc. v. Levinson*,[39] which held that a corporation that denies that it is in merger negotiations violates Rule 10b-5 if the denial is false and the information is material.[40] Macey and Miller criticize this result. They begin by arguing, as others have, that from an economic perspective fiduciary principles are simply contractual devices:

> This economic perspective is important because it generates a mechanism by which courts can decide cases. In particular, when scrutinizing managerial behavior, courts should treat an allegation of a breach of fiduciary duty as they would treat any alleged breach of contract. This analytic method often is described as the "hypothetical bargain" approach. Under this approach to fiduciary duty, courts would evaluate whether the managers' actions were consistent with the terms of a hypothetical fully specified, contingent contract that informed, value-maximizing investors would have agreed to *ex ante*.[41]

Based on this perspective, Macey and Miller argue that lies by corporate officials should be exempt from liability if they are made with the good faith intention of furthering the shareholders' interests, and do not reduce allocative efficiency in ways that are not internalized by the corporation and create negative externalities. (An example of

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[38] Macey & Miller, Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory, 42 Stanf.L.Rev. 1059 (1990).

[39] 485 U.S. 224 (1988).

[40] The Court added that materiality in a merger context depends on the probability that the transaction will be consummated and its significance to the corporation if it was consummated.

[41] Macey & Miller, supra note xxx, at xxx.

a lie that they say would be impermissible under this rule would be a false statement that a corporation *is* involved in merger negotiations, where the purpose of the statement is to make it seem that the corporation is in play, and thereby increase the likelihood of takeover bids. Here, potential bidders would waste resources in sifting through false information disseminated by the corporation.)[42] Accordingly, Macey and Miller say, the issue that arose in *Basic* should have been resolved by asking whether a rational shareholder group would endorse a corporation's strategy of publicly and falsely denying that it was involved in merger negotiations. Based on this standard, Macey and Miller conclude, a corporation should be able to falsely deny that it is in merger negotiations, because nondisclosure facilitates merger negotiations, merger negotiations facilitate mergers, and mergers increase shareholder wealth.

There are important problems with the Macey and Miller analysis even taken on its own terms. One of these problem is that if the Macey and Miller rule prevailed, then whenever a corporation made a statement investors could not know whether, if the

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[42] Macey and Miller summarize their distinction between permissible and impermissible lies as follows:

> Thus, only nondisclosures and misrepresentations the costs of which are internalized by the firms making such nondisclosures and misrepresentations should be permitted. These will typically be strategic misrepresentations that cause share to trade at artificially low rather than artificially high prices. Misrepresentations that cause a firm's share prices to shift from an efficient level to an inefficient level will cause negative externalities and should be discouraged. On the other hand, misrepresentations or nondisclosures that allow the price of a firm's share to continue to trade at an inefficient level in order to preserve the confidentiality of corporate information should not be discouraged.

Id. at xxx.

statement was a lie, it was the kind of lie that would be permitted or prohibited under the Macey and Miller rule. Since the Macey and Miller rule isn't limited to statements concerning merger negotiations, investors would have to discount all corporate statements, because they might be permissible lies. Discounting all corporate statements, however, would make the market significantly less efficient, if not positively inefficient, which would be bad for shareholders as a class.

Another, related point is made by Ian Ayres. Assuming that a rule that permitted a corporation to lie was a default rule, then a corporation could vary the rule by committing itself to honesty. If a corporation didn't commit to honesty, the market would simply assume that any statements the corporation made were dishonest. This in turn would induce all corporations to commit to honesty, which would bring us back to where we are now.[43]

The most fundamental problem with the Macey and Miller analysis, however, is that it ignores the expressive function of law. If the Macey and Miller rule was adopted, the message that the law would send is that there is nothing wrong with lying; that truth-telling is valued not for its own sake, but only instrumentally. Such a message would significantly diminish the force of the social norm of truth-telling. Just as the law can add to the force of an obligational norm by throwing its support to the norm, so it can reduce the force of an obligational norm by withdrawing support. Even if the result of

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[43] Ayres, Back to Basics: Regulating How Corporations Speak to the Market, 77 Va. L. Rev. 945 (1991).

sanctioning lies was good for shareholders in their shareholder capacity, therefore, it would be bad for society, and shareholders are members of society.

There is also a strictly economic reason why the law should not send such a message. The corporate system operates most efficiently where corporate actors act loyally -- that is, deal fairly and in a trustworthy manner -- and are perceived to do so. One way to achieve loyalty is by legal sanctions. This way is very expensive and probably has limited effectiveness, taken alone, because of the difficulty of detecting breaches of the duty of loyalty, and the cost of legal enforcement. A second way to achieve loyalty is to install intracorporate monitoring and bonding systems. This way is somewhat more effective than a legal regime alone, but it is also very expensive -- and the more effective, the more expensive.

In contrast, the operation of the social norm of loyalty is very inexpensive. Of course, if the loyalty norm is adhered to only because the actor fears reputational sanctions, the problem of detection remains significant. Drawing on terminology used by Bruce Chapman,[44] I will refer to loyalty that is based on an internalized norm -- particularly a norm that shapes character -- as *authentic*, and to loyalty that is based on reputational concerns as *instrumental*. Instrumental loyalty is good, but authentic loyalty is better. Instrumental loyalty will be forthcoming only when disloyalty is easy to

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[44] Chapman, Trust, Economic Rationality, and the Corporate Fiduciary, 43 U. Toronto L.J. 547 (1993).

observe. Authentic loyalty will be forthcoming even when disloyalty is difficulty to observe.

To put the extreme case, if all corporate actors fully internalized the social norm of loyalty and gave full effect to that norm, the costs of both legal sanctions and monitoring-and-bonding systems would be unnecessary, and the levels of loyalty would be much higher than those sanctions and systems can achieve. Accordingly, whatever the law does do to increase the force of the social norm of loyalty, and further its internalization, will lead to greater efficiency and will therefore benefit shareholders as a class. Whatever the law does to diminish the force of the social norm of loyalty, and lessen its internalization, will have the opposite effect. Therefore, even taking the interests of shareholders as a class, apart from their interests as members of society, a legal regime that promoted the view that the social norm of loyalty is only instrumental, and thereby diminished both the force of the norm and its internalization, would reduce the efficiency of the corporate system.

What is true of the corporate system in particular is also true of the economic system in general. As stated by Casson:

> Overall economic performance depends on transaction costs, and these mainly reflect the level of trust in the economy. The level of trust depends in turn on culture. An effective culture has a strong moral content. Morality can overcome problems that formal procedures – based on monitoring compliance with contracts – cannot. A strong culture therefore

reduces transaction costs and enhances performance – the success of an economy depends on the quality of its culture.[45]

An analogous objection applies to the conception, adduced by Macey and Miller in support of their argument, that the duty of loyalty is contractual. One problem with this conception is that it is factually incorrect. The duty of loyalty is seldom if ever imposed by a contract. Directors and officers do not agree that they will be bound by a duty of loyalty. Instead, the duty is imposed by law. As stated in *Guth v. Loft*, "A *public policy*, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty. . . ."[46]

It's true that the duty of loyalty, and the corresponding rights it creates, may be limited in certain respects by agreement. However, that a right or a duty may be limited by agreement doesn't make the right or duty contractual. For example, the general duty to exercise reasonable care can be contracted around, within certain limits,[47] but that doesn't make the law of negligence contractual. Similarly, the right to a jury trial can be waived, but that doesn't make the Sixth Amendment contractual. Nor is a right or a duty contractual because it is imposed on the basis of what courts or legislators believe the parties would want to do if they had addressed the issue. Even rules governing

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[45] Mark Casson, *The Economics of Business Culture: Game Theory, Transaction Costs, and Economic Performance* 3 (1991) as quoted by Cooter, supra, note xxx, at 1661.

[46] 23 Del.Ch. 255, 270, 5 A.2d 503, 510 (1939) (emphasis added).

[47] See Restatement (Second) of Torts, § 496B & Comment.

nonconsensual transactions, like the rules of tort law, could be justified on that basis. Furthermore, if the duty of loyalty was contractual, it would follow that the duty could be completely waived by agreement. Generally speaking, however, it cannot be.[48]

A more fundamental problem with the contractual conception of the duty of loyalty is that the critical role of trust in the success of the corporate system would be significantly undermined if the law sent a message that the duty of loyalty was merely a contractual duty, not a duty imposed by law. As Bruce Chapman has stated:

> Competitive corporate contracting cannot achieve all that this [*contract*] view . . . promises unless it is aided by the very value that a contractual understanding of the fiduciary obligation denies, namely, the duty of loyalty and trust. Trust plays an essential role in all modern economies, and without it, or without the coordination that is provided by institutional loyalty, even efficient wealth-maximizing corporate contracting can make us all worse off. . . . Nor can the concept of trust be very easily accommodated into the contractual model of the corporation. Properly interpreted, the concepts of trust and loyalty present a deep challenge not only to that contractual model, but also to the very conventions of instrumental rationality upon which the model is based.[49]

In short, the duty of loyalty is almost never the result of a real contract, and the adoption by the legal system of the contractual conception of the duty of loyalty, like the adoption of an instrumental conception of truth-telling, would disserve efficiency interests.

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[48] See, e.g., Del. Gen. Corp. Law § 102(b)(7); ALI, Principles of Corporate Governance § 5.09.

[49] Chapman, supra note xxx, at xxx.

Another role of the social norm of loyalty is to up the ante for violating the legal duty of loyalty even for those corporate actors who have not internalized the duty. Generally speaking, the legal sanctions for violating *legal* duty-of-loyalty rules are inefficiently low. The primary legal sanctions are rescission and restitution. Normally, however, these sanctions only put the fiduciary back to where he would have been if he had not violated his duty. Because not all violations will be detected, a fiduciary whose only objective was to maximize his wealth, and who feared only legal sanctions for violating the duty of loyalty, would have an incentive to violate the duty -- for example, by taking a corporate opportunity, or dealing unfairly with the corporation in a self-interested transaction. If the violation is undetected, the fiduciary comes out ahead. If it is detected, the fiduciary is normally no worse off, under the legal sanctions, than he would have been if he hadn't violated his duty.

Therefore, if the only reason for not violating the duty of loyalty was the prospect of a legal sanction, fiduciaries would regularly violate that duty. (Although it's true that additional legal sanctions are sometimes granted -- for example, loss of salary or punitive damages -- these sanctions are atypical, and it's therefore doubtful that the prospect of such sanctions, discounted by the likelihood that they will be granted, change the picture that much.) The social norm of loyalty, however, adds the sanction of loss of reputation to the legal sanction. Because the legal sanction is set at an inefficiently low level, the increase in sanctions provided by the social norm is necessary if the total sanctions for breach of the duty of loyalty are to approximate an efficient level.

In the case of the duty of care, the present posture of the law is essentially to support the social norm of care with a legal standard of conduct that is unaccompanied by an enforcement strategy. In the case of the duty of loyalty, the legal rules *are* accompanied by an enforcement strategy. Thus the legal rules in this area achieve their ends partly by regulation and partly by the support they give to social norms. The latter, expressive function of the legal rules in the loyalty area is analogous to the expressive function provided by many other legal rules. However, the expressive function of the legal rules of loyalty has a special cast, because those rules not only support the norm but make it operational and meaningful through concretization.

In this connection, McAdams draws a useful distinction between general norms, like "friends should be loyal," and concrete norms, like the obligations "to listen attentively to a friend's troubles, to water her plants when she is away, to drive her home when she is intoxicated, and so on."[50] "Narrow, concrete norms," he points out, "often define the *meaning* of a specific behavior by defining that behavior as complying with or violating an internalized abstract norm. Thus, an antilittering norm may work because a consensus arises that littering violates the internalized norm to be a 'good neighbor.'"[51]

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[50] See McAdams, supra note 2, at 382.

[51] Id. at 383 (emphasis in original).

An important kind of case to which the distinction between general and concrete norms is relevant consists of norms about how particular social roles should be played:

> One social role many in our society internalize is that of "parent"; many feel guilt if they believe they fail to be a "good" mother or father. Like most abstract norms, the vagueness of these obligations makes them easily internalized but provides little concrete behavioral guidance. Yet concrete . . . norms give many meanings to this obligation: in some communities, the consensus dictates that a "good parent" reads to his or her children, teaches them table manners, takes them to church, and provides them with a "safe environment."[52]

Similarly, a general duty of loyalty is one thing; a web of specific duties that particularize that general duty is another. Few if any philosophers specialize in delineating the meaning of loyalty in the corporate context. Rather, it is the courts that have made the general principle of loyalty fully meaningful by spinning out the principle, through reasoned elaboration, into specific rules governing such matters as the fairness of self-interested transactions, disclosure, corporate opportunities, the use of corporate assets, and so forth. Once these rules have been developed, they serve to support the social norm of loyalty in a variety of ways -- for example, by giving clarity to the norm, by providing a focal point around which overlapping norms can cohere, and so forth. These messages, in turn, are amplified by corporate codes of conduct, in which the specific rules of loyalty are spelled out, and by stories in the business media that discuss particular transgressions. Thus in the loyalty area, the specific rules that courts develop

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[52] Id. at 407-08. McAdams uses his distinction to illustrate his "esteem" theory of norms, but the distinction is applicable even where norms have an effect for reasons other than the desire for esteem.

simultaneously regulate the conduct of corporate actors and are transmuted into social norms concerning the conduct of corporate actors.

The role of the law in developing specific social norms in the loyalty area is important in itself. It also bears on the role of shareholder suits. For at least fifty years, shareholder suits have come under criticism based on cost-benefit analyses that purport to show that the financial benefits of such suits are on average less than their costs.[53] Most or all of these studies are technically flawed,[54] but I put that to one side. The most basic problem with these studies is that in calculating benefits they count only direct financial benefits. This approach ignores two of the most important benefits of shareholder suits. The first, and most obvious, is their deterrent effect. The second, and even more important, benefit is that it is through shareholder suits that the specific legal rules of the duty of loyalty have been shaped. Those legal rules, in turn, have given specific meaning not only to the legal duty of loyalty, but to the social norm of loyalty. The social norm, in turn, provides an extremely effective and low-cost way to achieve loyalty. Thus shareholder suits, whatever their short-term purpose and result, have the long-term result of creating an extremely valuable public good. The desirability of such suits cannot be measured without counting the value of that good.

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[53] See, e.g., Franklin Wood, *Survey and Report Regarding Stockholders Derivative Suits* (1944); Robert Romano, The Shareholder Suit: Litigation Without Foundation?, 7 J.L.Econ. & Org. 55 (1991).

[54] See, e.g., William L. Cary & Melvin A. Eisenberg, Corporations: Cases and Materials 1126-29 (7th ed. 1995); William L. Cary & Melvin A. Eisenberg, Corporations: Cases and Materials 928-31 (6th ed. 1988).

B. Corporate Governance

I now turn to issues of corporate governance, first at the management level and then at the ownership level. In each of these areas there has been a relatively sudden shift in the governing norms: in the former area, from a managing board to a monitoring board; in the latter, from passivity to activity on the part of institutional shareholders. Each of these shifts in norms resulted in significant part from a change in the belief-systems of the relevant corporate actors, and each illustrates the manner in which norms can shift relatively suddenly once a tipping-point is reached.

1. *The Monitoring Board.* Until about twenty years ago, the dominant model of the board was that the board was responsible for managing the business of the corporation.[55] This model was hopelessly unrealistic, because part-time directors cannot manage the business of, or even set business policy for, a complex enterprise.[56]

Today, the managerial model of the board has been supplanted by a monitoring model. The monitoring model recognizes that the business of a publicly held corporation is managed by its full-time executives. Under the monitoring model, therefore, the primary functions of the board of a publicly held corporation are, not to manage the business of the corporation, but to select, regularly evaluate, fix the compensation of, and,

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[55] See Melvin A. Eisenberg, *The Structure of the Corporation* xxx (1974).

[56] See id. at 140-48.

where appropriate, replace the senior executives, and to monitor the conduct of the corporation's business to evaluate whether the business is being properly managed.[57]

This functional component of the monitoring model is complemented by a structural component. If the board has the function of monitoring the senior executives, it must be structured to effectuate that function. Effectuating that function requires that the board consist of at least a majority of directors who are independent of the senior executives, and that the board have audit, nominating, and compensation committees composed exclusively of such independent directors.[58] I will refer to boards that have this structure and perform the monitoring function as monitoring boards.

Today, the monitoring model of the board has been almost universally accepted and adopted in large publicly held corporations. Ultimately, the acceptance and adoption of the monitoring model of the board rests on its perceived economic advantage in providing an additional system to monitor the efficiency of management -- in particular, of the CEO. The monitoring board, taken alone, is an imperfect mechanism to achieve that end, but because all systems to monitor the efficiency of the management of publicly held corporations are imperfect, it is important to construct a web of overlapping and even redundant monitoring systems. The monitoring board is one important part of that web.

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[57] See, e.g., ALI, Principles of Corporate Governance: Analysis and Recommendations §§ 3.01, 3.02 (1992).

[58] See, e.g., ALI, Principles of Corporate Governance §§ 3.05, 3A.02 - 3A.05.

However, the monitoring model would have made as much economic sense twenty years ago as it does now. The significant question then is not why the monitoring model has been widely accepted and adopted, but why has it only *recently* been widely accepted and adopted -- that is, why a social norm that is efficient now, and would have been efficient then, wasn't adopted then? As in the case of the duty of care, the answer in large part is that there was a shift in the belief-systems of the relevant actors. The business community, the investment community, the bar, and the bench came to believe that the monitoring model was important, and acted accordingly.

To begin with, the business community accepted the monitoring model. Thirty years ago, many prestigious corporations had few or even no independent directors, and the audit and especially the nominating committee were still in early days. Now, the situation has completely turned around. The business community's widespread acceptance of the model is evidenced not only by actual practice, but by that community's statements on best practice. For example, The Business Roundtable, which consists of the CEOs of 200 American corporations, including most of the largest corporations, has issued several statements on corporate governance, each of which has included a strong endorsement of the monitoring model.[59] At this point, the monitoring model is not only endorsed by the business community, but virtually taken for granted.

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[59] Business Roundtable, Statement on Corporate Governance (September 1997); Business Roundtable, Corporate Governance and American Competitiveness, 46 Bus. Law. 241 (1990); Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 Bus. Law. 2083 (1978).

Similarly, the investment community came to believe in the economic value of monitoring boards, and began to put pressure on corporations that did not adopt it. Boards that do not adopt the monitoring model are subjected to severe criticism by institutional investors, and are publicly derided in forums like *Business Week*'s annual list of the twenty-five worst boards, CalPers's annual list of underperforming companies, and a list of turkeys issued by the Council of Institutional Investors.

The corporate bar also came to believe in the efficiency of the monitoring board, and transmitted that belief to the business community, partly through the ALI's *Principles of Corporate Governance*[60] and the ABA's *Corporate Director's Guidebook*.[61]

Finally, decisions of the Delaware courts over the last fifteen or twenty years provided an incentive for adopting the monitoring model, by making clear that in duty-of-care, duty-of-loyalty, and takeover cases very heavy weight would be put on process considerations, and that the structure of the board, and the way that structure found expression in the particular case, was a very important process consideration. Indeed, many of the Delaware cases in the last fifteen or twenty years concerning the duty of care, the duty of loyalty, and takeover bids can be viewed in significant part as corporate-governance cases.[62]

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[60] See ALI, Principles of Corporate Governance §§ 3.01, 3.02.

[61] ABA Section on Business Law, Corporate Director's Guidebook, xxx Bus. Law. Xx (19xx).

[62] See, e.g.,

It could be argued that this legal stimulus, rather than a change in belief-systems, caused the change in board norms. Certainly the regulatory aspects of these cases contributed to the adoption of the new norm, but it is not a full explanation. The criticism that institutional investors and the media level at corporations that have not adopted the monitoring model is not based on liability concerns. The promotion of the monitoring model by the Business Roundtable, the ABA, and the ALI is not based on liability concerns. Furthermore, an explanation of the new norm based solely on the regulatory effect of Delaware decisions would fail to explain what led the Delaware courts to reach these decisions. Judicial decisions don't drop from clouds. They are, to a significant extent, the product of the same belief-systems that motivate private actors.

What then caused the shift in belief-systems concerning board function and structure? One possible reason is simply that the relevant communities were persuaded by a new idea. Not too long ago, the dominant concept was that the board had the function of directing the business of the corporation, not of monitoring management. The new monitoring idea may have been taken up partly because it struck the business community, the investment community, the bar, and the courts as markedly better than the old idea.

Another possibility is that the information concerning managerial efficiency that was transmitted by the spread between takeover-bid prices and market prices affected not only belief-systems concerning the individual director's duty of care, but also belief-systems concerning the functions and structure of the board.

It might be objected that acceptance of the monitoring model did not result from a change in belief-systems, but from new efficiency considerations. However, such an objection would be hard to sustain. One possible story would be that until twenty years ago all managements were highly efficient, and a monitoring board was therefore unnecessary. Then, managers became inefficient and monitoring a board became necessary. This story seems highly unlikely.

Another possible story would be that the institution of takeovers, coupled perhaps with an upsurge in foreign competition, required corporations to be managed more efficiently than they had been before. But that wouldn't be a story showing that the monitoring board wasn't needed twenty years ago. Instead, it would be a story that inefficiencies that were tolerated up to twenty years ago were no longer going to be tolerated. That story would leave us where we started from: A mechanism that is efficient now, and would have been equally efficient then, wasn't adopted then.

An important implication of this history is that it suggests that the governance structures in place at any given time are not necessarily the most efficient structures. This suggestion is in line with recent work by Mark Roe,[63] Michael Klausner,[64] Marcel

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[63] Mark Roe, Chaos and Evolution in Law and Economics, 109 Harv.L.Rev. 64 (1996).

[64] Michael Klausner, Corporate Law, and Network of Contracts, 81 Va.L.Rev. 757 (1995).

Kahan,[65] Jody Kraus,[66] and others on elements such as path dependence, network externalities, and the theory of cultural evolution. However, the problem does not reflect only those elements. Board structure involves a significant conflict of interest, because a CEO will normally prefer not to be monitored. It took a certain amount of weight on the other side of the scale to overcome this conflict-of-interest preference. This weight needed to build up until it reached a tipping point, through the accumulation of changes in belief-structures and outside pressures that were themselves based on those changes. Once the tipping point was reached, the result was a relatively sudden widespread acceptance and adoption of the new norm.

The monitoring-board model is an obligational norm, in that publicly held corporations that deviate from the model are subject to criticism. It is, however, an unusual kind of obligational norm. On its face, it seems to apply to institutions, rather than to individuals. Furthermore, most obligational norms involve interactions between actors. In contrast, on its face the obligation of the monitoring-board norm seems to concern only how the corporation should organize itself, rather than how it should interact with other actors.

[65] Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate contracting, 83 Va.L.Rev. 713 (1997).

[66] See Kraus, supra note 2.

The apparently paradoxical nature of this norm, and of other like institutional norms, can be resolved in two steps. The first step is to disaggregate the corporation into managers (including, for this purpose, directors) and shareholders. The second step is to invoke the obligational norm that managers should manage the corporation in the interests of the shareholders. If it is accepted that the monitoring board is an important instrument to serve the interests of the shareholders, then directors who fail to adopt the monitoring model have violated the latter, *individual* obligational norm.[67]

B. Institutional Investors

I now turn to developments in governance at the shareholder level. The most important development at this level is the dramatically increased activity of institutional investors. Twenty or thirty years ago, the basic norm that governed institutional voting a norm of passivity, reflected in part in the Wall Street Rule: If you don't like management, sell; if you don't sell, support management. Under the passivity norm,

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[67] Now that the monitoring model has been accepted as a norm, we can observe a cluster of other, evolving norms that rest on the foundation of the monitoring model. Some of these norms are well along in the evolutionary process and have either taken hold or are taking hold. Others are in early stages, and may or may not flourish.

One of these emerging norms is the treatment of the body of independent directors as a de facto corporate organ. For example, the General Motors Board of Directors Corporate Governance Guidelines provide that the outside directors of the board will meet in executive session three times each year, and that decisions on matters of corporate governance presumptively will be made by those directors. The new CalPers Corporate Governance Guidelines also call for the independent directors to meet periodically as a group. The Principles of Corporate Governance provide that independent directors should be entitled, acting as a body to retain legal counsel, accountants, or other experts, at the corporation's expense, where required for the proper performance of the independent directors' functions and powers. A related emerging norm is the concept of a lead outside director, which is adopted, for example, in the GM Guidelines and the CalPers Corporate Governance Guidelines.

taking sides against management -- voting against management proposals, supporting shareholder proposals, selling into tender offers, and so forth -- "wasn't done."

To a certain extent, the passivity norm reflected an efficiency element: Collective action by dispersed shareholders was difficult to achieve, and if some but not all shareholders were active, they would bear all the costs, while the passive, free-riding shareholders would participate in the benefits.

However, it's easy to overemphasize this element. For example, many issues that come before shareholders require little cost to evaluate. And some issues come before shareholders in a recurring way -- for example, proposals concerning anti-takeover provisions -- so that the effort required to analyze the first such proposal can be amortized over a number of like proposals. The passivity norm was not driven only by an efficiency element, but by conflicts of interest on the part of institutional investors. For example, bank *B*, which holds stock in Corporation *C* as a trustee, may also have, or seek to have, a commercial relationship with Corporation *C*, which would be jeopardized if *B* voted the stock it holds against a management position. The passivity norm also reflected a cultural attitude. The managers of institutional investors are themselves typically managers of business entities, and siding with managers came more naturally to them than siding with shareholders.

In contrast to the time, not that long ago, when the dominant norm was one of passivity, today institutional investors, or many of them, stand ready to and periodically do vote against management proposals and for shareholder proposals, are willing to sell

into tender offers, often pressure management to take specific actions, and sometimes act to achieve changes at the top management level. I will refer to this mix of conduct as the *activity norm*.

Like the shift to the monitoring board, the shift from the passivity norm to the activity norm arose for efficiency reasons. Indeed, institutional activity is itself a form of monitoring – shareholder monitoring of corporate structures, management proposals, and managers. Institutional monitoring, like board monitoring, is imperfect, but it is important because of the need for overlapping systems when each system is imperfect.

But why is the norm of institutional activity only a recent development? To some extent, the shift in the governing norms can be accounted for by legal and economic developments. On the legal side, in the 1980s the Department of Labor, which administers ERISA and therefore has jurisdiction over pension funds, issued various letters and interpretive bulletins that made it clear that the fiduciary duties of trustees who manage pension-fund assets include not only investment decisions but voting decisions.[68] This position had a direct bite on pension-fund managers. It also had an indirect bite on mutual-fund managers, because under the Investment Company Act and the Investment Advisers Act, investment companies and their advisers also have fiduciary obligations.[69]

On the economic side, a number of developments have lowered the cost of institutional activity. One of these developments is a significant increase in institutional

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shareholdings. Another is the creation and growth of infrastructures that facilitate institutional activities. Chief among these infrastructures are research-and-analysis and proxy-advisory organizations, such as Investors Responsibility Research Center (IRRC) and Institutional Shareholders Services (ISS). These organizations provide a variety of services to institutions, including analysis of the subject-matter of issues that are up for a vote and advice on voting. The development of this kind of infrastructure institution has allowed institutional investors to form a kind of de facto research-and-analysis coalition by pooling their funds through the fees they pay to these organizations. This infrastructure reduces the cost of making voting decisions and reduces free riding. Furthermore, portfolio corporations must be sensitive to the views of these organizations in formulating management proposals and dealing with shareholder proposals.

A second infrastructure is the Council of Institutional Investors (CII), an organization of institutional investors. CII addresses investment issues that affect the size or security of pension-fund assets. It allows institutional investors to form a de facto coalition to address substantive interests of common concern, such as board and committee composition and functions, dual-class voting structures, takeover defenses, and the structure of compensation arrangements. CII reduces the collective-action and free-rider problems by coordinating or representing member institutions when such issues become salient in particular companies held in member portfolios. The bulk of CII's membership consists of public-pension and labor-pension funds, but some very large private-pension funds, such as the Coca-Cola and MacDonald's funds, are also members.

A third infrastructure consists of shareholder-proposal entrepreneurs, who provide focal points for tacit coalitions of institutional investors. Shareholder-proposal activists are not new. The Gilbert brothers were making shareholder proposals forty years ago. But the Gilbert brothers, and others like them, were by and large not trying to build coalitions, although of course they welcomed support. In contrast, shareholder-proposal entrepreneurs, the most notable of which is Investors Rights Association of America, are skilled at crafting proposals that are designed to, and do, attract a coalition of institutional investors. The beauty of this kind of infrastructure, from an institutional-investor point of view, is that the coordination is more implicit than explicit. Accordingly, If a shareholder proposal can be crafted that will attract a number of institutional votes institutions can coordinate at extremely low cost without directly communicating.

On another front, the 1992 amendment to the Proxy Rules made it less expensive for institutional shareholders to stake out public positions and to communicate with each other.[70] As a result of these amendments, in 1993 *The Economist* reported that "in this year's lone battle of any consequence [the fight to separate the jobs of chief executive and chairman at Sears, Roebuck, the] United Shareholders Association, a group of small shareholders, plans to contact the company's 1,000 largest shareholders, who have around 70% of the votes. This will cost $5,000-10,000. Under the old SEC rules, which obliged

[70] See Coffee, The SEC and The Institutional Investor: A Half-Time Report, 15 Cardozo L.Rev. 837, 840-41 (1994); Pitt, Steinwurzel, Weinstein & Renzi, Proxy Reform: A New Era of SEC Activism, Insights, November 1992 at xxx.

the association to contact all shareholders if it lobbied more than ten, the exercise would have cost [$1 million]."[71]

The percentage of stock held by institutional investors has also increased. This may be relevant because if individual investors tend to be passive because their stakes are so small and their expertise so limited, then it may not be worthwhile for institutional investors to be active unless there is a critical mass of such investors that can be mobilized to support a given position.

In short, the shift in the norm of institutional activism can be explained in part on the basis of liability and economic developments. However, these elements don't seem sufficient, taken alone, to explain the shift from the passivity norm to the activity norm. For example, the Department of Labor's efforts in this area, while significant, have not been accompanied by an important enforcement regime, and in any event directly affect only certain kinds of institutional investors. The provision of infrastructures can be seen as an effect, as well as a cause, of an increased willingness on the part of institutions to be active.

Similarly, although it's true that the percentage of stock held by institutional investors has increased, this factor doesn't seem sufficient to explain the shift in norms. Exact data on the percentage of stock held by institutional investors is notoriously difficult to pin down, and reported percentages vary from source to source. I will use the

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[71] American Corporate Governance: The Shareholders Call The Plays, The Economist, April 24, 1993, at 83.

Federal Reserve Flow of Funds Accounts as reported by the New York Stock Exchange in its booklet *Shareownership*, partly because my major interest here is in historical changes, and even assuming that there are somewhat more accurate measures than the Flow of Funds Accounts (which is not at all certain), that data is presumably internally consistent in its methodology from year to year, so that the rate of change should be reliable even if the percentages reported for each year are slightly too high or too low.

According to this data, institutions held approximately 50% of all corporate stock in 1987, around the time when the norm began to shift, and this figure has stayed fairly constant. But in 1974, almost 25 years earlier, institutions held only 20% less of all corporate stock -- 41% rather than 50%. And as far back as 1969, institutions held 31% of corporate stock. Moreover, these figures understate the amount of publicly held stock held by institutions, because they represent the percentage of all stock so held, not merely publicly held stock. The New York Stock Exchange estimates that this understatement is around 10%. Making that adjustment in the data, institutions held around 46% of publicly held stock as far back as 1974, which corresponds with an estimate made by the New York Stock Exchange that in that year institutions held 45% of stock listed on that Exchange.[72]

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[72] Data assembled by the Conference Board reports a lower level of percentage of total stock held by institutions, but the rate of change is not that different. For example, the Conference Board reports 44% ownership in 1988, against Federal Flow of Funds ownership of 49%, and 34% in 1980, against Federal Flow of Funds ownership of 39%.

To fully explain the shift in the norm, therefore, two other factors must be added to the mix. The first -- once again-- is the rise of the takeover institution. In the face of tender offers at prices well above the market value of portfolio stocks, institutional investors who had always sided with management often found themselves opposing management. Once the passivity norm was breached in this way, it became easier to breach it in other ways.

The second factor was a change in the demography of institutional investors, consisting of the dramatic rise in the relative percentage of institutional shareholdings held by public-pension funds. The passivity norm reflected both the conflicts of interests of institutional investors and the cultural attitudes of their managers. Although the public-pension funds are not completely free of conflict-of-interest problems, their conflicts of interest with managers are much less severe than the conflicts of most other institutional investors, and their cultural outlooks are not the same as managers of private entities. As a result, the public-pension funds are able to get out in front on wealth-enhancing issues. Managers of more conflicted institutional investors, who might be uncomfortable getting out in front, often feel less discomfort in following behind. Thus the leadership of public-pension funds sparked what Jeff Gordon has aptly called the latent activism of other institutional investors.[73]

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[73] Jeffrey N. Gordon, The Shaping Forces of Corporate Governance in The United States, 31 U.Richmond.L.Rev. 1473, 1789 (1997).

At the same time, the expressive effect of the DOL's letters and interpretive bulletins, even in the absence of a vigorous enforcement apparatus, made the passivity norm hard to justify. Managers of many institutional investors also became persuaded that at least some actions at the shareholder level, such as the elimination of poison pills or the rejection of poorly designed mergers, could add value to portfolios. The combined weight of liability and economic changes, on the one hand, and changes in belief-structures resulting partly from changes in demography, built to a tipping-point that moved institutional investors relatively quickly from the passivity norm to the activity norm.[74]

VI. Takeover Bids

Until the mid-1970s, hostile takeover bids were not of overarching significance. After that time, the institution of hostile takeover bids exploded and, in tandem with increased foreign competition and drastic changes in information technology, significantly altered the manner in which American businesses were managed. What caused the change?

Hostile takeovers were far from unknown before the mid-1970s. Indeed, by that time they were regulated on the federal level by the Williams Act, which had been

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[74] The norms governing the *subject-matter* of institutional-investor interest have also changed significantly in the last twenty years. Institutional investors first moved to more active voting decisions. Next, they moved to assessing corporate governance structures. The latest move has been toward assessing management and management policies. The change in the subject-matter of institutional-investor interest, in turn, has been accompanied by a change in the modalities through which these interests is expressed. Proactive consultation has come to join shareholder voting and purely reactive consultation.

adopted in 1968. However, prior to the mid-1970s the social norms of the members of the business, financial, and legal establishment were strongly opposed to hostile takeovers. In general, establishment corporations would not make hostile tender offers, establishment investment bankers would not assist in hostile tender offers, establishment commercial banks would not finance hostile takeovers, and establishment law firms would not represent hostile bidders. Accordingly, until the mid-1970s hostile takeovers were normally engaged in and aided by non-establishment players, such as law firms consisting of lawyers whom establishment law firms had either cast off or would not hire because of religious discrimination.

The norms of the establishment were not economically justified. Hostile takeovers could increase the wealth of shareholders, investment banks, commercial banks, and lawyers. The threat of hostile takeovers could increase the efficiency of those firms that were not targets but that were afraid they might be. There was, however, one prominent group whose wealth or at least whose position would be decreased by hostile takeovers: corporate managers. Accordingly, it was in the self-interest of corporate managers to view hostile takeovers as something that was not done, and establishment investment banks, commercial banks, and law firms adhered to the norm -- partly because they were concerned with loss of corporate business if they were perceived as norm-violators, and partly because, as members of the establishment, they internalized the norm.

The equilibrium was changed, and the norm was shifted, by several linked events in the mid-1970s. In 1973, United Technologies wanted to acquire ESB, a battery

company (formerly known as Electric Storage Battery) whose technologies were compatible with those of United. ESB turned United away, and United, following the then-prevailing norm, did not attempt to make a hostile bid. In 1974, however, International Nickel (Inco) did make a hostile bid for ESB. International Nickel was a member of the corporate establishment, but not completely -- it was a Canadian corporation.[75] More important, a premier establishment investment bank, Morgan Stanley, decided to break ranks and assist Inco's hostile bid. The story is told by Ron Chernow in his book, *The House of Morgan*.

> [In the early 1970s, corporate] restructuring was still curbed by Wall Street etiquette, which frowned on unsolicited takeovers. Afraid of conflicts with clients, Morgan Stanley had a rule against hostile takeovers. In 1970, it nearly engaged in its first hostile bid when Warner-Lambert decided to take over part of Eversharp's shaving business, in that case, the mere threat of a hostile takeover made the target submit. So Morgan Stanley's taboo-breaking hostile raid was postponed until 1974, when International Nickel (Inco) pursued the Philadelphia-based ESB, formerly called Electric Storage Battery.
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> > . . .[T]he auspices [of the bid] shocked Wall Street, for Inco was a conservative, blue-chip firm and Morgan Stanley was the official custodian of the Gentleman Banker's Code.[76]
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> The nearly forty Morgan Stanley partners . . . debated whether to spurn Inco or defy a code that had governed the world of high finance for almost 150 years. . . .
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> . . . The argument of inevitability was probably the decisive one. As one partner recalls, "The debate was, if we don't do what our clients want, somebody else will." . . . .

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[75] Id. at 599-600.

[76] See id. at 602.

> Frank Petito [Morgan Stanley's chairman] figured out how to twist the desecration of tradition into seeming veneration: in obliging Inco, the firm would simply be honoring an old Morgan tradition of serving faithful clients. But Petito had enough qualms about what they were doing to cast the upcoming Inco raid as an exception. A compromise was forged: the bank, in future, would engineer hostile raids only for existing clients and would fully warn them of unpleasant consequences. This, of course, didn't rule out much business. Morgan Stanley's large clients were just the sort that would now want to conduct raids, and they would know all about the unpleasant consequences. The compromise mostly reassured the firm's clients that it wouldn't be coming after *them*.

The qualifications that Baldwin put on Stanley Morgan's willingness to assist in tender offers serve to underline the extent to which Morgan Stanley realized that it was transgressing the social norm. So does the ensuing situation with Morgan's traditional law firm, Davis Polk, as reported in Ron Chernow's book, *The House of Morgan*:

> At this juncture, Morgan Stanley made another unorthodox decision. . . . [T]he firm had long relied on the white-glove law firm of Davis, Polk, and Wardwell, which had looked on takeover work as vulgar and avoided it. With Morgan Stanley partners terrified of lawsuits onsuing from takeover work, they now wanted a tough, seasoned specialist. . . . [and hired] the experienced Joe Flom, of Skadden, Arps, Slate Meagher & Flom. . . . [Flom had] pioneered in hostile takeovers in the 1950's, when Skadden, Arps was still a humble, four-man operation. For twenty years, he thrived on the scraps from law firms that were too haughty or too dignified to conduct hostile raids. . . .
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> When Flom was made a special counsel to Morgan Stanley, there were stormy scenes with Davis, Polk partners, who were deeply offended by the decision. Whatever its other consequences, the trend in hostile takeovers democratized the New York legal world and provided an opening in Wall Street for Jewish lawyers.[77]

Stanley flipped, the norm crumbled.[78]

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> Once Morgan Stanley sanctioned hostile takeovers, competitors jumped in. A year later, George Shinn of First Boston paired up Bruce Wasserstein and Joe Perella to launch a separate M & A operation. In 1974, $100 million was still considered a big deal. By 1978, over eighty deals exceeded that amount, with a $500- to $600-million range already commonplace. . . .

Established corporations -- including United Technologies, in 1975 -- launched hostile takeovers. Similarly, establishment corporations and establishment banks began financing hostile bidders, and establishment law firms began representing hostile commercial bidders.

In one important respect, the takeover story is somewhat different than some of the stories considered up to now. In the cases of directorial care, the structure of the board, and the role of institutional shareholders, the old, inefficient norm was descriptive, and gained its power through its licensing or insulating effect. In the takeover case, however, the old, pre-takeover norm was not merely descriptive, but obligational: making or assisting in takeovers *wasn't done* -- at least, not by those who conceived of themselves as blue-chip players. In other respects, however, the takeover story resembles those other cases, by illustrating both the highly significant role of social norms in corporate law, and the way in which social norms may be bad or inefficient as well as good or efficient.

VII. Conclusion

The role of social norms is pervasive in the law generally, and in corporate law in particular. In some cases, social norms increase efficiency. This has traditionally been true in the loyalty area, where the efficiency of social norms in achieving loyalty far

exceeds the efficiency of liability rules or monitoring and bonding systems. Today, at least, this is also true in the other areas considered in this paper -- care, board structure, the role of institutional investors, and takeovers. As recently as twenty or thirty years ago, however, the social norms in those areas promoted inefficiency. Indeed, one valuable lesson that can be learned from studying the role of social norms in corporate law is to reinforce the point, made by the recent literature on the corporation from somewhat different perspectives,[79] that notwithstanding modern arguments of social Darwinianism,[80] the structure of corporate institutions at any one time is not necessarily the most efficient structure.

At least three other important lessons can be learned from studying the role of social norms in corporate law.

First, it isn't possible to understand the field of corporate law without understanding the role of social norms in that field.

Second, to fully evaluate the effect of legal rules and legal institutions in the field of corporate law, account must be taken of their impact on the formation and effect of social norms in that area.

Third, the classic distinction between private action and collective action is too simplistic. Under this distinction, the term *collective action* is more or less a synonym for

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[79] See the articles cited at notes xxx-xxx, supra

[80] Frank Easterbrook & Daniel Fischel . . . .

official rules of conduct backed by coercive sanctions. Social norms, however, are also a form of collective action, which often take the form of *private* collective rules backed by coercive sanctions. From this perspective, the operation of social norms in corporate law may be viewed as a kind of "soft" regulation.