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"Recent developments in the US debate on Corporate Governance: a critical review of Bainbridge's *The new corporate governance in theory and practice* and Greenfield's *The failure of corporate law - fundamental flaws and progressive possibilities*"

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Preface

The North American academic debate has been the spotlight of worldwide reflection on corporate governance for decades. It is a continuously evolving debate, presently investigating the nature of public companies, and trying to solve main problematic features of them. Actually, two are the theme around which debates focused mostly, those of interest persecuted by the enterprise and governance; two recent books, in particular, gave the classical debate new outburst, mixing traditional assumptions with innovative points of view and, partially, new solutions.

Particularly, the Greenfield's "*The failure of corporate law – fundamental flaws and progressive solutions*" is aimed to explain main faults of modern corporate governance, both in its normative both in its positive configuration, and to drastically reform it internalizing different interests than shareholders' ones. The other, Bainbrigde's "*The new corporate governance in theory and practice*", focused instead on the matter of control, assessing a theory with empirical groundings, which tries to explain how the corporate governance evolved in last years, through the shift of control from managers to the board of directors, trying to develop a theoretical foundation of the phenomenon.

The choice of these two books above all is not casual. They are emblematic of the contemporary US debate on corporate governance. They are emblematic of its main features, focusing each on interest and control, and they are emblematic of the method and approach of US academic commentators, matching legal traditional knowledge, sociologic implications, law and economics methodologies.

Regarding their content, as above mentioned, they both investigate on the two traditional taxonomies of corporate governance: the first is the matter of interest, so of who is the residual claimant of the management of firm, in other world whether firm is aimed to satisfy shareholders 'interest at the maximization of wealth or not, and, if not, which interest it has to satisfy. The second is the matter of control that means assessing who, into the company, so if shareholders, managers or board, have the ultimate power to manage and bind it. Beside these two fundamental, unavoidable matters, there is a third theme to investigate, that of accountability. Even if it is the core matter, the knot that has to be completely solved in order to have an exhaustive theory, the theme of accountability, so to whom and in which ways, controllers are responsible, needs the previous assessment of the matter of interest and control. In fact, only once is defined which interest the company has to pursue and who wield authority, it is possible to verify if and in which terms he is accountable.

In spite the two books are intrinsically different each other, they well summarize their common backgrounds and the academic environment they have grown. They assume all the traditional theory of corporate governance, developed from thirties' with the Berle and Means' contractual model, to the developing of the market and the global dimensions of companies. Consequently, also this critique presumes that knowledge and tries to go further, towards and into contemporary daily developments of that tradition that is certainly given as unavoidable, and is assumed as wisely recently shown by the recent "Corporation law" by Franklin A. Gevurtz, but is not overpassed in order to find new solutions able to fit to an ongoing, evolving reality.

Their symbolic value justifies why a valid reflection on contemporary debate can move from a deep analysis on the two texts, using them as keystones from which developing a deeper study able to embrace other more specific dimensions towards an exhaustive and all-inclusive research.

A last clarification is necessary: this brief overlook is focused on the debate on public, with spread ownership, not on smaller, with families or majority shareholders controlling them. This obviously limits the validity of the model draft, because of the non-existence of such reality in our economic and legal system. The relevancy of the US experience, by the way, makes it worthy to be further analyzed, also because of the influence it has on all the Western legal and economic tradition.

The Books

a) "The new corporate governance in theory and practice" S.M. Bainbridge

With "*The new corporate governance in theory and practice*" Prof. Bainbridge assesses the "*Director Primacy*" theory. It tries to draft an exhaustive model, which uses facts to recognize a practice and tries to justify it on the theoretical level. It could be a complete and self-standing model if it wouldn't lack of some rigorousness.

Bainbridge investigates both the themes of interest and control. The first matter is solved affirming strongly the prevalence of shareholders' interests, on the base of three main arguments: i) because shareholders agree on their main and ultimate interest, that of maximization of interest, even if they can differ in the ways to realize it; ii) because

it’s more efficient to leave other branches of the law to regulate other interests; iii) because shareholders are the residual claimants of the firm, bearing the risk of it.

The matter of control is taken in account from two different points of view, why firms need authority and why authority must be set on the board. For the first point, the author draws on the traditional Arrow’s literature, affirming that the need for a center holding authority, able to manage all different relations incident to the firm, derives from the nature of company as a nexus of contracts between many different parties. The reason because directors should hold this power is that they’re not so changeable as shareholders, who can all move towards the maximization of wealth, but may diverge on the concrete actions to undertake in order do to it or in the time horizon they look at, with institutional investor preferring maximization in the short term and other preferring the medium-long one. Why control is set on directors and not on managers is a central knot of the theory: this is due in part to the recognition of a new trend in the practice, due to reforms in legislation, mainly with the Sarbanes Oxley Act, and to a wider adoption of best practices and straighter self-regulations by stock exchanges, in part to the recognition, on a theoretical level, of a more efficiency given by a board owning control; again, Bainbridge takes inspiration from the Law and Economics school, especially from the Behavioral Economic branch, affirming the primacy of groups’ decision making process than the individual one and so of the board primacy than the managers’ one.

A third point, that of accountability, is dealt too, maybe paying to it not all the attention it deserves. The need of someone to monitor the board derives clearly from the assessment of control on it. Three solutions are taken into account: monitoring by

shareholders, by takeovers, in other words the market, and the Courts. Any of these is really satisfying: shareholders should be controller just because their interest is undertaken by directors, because they're residual claimants, but in order to exercise control they should hold an effective voting right able to influence management. They do not: in spite of recent reforms, that widened the range of natter subject to vote by shareholders, there is still not a real effective power, because of the limitation of matters and the high costs they have to bear in order to exercise the right, that make more efficient to sold the stocks than trying to influence directors. This is the same reason because of which even the market, or better the capital market, cannot exercise control neither: well-functioning of the market, in fact, presupposes liquidity of stocks and easy opportunity to exchange them. But stocks have value, beside the economic one, also because they attribute voting rights, so if these rights are not effective, the stocks itself is less attractive and the market, as place of negotiation where bad performing firms are sanctioned through selling, do not work, since nobody wants to purchase if the risk is not counterbalanced by voting power. This is true also with regard of takeovers, which work, and so can play as efficient ways to promote good performance, just if markets rightly work and so if voting rights are effective and functioning. Finally, regarding Courts, the consolidation of the Business Judgment Rule makes their control less trenchant, since in the critical and core balance within authority and accountability Courts have surely preferred the first, recognizing wide powers to directors in the merit of their decisions.

This misinterpretation is the biggest fault of Bainbridge's theory: in spite of its practical and theoretical foundation, it lacks to solve the core matter of the

accountability, without providing a solution coming from facts or from theoretical reflections that could be really satisfactory. Under this point of view, the model do not differ from others developed by US commentators: the matter of accountability is that on which many, even all, theories break their validity.

b) "The failure of corporate law - fundamental flaws and progressive possibilities" K. Greenfield

As it comes clearly from the subtitle of the book, the Greenfield's one has a strongly theoretical nature. Even if it moves from practical evidences, that obviously give reasons to individuate faults in the modern corporate governance, he develops the theory without enough accuracy, mixing legal with socio-political arguments, certainly with the aim of advance a more *de iure condendo* theory than the Bainbridge's one, recognizing himself political commitments of it.

Greenfield's core idea is that the protection of workers, and their interests, should be internalized by the corporate law, abandoning the aim of the sole maximization of shareholders' wealth. He defends this thesis on the base of three main points: i) the persecution of workers' interest would mean to overpass the inner different of time horizon that characterizes different shareholders: workers looks at the long term, so to internalize their interest would mean to adopt a long-term approach that would fits better to the interest of firm itself and would permit a maximization of wealth for the firm as a whole, without peregrine and immediate speculative enrichments; ii) workers are the weaker counterpart the firm has to interact with: the matter is not who is the residual

claimant, as traditional corporate law suggests, so who has an unfixed contract with the firm, e.g. shareholders, but who is satisfied lastly in the case of wind up, so workforce too. Furthermore, workers are those more strictly bound to the firm, since labour market is intrinsically less liquid than capital one, so if shareholders are free to sell their stocks and escape from bad performing firms, employees cannot. iii) Finally, Greenfield finds a third, almost political, proof, grounding on the recognition that the "*internal affairs doctrine*" allows companies to choose, through the State of incorporation, the applicable law, leading a real "raise to the bottom" because of which workers find their rights seriously weakened. Greenfield also stresses that in this way, workers find themselves bounded not only to less protective regulations, but also to legislation for which they had not have voted, because resident in other states than those of incorporation, individuating in this a serious distortion of the democratic principles.

On the base of these arguments, each of which intrinsically vulnerable, Greenfield states the need to internalize workers' interests in the common management of the firm, not through an employees representative in the board, as in the German codetermination model, but simply forcing directors to act with their interests as landmark, internalizing it even in the Business Judgment Rule framework.

Many are the faults of Greenfield's theory. They will be all further deepened, but it is worthy stressing at least two main faults: the missing recognition, in the realization of workers' interests, of the role of other branches of the law, as for all stakeholders, and the lacking of a system of accountability of the so draft model. No mention is done about ways and techniques through which directors should be accountable towards workers of their actions.

Main taxonomies

1) **Interest**

This matter tries to assess which interest the firms is intended to pursue. Within a spread debate which involves many different and particulate positions, at least two main views can be identified: the traditional dichotomy between shareholders and stakeholders theories. Without recalling deeply all the evolutions, historical and substantial, between them, it will be here analyzed just how the two books deal with it and in which terms they innovate respect previous commentators.

They are exemplar theories, both sitting at the opposite sides of the debate, with Bainbridge being a strong backer of the persecution of the sole shareholders 'interest and Greenfield assessing the need of a global rethinking towards the internalization of stakeholders' interests, first of all of workers. The *shareholders versus stakeholders* fight finds in them valid exemplification, even extremism sometimes.

In order to have an organic and comprehensive view, the reasons on the base of which shareholders primacy is affirmed, by Bainbridge and other traditional scholars, will be here shown with a parallel criticism coming from Greenfield and the supporters of stakeholders theory, on the base of three main arguments.

i) Shareholders are the residual claimants of the firm. This mean that they bear the burden of it, since they do not have fixed contracts which regulates their relations with the corporation, but, as the classical model states, they bear the risk of bad performances, being the last claimants who will be satisfied in the case of wind up. Greenfield refuses this assumption, affirming that even

workers suffer of bad performances, even most than shareholders, since their position is less negotiable on the market, being labour markets less liquid than stock ones, so not having workers the chance to exercise a sort of exit right as them. The core matter, that seems to be not identified by Greenfield, is that shareholders are the residual claimants because they own the firm, but their contracts aren't fixed, as workers ones, so in the case of wind up, if employees are someway protected by labour law which disciplines fire, shareholders are not and they simply lose all what they own.

ii) Secondly, the shareholders primacy is based on the recognition of the convergence of stockholders towards a common aim, that of the maximization of wealth. This ultimate harmony allows the management to have a final purpose and to overpass unavoidable differences between shareholders in the translation into practice of the final aim. In fact, each of them could have a different idea on how concretely persecute it. This mediation role gives further reason to Bainbridge's theory, also on the matter of control, as it will be developed below. On the other hand, who proposes the internalization of stakeholders' interests drastically falls on this field. Requiring the satisfaction of other interests would need something that binds firms to act in that way, as, for example, law; otherwise no valid reason to internalize such interests could be find, but common sense and ethical concerns. All evidences given by Greenfield to justify the persecution of workers' interests could be captivating at first sight, but they lack of theoretical foundation, since labour law is aimed

to protect employees and there is no reason on the base of which firm should do so, without a mandatory provision.

iii) It is more efficient that other interests are persecuted by other branches of law, because making directors accountable to various stakeholders would mean making them accountable to any of them. Just the persecution of shareholders' interest makes possible to engage that fiduciary model, with its mechanisms that allows the firm to work. There is no reason to believe Greenfield when affirms that internalizing labour law in the corporate one would mean reduce costs and raise more efficiency. This is a dogmatic assumption failing both because not further explained, both because it doesn't recognize that internalizing the protection of workers would mean to leave it to the autonomy of the parties, in a dualism clearly characterized by a part, the employee, much stronger than the other. For this reason, the internalization could lead to less protection for workers than that provided by other branches of law, that are mandatory for companies even if they are not included in the company law. It could also be stressed that other legal forms to engage economic activities with the full internalization of workers' interests till the strict connection between them and the aim of enterprise itself, e.g. cooperative society, are already provided.

On a theoretical level, the Stakeholder Theory could be targeted as a contractual or an institutional one, according the two taxonomies that characterize mainly the European debate. If shareholderism has certainly a contractual nature, in fact, stakeholderism can

be lead to each of them: it is more institutional if the higher interest is given from external subjects, as legislator, while it's more contractual if the interest of the firm derives from a mediation between different parties, all stakeholders, as workers, community, consumers, environment agents, all bound by contracts with the firm. In any case, acting to persecute such kind of interests would need for political decision and political mechanism to find legitimation of it. It comes clearly that is not consistent with practice.

2) Control

The matter of control tires to investigate who, inside the firm, has the power to bind it and act in its behalf. Under this point of view, the two books are less innovative, with Greenfield who didn't take it into account, writing generally about board and management, and Bainbridge who, in spite he focuses all his model on this matter, has an empirical approach on it, with his theoretical evidences very close to the traditional ones.

As draft, the main innovation sits in the recognition of the new role played by directors, in spite of managers; Bainbridge gives practical evidences of this, showing how the same corporate law changed towards a bigger involvement of the board and a reduction of the powers of the CEO and top managers. The Delaware Code is mentioned as it states that "*business and affairs shall be managed by or under the direction of the board of directors*", but also most recent reforms, which, strengthening and increasing role and number of independent directors for example (as required by Section 301 o

Title II of Sarbanes-Oxley Act, or by the New York Stock Exchange and the Nasdaq Stock Exchange Regulations), recognize more powers to the board.

Beside this, that is certainly true but cuts off from his model any predictive validity, Bainbridge tries to find theoretical justification of the trend, using the traditional evidences of doctrine about the major efficiency of authority versus consensus that was showed above: authority is more efficient than consensus, in a reality as firm where many divergent interests of many parties involved need to be taken into account. Beside the need of a convergent vision, provided by directors, Bainbridge affirms that the management of the firm requires also full availability of information.

Bainbridge falls on two levels: he doesn't explain with enough proves why authority has to be set on directors, if not just because is required by the law and because of the best functioning of group decision making process than individual one, and how directors respond to shareholders of their power, in fact, he doesn't give new outburst to the agency and accountability matters. The latter point will be stressed on the following paragraph, while regarding the first no more is given by this author but the ability of the board to mediate between different slants of different shareholders. Are not managers able to do the same? According to Bainbridge they aren't. As to affirm the supremacy of authority towards consensus he recalls the Arrowian school, to assess that groups-decision making process is better than the individual one, he recalls behavioral economics and its vivid debate on it.

Even if Bainbridge doesn't explicit it, it comes clearly that the recognition of a center of authority is consistent with the contractual nature of his model: there is no need to recall sociologist or behavioral theories since any contract, in spite it faces two different

parties with one stronger than the other, doesn’t need any external regulation because the discipline is left to the autonomy of contractors who freely negotiate the object of their obligations.

Regarding Greenfield, instead, any investigation of this matter is provided: he doesn’t propose to adopt codetermination, he even agrees with Bainbridge on the need of authority affirming that, in spite the recognition of other interests, firm is still managed by the board which will be accountable of workers protection just in the limit of the Business Judgment Rule. This solution shows all the intrinsic weakness of Greenfield’s theory.

3) Accountability

In the Brainbridge’s theory, that of accountability is the biggest point of weakness: recognizing powers to manage the firm to the board asks for the resolution of the traditional matter of how making those accountable towards shareholders, whose interest are pursued. The matter is not new, coming directly from the recognition of the inner separation between ownership and control of public companies.

Traditionally, at least three mechanisms to monitor the board, more generally to monitor who exercises control, are identified: shareholders through their administrative rights, the market, through takeovers, and the Courts. Bainbridge takes into account all of them, trying to explain why shareholders are not able to monitor and stressing the role of the market, being again mistaken.

Since shareholders are the residual claimants of the firm, who hold the final interest that is pursued, shareholders should have rights to elect and revoke directors and even voting rights able to influence the management, at least on certain unavoidable matters. This is what is required by the classical model, but, as Bainbridge recognizes, this is not consistent with the practice, since shareholders, both because of the fragmentation of properties and consequential high costs to exercise rights, both because of a restricted range of matters on which they can be involved according to the law, do not monitor directors through traditional issues of the fiduciary relationship engaged with directors. The only power is given them is that of sell their stocks, exercising the s.c. *exit right*, as the "*Rule of Wall Street*" states: the only remedy is not trying to influence performance, but escaping when directors badly perform.

The principle is similar to that of the takeover mechanism: the market, trough takeovers, punishes bad firms. Bainbridge really stresses the role of the market, both capital both reputational, and really trusts on the takeover mechanism and its warning –*ex ante*- and punishing –*ex post*- power. In spite Bainbridge recognizes as reasonable the Business Judgment Rule, as developed by Courts, a right way to obtain a balance between accountability and authority, not limiting the initiative to manage the firm of the board, he trusts more on the market as mechanism to monitor and punish directors, as in the most traditional doctrine.

This point of view makes come to light to arguments: first of all, briefly, it must be stressed that Bainbridge's poor believe on trials could seem as inappropriate to an Italian lector: US Courts work, trials soon come to an end, shareholders can really suit to

defend themselves. This evidence doesn't receive enough care by Bainbridge, who takes it for granted.

The second, most important critic that has to be moved towards his theory sits on the fact that, if shareholders do not control controllers because their voting rights are ineffective, the same does not the market. In fact, the market works if voting rights, that are the counterweight of the risk taken trough stocks, allocate a real and effective power. Furthermore, affirming that through takeovers bad performing directors are punished, and so they find in the risk of them right incentive to manage well, is unrealistic: certainly, on a theoretical level, the mechanism should work, but is quite unlikely that any bad performing firm can be punished by the market thought it, as the practice proves.

Unfortunately, therefore, the theme of accountability seems to be not solved by Bainbridge, who only recalls traditional doctrine on the matter, without innovation, neither dragging it from practice, neither developing new solution from a theoretical level.

Conclusion

This brief critique didn't want to give solution to the matters above explained, but just to describe, critically, how two recent books, by distinguished US commentators, deal with them.

It comes clearly that some points remain without a complete and persuasive answer, as the theme of accountability, which seems to fall into the vicious circle given by separation of ownership and control on one side and malfunctioning of fiduciary measures on the other. Similarly, the incorporation of wider interests, as that of workers, is certainly a matter worthy of a deepening, but it is quite clear that Greenfield doesn't hit the target affirming, in a too simplistic way, that directors must take them into account and courts have to internalize in the Business Judgment Rule the persecution of workers' interest. No reason is given on why they should do so and no reason is given on how they could do so.

Bainbridge and Greenfield's books show interesting theories and certainly brings to light evidences and needs requiring a deeper theoretical analysis, but they both lack, in different ways, of punctiliousness.

Finally, as further starting point for future researches, it could be stressed that many others matters are now coming from the US academic debate, in part linked with those here shown. For examples: the globalization of firms requiring for a parallel globalization in corporate law; changes in firms transformed from industrial corporation into financial ones, owning more financial goods than material goods related to their main activity; the role of big companies in fighting developing countries', especially

China, attack to Western economies. The debate is open and there is wide room to deepen each of these matters and to follow its developments with critical attention.

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