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Corporate Governance Reform for the 21st Century: A Critical Reassessment of the Shareholder Primacy Model

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Corporate Governance Reform for the 21st Century: A Critical Reassessment of the Shareholder Primacy Model

CAROL LIAO*

This article questions the efficiency of the shareholder primacy model of corporate governance in light of the financial calamities that have plagued the first decade of the 21st century. Reform efforts following the global financial crisis have focused on failures in securities regulation, but that is only part of the story. Effective reform measures must also address the legal and normative prescriptions found within existing governance structures, and the collateral effect those prescriptions have on political and regulatory inaction.

There was strong ideological support for the shareholder primacy model at the start of the century. Following the corporate and accounting scandals of 2001 and 2002, three scholarly perspectives emerged addressing the effectiveness of the model. This article continues the dialogue on those perspectives and examines two factors that contributed to the collapse of the US subprime mortgage market: the repeal of the *Glass-Steagall Act* and the originate-to-distribute model of lending. The examination reveals how the shareholder primacy model played a key role in the onslaught of the global financial crisis by incentivizing the obstruction of efficient regulation. Alongside this analysis is an interwoven account of the evolution of law and economics scholarship. The article provides a timely outlook on how the shareholder primacy model encourages corporate behaviour that perpetuates the likelihood of future crises. It concludes by offering potential solutions for reform.

Dans cet article, on s'interroge sur l'efficacité du modèle de la primauté des actionnaires dans le cadre de la gouvernance d'entreprise à la lumière des désastres financiers qui ont marqué la première décennie du 21e siècle. Les projets de réforme qui ont suivi la crise financière mondiale se sont concentrés sur les lacunes de la règlementation des valeurs mobilières, mais ce n'est là qu'une partie du problème. Si l'on veut que les mesures de réforme aient une réelle efficacité, il faut également s'attaquer aux prescriptions juridiques et normatives que l'on retrouve dans les structures de gouvernance existantes et l'incidence collatérale que ces prescriptions ont sur l'inaction en matière politique et réglementaire.

Le modèle de la primauté des actionnaires a bénéficié d'un fort appui idéologique au début du siècle. Dans la foulée des scandales financiers et comptables de 2001 et 2002, trois perspectives savantes se sont penchées sur la question de l'efficacité de ce modèle. L'auteur de cet article poursuit le dialogue amorcé par ces différentes perspectives et analyse deux des facteurs ayant contribué à l'effondrement du marché des prêts hypothécaires américains à risque : l'abrogation de la *Glass-Steagall Act* et le modèle d'octroi puis de cession du crédit. Cette analyse permet de dégager la manière dont le modèle de la primauté des actionnaires a joué un rôle déterminant dans le déclenchement de la crise financière mondiale en incitant à l'obstruction d'une réglementation efficace. Elle s'accompagne d'un compte rendu entrelacé de l'évolution de l'érudition en matière de droit et d'économie. Cet article présente une perspective tout à fait d'actualité sur la manière dont le modèle de la primauté des actionnaires encourage chez les entreprises un comportement qui perpétue la probabilité de futures crises. Il conclut en offrant d'éventuelles solutions de réforme.

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I. INTRODUCTION

The financial calamities that have marked the first decade of the 21st century indicate it is time to pose new challenges to the assumed efficiencies of the shareholder primacy model of corporate governance. As the facts behind the global financial crisis continue to unfold, reform efforts have focused on failures within securities regulation—but that is only part of the story. While the shareholder primacy model may be ideologically entrenched in the United States of America (US), the severity of the crisis calls for a reassessment on the merits of this mainstream corporate governance model.

It is important to recognize that the account in this article is based on US sources, and addresses US-specific issues. The global financial crisis clearly affected many other nations, among which the causes and timelines may differ. Part II of this article looks back in time to the corporate and accounting scandals that immobilized the US financial markets between 2001 and 2002. It first identifies the prevalent support of the shareholder primacy model prior to the scandals, and then traces three scholarly perspectives that emerged shortly thereafter. The first group of scholars supported laissez-faire market principles and felt the demise of companies embroiled in the scandals only evidenced that the market was working effectively. The second group called for stricter market regulations to support the existing governance model. The third group believed nothing less than a fundamental rethinking of corporate governance practices was required, and pushed for deep normative and structural reform. Within law and economics scholarship, the scandals marked a period when behavioural approaches began to gain greater momentum and influence in the field.

Part III then delves into an analysis of some of the factors that contributed to the collapse of the subprime mortgage market (recognized as the first in a series of events that have come to define the global financial crisis): the repeal of the *Glass-Steagall Act*[1] and subsequent development of large financial conglomerates

1 *Banking Act of 1933*, Pub L No 73-66, 48 Stat 162 (codified as amended in scattered sections of 12 USC). Also known as the *Glass-Steagall Act* [*GSA*].

and "shadow banks;"[2] and the development of the originate-to-distribute model of lending in an unregulated over-the-counter derivatives market. The narrative behind the repeal of the *Glass-Steagall Act* exposes how regulators can be intimately involved with the corporate entities that they govern, and cannot be relied upon as sole protectors of broader stakeholder interests. In the narrative behind the originate-to-distribute model of lending, the competitive need to generate profit induced several mortgage lending institutions to use questionable and even predatory lending tactics on potential borrowers. The examination shows how intensive lobbying efforts by interested corporate institutions essentially forced legislators to roll back anti-predatory lending laws.

In Part IV, key scholarly perspectives that emerged in the aftermath of the crisis are identified and incorporated into the three perspectives examined in Part II to reveal how positions have changed since the scandals of 2001 and 2002. The article highlights how the legal and ideological support of the shareholder primacy model of governance has laid the groundwork for corporate behaviour that heavily influences regulatory inaction and perpetuates the likelihood of future crises. Part V concludes by offering elements from both old and new institutional law and economics approaches as a starting point to recalibrate efficiencies within the existing governance model, and then provides examples from emerging hybrid corporate structures as potential solutions for reform.

Power and control issues among corporate actors, and the placement of incentives that support existing power arrangements, are only amplified when viewed from within an industry capable of impacting the economic health and well-being of so many. Several types of corporate and financial institutions played key roles in the crisis. It was a large-scale event that involved a significant cast of characters: banks, shadow banks, mortgage lending institutions, credit rating agencies and trade and lobby groups, among others. The governance of financial institutions may statutorily differ in many ways from that of large, public corporations, but there are intricate and delicate commonalities found in the balancing of relationships between the actors familiar to both types of institutions: directors, officers, shareholders and other stakeholders. The events of the crisis highlight how similar norms pervade the structural makeup of both corporate and financial institutions. The prescriptive model that drives the ongoing development and application of corporate and regulatory law is what matters. Reforming that model is the key to bringing about lasting change to the way corporate and financial institutions conduct themselves going forward.

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2 Shadow banks can be defined as "financial institutions [such as mutual funds, investment banks and hedge funds] that in some respects parallel banking activities but are subject to less regulation than commercial banks." Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Washington, DC: US Government Printing Office, 2011) at 543, online: US Government Printing Office <http://www.gpo.gov>.

II. LAW, ECONOMICS AND THE SHAREHOLDER PRIMACY MODEL

A. Shareholder Primacy at its Peak

In their well-known 2001 article "The End of History for Corporate Law," Henry Hansmann and Reinier Kraakman argued that the basic law of corporate governance had already achieved a high degree of uniformity to the shareholder primacy model and that "continuing convergence toward [this] single, standard model is likely."[3] According to Hansmann and Kraakman, some key normative principles in this consensus include:

> 1) ultimate control over the corporation should rest with the shareholder class;
> 2) the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders;
> 3) other corporate constituencies, such as creditors, employees, suppliers, and customers [which, together with shareholders, are included as "stakeholders"], should have their interests protected by contractual and regulatory means rather than through participation in corporate governance;
> 4) noncontrolling shareholders should receive strong protection from exploitation at the hands of controlling shareholders; and
> 5) the market value of the publicly traded corporation's shares is the principal measure of its shareholders' interests.[4]

Arguing from an Anglo-American perspective, Hansmann and Kraakman believed that alternative governance models (identified by them as manager-oriented, labour-oriented and state-oriented) had already been tried and had failed.[5]

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3 Henry Hansmann & Reinier Kraakman, "The End of History for Corporate Law" (2001) 89:2 Geo LJ 439 at 439.

4 *Ibid* at 440-41. There seems to be little contention in legal scholarship regarding Hansmann and Kraakman's definition of shareholder primacy. See e.g. Stephen M Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance" (2003) 97:2 Nw UL Rev 547 at 573 (which describes two principles of shareholder primacy: the shareholder wealth maximization norm and the principle of ultimate shareholder control); Jill E Fisch, "Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy" (2006) 31:3 J Corp L 637 (which asserts that shareholder primacy "defines the objective of the corporation as maximization of shareholder wealth" at 637); Ian B Lee, "Efficiency and Ethics in the Debate about Shareholder Primacy"(2006) 31:2 Del J Corp L 533 (which defines shareholder primacy as "the view that managers' fiduciary duties require them to maximize the shareholders' wealth and preclude them from giving independent consideration to the interests of other constituencies" at 535).

5 Hansmann & Kraakman, *supra* note 3 at 443-47. Hansmann and Kraakman describe the manager-oriented model as one that existed between the 1930s and the 1960s in the US; the labour-oriented model as one that peaked in Germany in the 1970s and caused the Commission of the European Communities to draft the *Amended Proposal for a Fifth Company Law Directive Founded on Article 54 (3) (G) of the Treaty Concerning the Structure of Public Limited Companies and the Powers and Obligations of their Organs*, [1983] OJ C240/2; and the state-oriented model as one most extensively realized in France and Japan post-World War II. The examination of these historical and international governance systems is beyond the scope of this article.

Pointing to the shareholder primacy model's assumed efficiencies and its historical economic domination, they contended that the ideological convergence of this model is unlikely to be undone, especially since "no important competitors to the standard model of corporate governance remain persuasive …."[6] US confidence in the shareholder primacy model was at its peak. To Hansmann and Kraakman, the ideological convergence toward the model meant that general convergence in practice would eventually follow—thus signifying, for all intents and purposes, an end of history for corporate law.[7]

Economic efficiency was the main force behind Hansmann and Kraakman's presumption of the long-term international acceptance of shareholder primacy. They identified profit maximization, historical success and international competitive advantage as factors that "made the virtues of [the shareholder primacy] model increasingly salient."[8] Their logic is in line with the beliefs held by scholars of the Chicago School of law and economics, who have frequently used an Anglo-American view of neoclassical economic theory and efficiency analysis to explain and understand the development of law.

Scholars within the Chicago School generally accept and adhere to principles that have been at the core of modern economics since Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations*,[9] a work many Chicago scholars cite with regularity.[10] A defining characteristic of the Chicago School is its contention that legal rules and outcomes can be assessed on the basis of their efficiencies.[11] Richard Posner, recognized as the foremost leading proponent of the Chicago School,[12] was

6 Hansmann & Kraakman, *supra* note 3 at 454.

7 *Ibid* at 455. There is considerable discourse available on the issue of the global convergence of corporate governance, both prior to and following Hansmann and Kraakman's work. See e.g. John C Coffee Jr, "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications" (1999) 93:3 Nw UL Rev 641; Jeffrey N Gordon & Mark J Roe, eds, *Convergence and Persistence in Corporate Governance* (Cambridge, UK: Cambridge University Press, 2004).

8 Hansmann & Kraakman, *supra* note 3 at 449.

9 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 7th ed, Eighteenth Century Collections Online, (1776).

10 See Steven G Medema, "Adam Smith and the Chicago School" in Ross B Emmett, ed, *The Elgar Companion to the Chicago School of Economics* (Cheltenham, UK: Edward Elgar, 2010) at 40 (where he states, "[t]here is … no question that the Chicago School has both claimed and evidenced a close affinity with Smith—directly or indirectly—for three-quarters of a century").

11 See generally Richard A Posner, *Economic Analysis of Law*, 7th ed (New York: Aspen, 2007) at 13 [Posner, *Economic Analysis (7th ed)*] (where despite a variety of measures surrounding the concept of efficiency, Posner points out that the common operating definition in economics is "nine times of out of ten" in reference to Kaldor-Hicks efficiency). Under Kaldor-Hicks efficiency, an outcome is considered more efficient if the monetary value of society's resources is maximized. If the marginal willingness to pay by those who benefit from an action is equal to the marginal willingness to accept payment by those harmed, Kaldor-Hicks efficiency contends that all parties end up no worse off than before (assuming those harmed are paid directly or indirectly by those benefiting or their proxies).

12 See e.g. Nicholas Mercuro & Steven G Medema, *Economics and the Law: From Posner to Postmodernism and Beyond*, 2d ed (Princeton, NJ: Princeton University Press, 2006) at 94 (which states, "[t]he work of [Chicago School law and economics] scholars—of whom Posner as professor, scholar, and judge is perhaps the foremost exponent—forms the core of the Chicago approach").

one of the first to advance the efficiency hypothesis in detail.[13] The Chicago School's application of neoclassical economics to legal theory has meant that principles surrounding rational maximizers who respond to price incentives are considered when implementing and applying legal rules to market and non-market subjects.[14] Applying the principles of neoclassical law and economics on a global market level, one sees how the singular objective of a higher share price within the shareholder primacy model (the "shareholder wealth maximization norm"[15]) is legitimized in theory, providing a necessary "invisible hand" of self-interest to promote efficient outcomes within the supply and demand of the free market.[16]

Using this measure in a corporate law context, the existing shareholder primacy model can purport to be bolstered by neoclassical efficiency analysis. Hansmann and Kraakman have pointed to the standard model's many notable economic advantages, some of which they list as "access to equity capital at lower cost (including, conspicuously, start-up capital), more aggressive development of new product markets… and more rapid abandonment of inefficient investments."[17] The common concerns surrounding efficiency and wealth maximization relate to agency costs associated with divergent objectives between managers and shareholders.

While recognizing that "the problem of agency costs … limits the efficient size of firms,"[18] Posner has contended that, within the separation of ownership and control, agency costs are generally contained. In his 1998 edition of *Economic Analysis of Law*, Posner stated, "[m]ismanagement is not in the managers' self-interest; it is in fact very much contrary to their self-interest, as it will lead eventually to the bankruptcy of the firm (and of the managers' future employment prospects), as a result of the competition of better managed rivals."[19] Agency costs relating to any divergent interests in the manager-shareholder relationship will likely be addressed through protective features within a company's charter and bylaws, which Posner believes "shareholders would normally insist upon…."[20] Hansmann and Kraakman as well state that the shareholder primacy model has "stronger incentives to reorganize along lines that are managerially coherent…."[21] In addition, norms analysis has played a greater role in law and economics scholarship in recent decades. Janis Sarra notes, "[l]aw and economics scholars have used norms analysis to explain particular

13 Other founding scholars of the Chicago School, notably Ronald Coase, Guido Calabresi, Henry Manne and Gary Becker, have also made significant contributions to the study of efficiency in law and economics research. See e.g. *ibid* at 94-102.

14 Posner, *Economic Analysis (7th ed)*, *supra* note 11 at 4.

15 See e.g. Bainbridge, *supra* note 4; Fisch, *supra* note 4; Lee, *supra* note 4 (for definitions of the concept).

16 Smith, *supra* note 9 (who famously stated: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest" at 22).

17 Hansmann & Kraakman, *supra* note 3 at 450-51.

18 Posner, *Economic Analysis (7th ed)*, *supra* note 11 at 420.

19 Richard A Posner, *Economic Analysis of Law*, 5th ed (New York: Aspen, 1998) at 452. Note, however, that the comment did not appear in the next edition.

20 *Ibid*.

21 Hansmann & Kraakman, *supra* note 3 at 451.

corporate conduct that does not easily fit into the pure market-driven conception of the corporation, suggesting that corporate officers… [are] influenced by norms that bridge the gap between efficiency-enhancing activity and duties of care and loyalty."[22]

B. Three Perspectives Following the Corporate and Accounting Scandals of 2001 and 2002

Hansmann and Kraakman's article was published in early 2001, prior to the fall of Enron Corporation (Enron) and a number of other corporate and accounting scandals that devastated the financial markets in the latter half of 2001 through to 2002. Readers are advised to consult the extensive documentation and analysis of Enron's collapse that is available,[23] but in brief, Enron's bankruptcy resulted from unlawful transgressions by its managers, which included non-transparent financial reporting, mark-to-market accounting and the creation of complex corporate structures for the sole purpose of concealing billions of dollars in debt.[24] Once this information was revealed to the public, the outrage expressed by investors, employees, pension holders and politicians was palpable.[25] Following in rapid succession after the fall of Enron was a series of other corporate and accounting scandals that brought down several other companies, including most notably WorldCom,[26] whose bankruptcy quickly replaced Enron's as the largest in history.[27] Its downfall was due in part

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22 Janis Sarra, "Oversight, Hindsight, and Foresight: Canadian Corporate Governance through the Lens of Global Capital Markets" in Janis Sarra, ed, *Corporate Governance in Global Capital Markets* (Vancouver: UBC Press, 2003) 41 at 42. See e.g. Eric A Posner, "Law, Economics, and Inefficient Norms" (1996) 144:5 U Pa L Rev 1697; Melvin A Eisenberg, "Corporate Law and Social Norms" (1999) 99:5 Colum L Rev 1253 (for more on norms analysis).

23 Notable scholarly works are included in these footnotes. Enron's collapse has also been retold in non-fiction books and movies. See e.g. Bethany McLean & Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (New York: Portfolio, 2004); Mimi Swartz with Sherron Watkins, *Power Failure: The Inside Story of the Collapse of Enron* (New York: Doubleday, 2003); *Enron: The Smartest Guys in the Room*, DVD: (New York: Magnolia Pictures, 2005); *Frontline: Bigger Than Enron*, 2002, DVD (Boston, MA: WGBH, 2009).

24 See e.g. Douglas M Branson, "Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?" (2003) 48:4 Vill L Rev 989 at 997-1002 [Branson, "Systems Fail"] (for a helpful summary).

25 See e.g. Kevin Anderson, "The Enron Outrage Game," *BBC News* (26 February 2002), online: BBC News <http://www.bbc.com>.

26 Other companies included Tyco International, Adelphia Communications, Peregrine Systems and Global Crossing.

27 See Luisa Beltran, "WorldCom Files Largest Bankruptcy Ever," *CNN Money* (22 July 2002), online: CNN Money <http://www.money.cnn.com> (which reports WorldCom's bankruptcy as the largest in the history of the United States with $107 billion in assets, dwarfing that of Enron, which listed $63.4 billion in assets when it filed for bankruptcy). At the time of writing, the WorldCom bankruptcy is the third largest in history, after the bankruptcies of Lehman Brothers Holdings ($639 billion) and Washington Mutual ($328 billion). See also Research Center: Largest All-Time Bankruptcies, *20 Largest Public Company Bankruptcy Filings 1980–Present*, online: BankruptcyData.com, <http://www.bankruptcydata.com>.

to management falsely inflating revenues and under reporting costs.[28] Following Enron's collapse, there came to be several discussions from legal scholars on the appropriate governmental response to the scandals. Simon Deakin and Suzanne Konzelmann's short article entitled "Corporate Governance after Enron: An Age of Enlightenment?"[29] identifies three groups of opinion that developed after the scandals. The following analysis summarizes Deakin and Konzelmann's findings and significantly builds upon them by highlighting some of the more persuasive voices from legal scholarship at the time, and categorizing them within Deakin and Konzelmann's three groups.

The first group believed that Enron's collapse only confirmed the existing model was working and "might actually be a reason to be more confident about corporate America."[30] Enron was an "aberration," and an example of one bad board did not denote that all boards were ineffective governance mechanisms.[31] This group, echoing Adam Smith's laissez-faire market principles, felt that "[m]arket sanctions, in the form of reputational damage to its senior managerial team and to its auditors…served as an effective disciplinary device."[32] William W. Bratton described this group as "supporters of deregulation" who found Enron's collapse to be "an exemplar of free market success."[33] In this sense, "If Enron was a house of cards, it was free market actors who blew it down, with a free market administration keeping its hands off."[34] Once discovered by the public, the false inflation of Enron's stock price came to an end, and its value within the financial markets quickly depreciated. Because of the swift market reactions to Enron's exposed activities, proponents of this first position believed there was little to be accomplished with wider reforms to the existing corporate model. Enron's bankruptcy, then, was a "triumph of capitalism."[35]

28 See Complaint (Securities Fraud), *Securities and Exchange Commission v Worldcom, Inc*, No 17588 (SDNY 2002), online: Securities and Exchange Commission <http://www.sec.gov/litigation/complaints/complr17588.htm> (which claims that WorldCom disguised its operating performance by using undisclosed and improper accounting that overstated its income by approximately $3 billion in 2001 and $797 million during the first quarter of 2002).

29 Simon Deakin & Suzanne J Konzelmann, "Corporate Governance after Enron: An Age of Enlightenment?" in John Armour & Joseph A McCahery, eds, *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford: Hart Publishing, 2006) at 155.

30 "Another Scandal, Another Scare," *The Economist* (27 June 2002), online: The Economist <http://www.economist.com>. See also Deakin & Konzelmann, *supra* note 29 at 155.

31 See Branson, "Systems Fail," *supra* note 24. See also Douglas M Branson, "Enron is an Aberration," *USA TODAY* (1 March 2002) 9A.

32 Deakin & Konzelmann, *supra* note 29 at 155.

33 William W Bratton, "Enron and the Dark Side of Shareholder Value" (2002) 76:5 & 6 Tul L Rev 1275 at 1281.

34 *Ibid*.

35 Robert L Borosage, "Enron Conservatives," *The Nation* 274:4 (4 February 2002) 4, online: The Nation <http://www.thenation.com> (noting that then-Treasury Secretary Paul O'Neill called Enron's rise and fall a "triumph of capitalism" at 5).

The second group acknowledged that both managerial and "gatekeeper"[36] failures had occurred, and pushed for reform specifically addressing the misdeeds of Enron's executives and its lack of proper corporate monitoring. This group focused on tightening securities regulation and improving the functioning of the shareholder primacy model, without challenging or restructuring it. Governance failures were traced back to conflicts of interest on the part of board members and its auditors. Many pointed to the false comfort of an independent monitoring board. On paper, Enron had a board that was ideal in several respects; among other favourable qualities, the board was diverse, with only two of their 14 directors classified as insiders.[37] Corporate governance issues thus focused on maintaining sufficient director independence and accountability, as well as a subtle shifting of powers from managers back to shareholders. Leading the charge was the Council of Institutional Investors (CII), an organization that in 2002 represented institutional investors holding approximately $2 trillion in pension assets. This group provided a detailed list of accounting and corporate governance reform recommendations "to prevent future Enrons."[38]

Many of the CII recommendations, along with other recommendations from the second group, eventually coalesced and led to the creation of the *Sarbanes-Oxley Act of 2002*[39] (*SOX Act*). The *SOX Act* was enacted directly in response to the scandals and implemented several new rules and regulations to curtail unwanted corporate behaviour. In particular, it contained provisions addressing director and managerial accountability through financial disclosure, including the imposition of a duty to disclose "on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English …;"[40] greater internal controls, such as stricter standards on the

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36 Gatekeepers are reputational intermediaries who provide verification and certification services to investors. The term "gatekeeper" is not simply an academic concept. See U.S. Securities and Exchange Commission (SEC), *Revision of the Commission's Auditor Independence Requirements*, 2000 SEC LEXIS 1389 (Securities Act Release No 7870 on 30 June 2000), at 5, online: SEC <http://www.sec.gov> (where the SEC noted, "[t]he federal … laws … make independent auditors 'gatekeepers' to the public securities markets").

37 Stuart L Gillan & John D Martin, "Financial Engineering, Corporate Governance, and the Collapse of Enron" (2002) [unpublished, archived at the Social Science Research Network] online: Social Science Research Network <http://ssrn.com>.

38 Council of Institutional Investors, Press Release, "SWIB Joins Council of Institutional Investors Seeking Reforms to Prevent Future Enrons" (4 February 2002), online: State of Wisconsin Investment Board <http://www.swib.state.wi.us>. The SWIB's recommendations, which were largely adopted by the *SOX Act*, *infra* note 39, were as follows: (1) "Reform auditor independence standards by prohibiting auditors from providing any non-audit services to their audit clients;" (2) "Radically reform the oversight of auditors;" (3) "Require enhanced disclosure of director links to companies;" (4) "Toughen the stock exchanges' listing standards on board independence and board composition;" (5) "Do not soften the SEC's stance on enforcement;" (6) "Restore integrity to the proxy voting system by eliminating the stock exchanges' 'broker may vote' rule;" and (7) "Meaningfully update disclosure requirements for financial and other critical information."

39 *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002) (codified at 15 USC § 7201 (2002)) [*SOX Act*].

40 *Ibid*, § 409 (1).

certification of annual and quarterly reports by top executives and a prohibition against share sales by corporate officers during pension blackouts;[41] auditor independence, such as rotating the auditor partner every five years;[42] as well as the addition of stricter criminal penalties for managers responsible for any violations.[43]

Deakin and Konzelmann called the perspective of the third group "a radically different explanation for Enron's fall."[44] While this group generally accepted and approved of the initiatives created by the *SOX Act*, the underlying belief was that these reform efforts did not go far enough in addressing the root of the problem. Deakin and Konzelmann noted, "[f]rom this [third] perspective, the fate of Enron is less important than the future of the business model which it came to represent …."[45] The group also believed that "[u]nless the regulatory framework is adjusted to make this model unattractive, it will only be a matter of time before the same approach is tried again."[46] The problems of Enron inherently grew from principles embodied within the shareholder primacy model of the corporation. Members of the senior management of Enron were given stock options that motivated short-term stock appreciation, and their unethical practices exemplified the "dark side" of the shareholder wealth maximization norm.[47] Proponents of this third position felt that the model fostered an environment that created oversized incentives, which invited corruption. "[G]overnance standards… [had] declined, particularly those addressed to the numerology of shareholder value,"[48] and the artificial inflation of Enron's stock was revealed only during the downward cycle of a cyclical economy. Clearly, some argued, a reliable corporate governance model should be designed to catch wrongdoing before it causes serious financial damage to shareholders and other stakeholders; therefore, the multiple scandals in 2001 and 2002 only demonstrated how the existing model did not work.[49] Deakin and Konzelmann shared this stance, stating:

> We believe that this third interpretation of events goes to the heart of the matter…. If we are to take this view seriously, nothing less than a fundamental rethinking of corporate governance practices and procedures is required. Above all, corporate governance must no longer confine its analysis to the relationship between managers,

41 *Ibid*, § 306(a).
42 *Ibid*, § 203.
43 *Ibid*, § 802.
44 Deakin & Konzelmann, *supra* note 29 at 156.
45 *Ibid*.
46 *Ibid*.
47 See Bratton, *supra* note 33 at 1284.
48 *Ibid* at 1284.
49 See e.g. Jeffrey N Gordon, "Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley" (2003) [unpublished, archived at Columbia Law School, Center for Law and Economic Studies].

> boards and shareholders. The narrowness of this focus is a major contributing factor to the present round of corporate scandals of which Enron is the most emblematic.[50]

Other scholars, such as Sarra, identified how the scandals signified a real need to reassess other models of corporate governance available throughout the world. When examining governance issues within the global capital markets shortly following Enron's bankruptcy, Sarra noted:

> [T]he recent failures of large, publicly traded corporations in the United States cast doubt on claims of the ultimate superiority of the market-centred system. When this doubt is coupled with the existence of other forms of corporate governance throughout the world, the need for closer examination of potential alternatives or improvements in corporate governance becomes more evident.[51]

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

> If corporate scandals stem from the same kind of underlying cultural problems that some insist afflict politics, sports, and even religion, then the core challenge for public policy will be to find ways to engender nothing less than a fundamental cultural shift.[52]

These voices aligned with scholars that had been supporting "counter-hegemonic" discourses on the shareholder primacy model for some time.[53] However, voices from this third group supporting structural changes to the shareholder primacy model did not gain much traction on the pathway to reform after the scandals of 2001 and 2002. They were easily outnumbered by those leading the second group and the mainstream push for greater regulation of financial

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50 Deakin & Konzelmann, *supra* note 29 at 156

51 Janis Sarra, "Introduction" in Sarra, *supra* note 22 at xv.

52 Cary Coglianese & Michael L Michael, *After the Scandals: Changing Relationships in Corporate Governance,* Regulatory Policy Program Report RPP-09 (Cambridge, MA: Mossavar-Rahmani Center for Business and Government, Harvard University, 2006) at 20, online: Harvard Kennedy School <http://hks.harvard.edu/m-rcbg/papers/afterthescandals.pdf>.

53 See e.g. Kellye Y Testy, "Linking Progressive Corporate Law with Progressive Social Movements" (2002) 76:4 Tul L Rev 1227 at 1232-40. Testy describes "hegemonic" discourse as discussions surrounding the shareholder primacy and wealth maximization model, where "managers' highest duties are to shareholders and to maximizing their wealth; thus, shareholders must be preferred in the event that a conflict between corporate constituents emerges" at 1231. Counter-hegemonic discourse thus seeks to describe alternative visions of corporate law.

reporting and auditing practices. The discussion during that period surrounded the effectiveness of the *SOX Act* and the alteration of the rules to curtail unwanted human behaviour within existing governance structures, rather than the possibility of revamping the dominant corporate form.

C. Ascendancy of Behavioural Approaches

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

> [F]raud has long been criminal, and the successful prosecution of the Enron executives suggests that adequate legal tools were in place to deal with such conduct before Sarbanes-Oxley.... As for the receipt by accounting firms of fees for consulting and accounting services…[i]t should be enough to require the corporation to disclose to investors the terms of its relations with its auditors, and leave the investors to penalize a corporation by bidding down its stock price if they think the auditor has been 'bought.'[54]

Other advocates of the Chicago School generally echoed this sentiment. For example, Gary S. Becker, Nobel laureate and a prominent figure in the Chicago School, argued that if a fully deregulated energy market had been in place, "the Enron political scandal would have been largely avoided" since "[t]he company could not have gamed the system by encouraging politicians to deregulate as it favored."[55] While conceding that the scandal "indicate[d] the need for stricter guidelines on accounting and greater Internal Revenue Service," Becker pointed out that "stock markets have responded by punishing Enron severely for the company's transgressions…" and that "flexible prices and competition are far more effective ways to improve energy markets than allowing bureaucrats and politicians to determine the speed and direction of deregulation."[56]

Despite the firm stance by leading scholars in the Chicago School, this controversial period in corporate history provided opportunities for other strands within law and economics scholarship, particularly behavioural approaches, to

54 Posner, *Economic Analysis (7th ed)*, *supra* note 11 at 452. See generally *ibid* at 450-52.

55 Gary S Becker, "Enron Was Mostly Right About One Thing: Deregulation," *Business Week* (18 March 2002) 26, online: Business Week <http://www.businessweek.com>.

56 *Ibid*.

broaden their audience. Objections to the depiction of human agents as rational actors within the field of law and economics, and especially the Chicago School, had frequently been voiced in the past by both its supporters and its critics.[57] The scandals exposed the overwhelming need for greater quantitative and qualitative research surrounding human behaviour in modern finance, while also providing a golden opportunity to apply behavioural approaches to pressing legal issues.[58]

Schools were eagerly adopting behavioural approaches in response to the Chicago School's concept of the rational, self-interested actor. Herbert A. Simon's notion of "bounded rationality," being "behavior that is *intendedly* rational, but only *limitedly* so …,"[59] and other approaches addressing limitations within human behaviour[60] were increasing in influence.[61] Robert Prentice, for example, noted how the scandals supported his continued attempts "to create more realistic policy prescriptions than have been derived from the Chicago School law and economics reasoning that has dominated the interdisciplinary approach to legal analysis …."[62] As well, Donald Langevoort asserted that "[t]he ones with the explaining to do [following the Enron debacle] are the believers in market efficiency …."[63] He contended that "behavioral finance is somewhat better positioned to test the real world impact of bias in market prices than research in more opaque economic settings,"[64] and went on to develop a constructive theory of behavioural securities regulation. It was clear that those pressing for more contextualized critiques to the mainstream Chicago School of law and economics now had the chance to capitalize on those corporate events.

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57 See Mercuro & Medema, *supra* note 12 at 102-4. See also Christine Jolls, Cass R Sunstein & Richard Thaler, "A Behavioral Approach to Law and Economics" (1998) 50:5 Stan L Rev 1471 (which noted that "[o]bjections to the rational actor model in law and economics are almost as old as the field itself" at 1473).

58 The field was undergoing a transformative period toward the wider acceptance of approaches extending beyond neoclassical economics, including offshoots that developed from the work of the Chicago School. See e.g. Mercuro & Medema, *supra* note 12 at 284-90 (which discusses, for example, Guido Calabresi's influence within what the authors call the New Haven School of law and economics).

59 Herbert A Simon, *Administrative Behavior: A Study of Decision-Making Process in Administrative Organization*, 2d ed (New York: Macmillan, 1957) at xxiv [Simon, *Administrative Behavior*] [emphasis in the original]. See also Herbert A Simon, *Models of Man: Social and Rational, Mathematical Essays on Rational Human Behavior in a Social Setting* (New York: John Wiley & Sons, 1957) [Simon, *Models of Man*].

60 See e.g. Jolls, Sunstein & Thaler, *supra* note 57.

61 This is not to say behavioural law and economics approaches were not already developing prior to the scandals of 2001 and 2002, but rather, that the corporate and accounting scandals allowed them to take centre stage. There have been disagreements as to when and how behavioural economics began. See e.g. Hamid Hosseini, "The Arrival of Behavioral Economics: from Michigan or the Carnegie School in the 1950s and the Early 1960s?" (2003) 32:4 The Journal of Socio-Economics at 391. But see Louis Uchitelle, "Following the Money, but Also the Mind: Some Economists Call Behaviour a Key," *The New York Times* (11 February 2001), online: The New York Times <http://www.nytimes.com>.

62 Robert Prentice, "Enron: A Brief Behavioral Autopsy" (2003) 40:2 Am Bus LJ 417 at 419-20.

63 Donald C Langevoort, "Taming the Animal Spirits of the Stock Markets: A Behavioural Approach to Securities Regulation" in Armour & McCaherty, *supra* note 29 at 66.

64 *Ibid* at 67.

Law and economics scholars that were adopting behavioural approaches around the time of the Enron scandal held, if anything, beliefs in line with the second group, which argued for greater transparency and accountability of directors and managers, and for stricter regulation following the scandals to support the shareholder primacy model. The work of behavioural law and economics scholars generally focused on ways in which the law could promote desired human behaviour within pre-existing structures. The field itself utilizes traditional economic tools and enhances them by providing a better understanding of human behaviour in a market-driven environment. While recognizing that there can be new and innovative prescriptions from these lines of inquiry, following the scandals, behavioural law and economics scholars tended to focus on economic improvements within the boundaries of securities regulation and on "prescriptions regarding how to make the legal system work better;"[65] not on challenging the very structures and institutions in which the law operated.[66] Behavioural law and economics served as a useful tool to expose the flaws within the existing model, but the approach was incapable of offering a meaningful alternative.

Nevertheless, the growing trend towards of behavioural approaches signaled a marked change in law and economics analysis. In a 1998 article, Christine Jolls, Cass R. Sunstein and Richard Thaler noted, "Thirty years from now we hope that there will be no such thing as behavioral economics. Instead we hope that economists and economically oriented lawyers will … transform economics into behavioral economics, and economic analysis of law into one of its most important branches."[67] Following the scandals, the study of behavioural effects on economics garnered greater strength and momentum from these market-immobilizing events. George A. Akerlof, for example, argued in his Nobel Lecture on December 8, 2001, two months after news of the Enron scandal broke, that macroeconomics should be behavioural and that John Maynard Keynes' *General Theory* "was the progenitor of the modern behavioral finance view of asset markets."[68] The following year, the selection of Daniel Kahneman as the co-recipient of the 2002 Nobel Prize in economic sciences indicated to many "the ascendancy of behavioral economics."[69]

One would think the corporate and accounting scandals of 2001 and 2002 would leave an indelible mark against Hansmann and Kraakman's claim that the shareholder primacy model was the final resting place of the corporate form.

65 Jolls, Sunstein & Thaler, *supra* note 57 at 1546.

66 See e.g. Prentice, *supra* note 62; Jolls, Sunstein & Thaler, *supra* note 57.

67 *Ibid* at 1547.

68 George A Akerlof, "Behavioral Macroeconomics and Macroeconomic Behavior" in Peter Englund, ed, *Nobel Lectures Including Presentation Speeches and Laureates' Biographies: Economic Sciences 2001-2005* (New Jersey: World Scientific, 2005) 19 at 37, online: Nobel Prize <http://nobelprize.org>.

69 Peter H Huang, "Regulating Irrational Exuberance and Anxiety in Securities Markets" in Francesco Parisi & Vernon L Smith, eds, *The Law and Economics of Irrational Behaviour* (Stanford, CA: Stanford University Press, 2005) 501 at 502.

Hansmann himself noted five years after his article with Kraakman that "[t]he most serious argument against the efficiency claim…is that the standard shareholder-oriented model involves too steep a tradeoff between material prosperity and social order.… It is from this perspective that the end of history claim is weakest."[70] It was apparent from the scandals that the human limitations of "bounded rationality, bounded will-power, and bounded self-interest"[71] exposed the inherent flaws found within perceived transparencies and efficiencies in the financial market. Following those events, many felt a behavioural approach to law and economics offered a better way of addressing human weaknesses in regulatory design, but the approach contained few positive prescriptions for the development of an alternative, competing model. The burden continued to rest on lawmakers' abilities to adequately protect stakeholder interests through contractual or regulatory means, and not on the corporate governance model itself. The scandals were potentially damaging to the reputation of the shareholder primacy model, but its continued survival only solidified Hansmann and Kraakman's argument that the model had lasting acceptance within US ideological thought.

III. NARRATIVES FROM THE GLOBAL FINANCIAL CRISIS

A. Repeal of the *Glass-Steagall Act*[72]

The *Banking Act of 1933*,[73] popularly known as the *Glass-Steagall Act* (*GSA*), had restricted commercial banks from any involvement in the securities industry, creating a firewall between commercial banking and investment banking. On November 12, 1999, then-US President Bill Clinton signed into law the *Gramm-Leach-Bliley Act*[74] (*GLBA*), which repealed some of the key elements of the *GSA* so that banks could thereafter be affiliated with securities firms.

Then-US Treasury Secretary Lawrence Summers described the repeal of the *GSA* as "updat[ing] the rules that have governed financial services since the Great Depression and replac[ing] them with a system for the 21st century," thereby allowing American banks to "grow larger and better compete on the world stage."[75] Senator Phil Gramm, the chief sponsor of the *GLBA*, identified the *GSA* as a

70 Henry Hansmann, "How Close is the End of History?" (2006) 31:3 J Corp L 745 at 747-48.

71 Jolls, Sunstein & Thaler, *supra* note 57 at 1476. See also Simon, *Administrative Behavior*, *supra* note 59 at xxiv-xxvii; Simon, *Models of Man*, *supra* note 59 at 196-206.

72 See Cristie Ford and Carol Liao, "Power Without Property, Still: Unger, Berle and the Derivatives Revolution" (2010) 33:4 Seattle UL Rev 889 at 919, n 123, 927-28, nn 153-54 (for an earlier account of the repeal of the *GSA*).

73 *GSA*, *supra* note 1.

74 *Financial Services Modernization Act of 1999*, Pub L No 106-102, 113 Stat 1338 (codified as amended in scattered sections of 15 USC) (commonly known as the *Gramm-Leach-Bliley Act*).

75 Cyrus Sanati, "10 Years Later, Looking at Repeal of Glass-Steagall," *The New York Times* (12 November 2009), online: The New York Times Deal Book <http://www.nytimes.com>.

"punitive" law that was brought about by fear and popular "demagoguery" from the Great Depression, and which "forced an artificial separation of the financial sector of our economy."[76] Other senators also argued that the *GSA* created "unnecessary barriers"[77] in the economy, and applauded its demise.[78]

Looking back, the *GSA* had already been considerably weakened by incremental bank incursions over the line of separation through the 1990s. However, what is less widely known is how one of the largest pending mergers[79] of its time, between two financial giants, Citicorp Inc. (Citicorp) and Travelers Group Inc. (Travelers), ultimately dealt the final blow to the Act. The deal between these corporations created the largest "financial supermarket" in the world, "giving [both institutions] access to an expanded client base"[80]—particularly with Travelers promoting its mutual funds and insurance to Citicorp's retail customers. The pending $70 billion merger (totalling over $698 billion in assets)[81] to form Citigroup Inc. (Citigroup) was in violation of certain provisions of the *GSA* as well as the *Bank Holding Company Act of 1956*[82] because of its resulting combination as a financial services company offering commercial banking and investment operations. All involved were aware the merger violated the law, but the potential financial gains were enough for powerful business executives to go out of their way and lobby politicians to ensure future law would support it.[83]

While it is true that the Citicorp-Travelers merger legally closed following the implementation of the *GLBA*, it had already been agreed to well in advance of the introduction of that legislation. When Citicorp and Travelers announced the signing of their merger on April 6, 1998, Sanford Weill of Travelers, in response to questions regarding the legal hurdles before the two corporations, stated, "We are hopeful that over that time the legislation will change.... We have had enough discussions [with the Federal Reserve Board] to believe this will not be a problem."[84] In the end, the executives of the future Citigroup "basically drafted the [legislation]

76 US, *Cong Rec*, vol 145, 20, at S28360 (4 Nov 1999) (Senator Gramm).

77 *Ibid* at S28354 (Senator Wyden).

78 See *ibid* at S28322-23 and S28355 (for statements by Senator Lieberman and Senator Hagel).

79 See Mitchell Martin, "Citicorp and Travelers Plan to Merge in Record $70 Billion Deal: A New No. 1: Financial Giants Unite," *The New York Times* (7 April 1998), online: The New York Times <http://www.nytimes.com>.

80 *Ibid*.

81 *Ibid*.

82 12 USC § 1841 (United States Government Printing Office Supp 1992).

83 The Senate Banking Committee had approved the initial draft of the *GLBA* on March 4, 1999, almost a year after the parties announced their deal to the media, and five months after the companies had effectively merged. See Senate Banking Committee, Press Release, "Time Line of Gramm-Leach-Bliley Act," online: United States Senate Committee on Banking, Housing & Urban Affairs <http://banking.senate.gov/prel99/1105tme.htm>; Citigroup Inc, *200Years Citi*, online: Citigroup <http://www.citigroup.com/citi/press/mobile/ir/html/timeline/index-com.html> [Citigroup] (which provides relevant dates in the 1992 timeline under "Capital markets after the merger" and "Momentous encounter leads to merger").

84 Martin, *supra* note 79.

that would govern its behavior."[85] Kenneth H. Thomas, a consultant and lecturer in finance at the Wharton School of the University of Pennsylvania, noted that "Citigroup is not the result of [the *GLBA*] but the cause of it."[86] Weill had forced the repeal issue of the *GSA*. In his induction into the Academy of Achievement, Weill's biography outlines the strategic manoeuvres that came with changing the law:

> Weill and Citicorp Chairman John S. Reed decided to force the issue [of repeal]. They went ahead with their plan and secured a waiver whereby the temporary merger of the companies would be permitted, pending congressional action. Weill recruited former President Gerald Ford, a Republican, and former Treasury Secretary Robert Rubin, a Democrat, to serve on the board of the merged companies and assist them in making their case to Congress.[87]

The timing by which Robert Rubin entered the picture is of particular interest. Rubin was still US Treasury Secretary at the signing of the merger, serving in that capacity from 1995 to 1999.[88] As Treasury Secretary, he played a large role in brokering the passage of the final draft of the *GLBA*, which allowed Citicorp and Travelers to legally merge. Following Senate approval of the bill on May 6, 1999, Rubin resigned as Treasury Secretary. Five months later, he became the Chairman of the Board at the newly formed Citigroup.[89] While recognizing that it was Rubin's expertise which made him a contender in a very small group of people who were under serious consideration to take on these government and private sector roles, the example is an exposing one. It is erroneous to believe that political actions are necessarily separated from corporate influence and powerful lobbying efforts, or that regulators and corporate actors at elite levels are distinctly separate. The United States Supreme Court decision in *Citizens United v Federal Election Commission*, which eliminated the ban on corporate political spending, could magnify this point in the future.[90]

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85 Chris Suellentrop, "Sandy Weill: How Citigroup's CEO Rewrote the Rules So He Could Live Richly," *The Slate* (20 November 2002), online: Slate.com <http://www.slate.com>.

86 Kenneth H Thomas, "Don't Underestimate the Power of Sandy Weill," Letter to the Editor, *Businessweek* (30 September 2002), online: Businessweek.com <http://www.businessweek.com> (comments that previous *Businessweek* articles on the Citibank-Travelers merger do not explain how Citibank essentially caused the *GLBA* to exist).

87 Academy of Achievement, "Sanford Weill Biography: Financier and Philanthropist," online: Academy of Achievement <http://www.achievement.org>. Interestingly, Weill recanted his position 13 years later. See Michael J De La Merced, "Weill Calls for Splitting up Big Banks" *The New York Times* (25 July 2012), online: The New York Times Dealbook <http://www.nytimes.com>.

88 US Department of the Treasury, "Robert E Rubin (1995-1999)," online: US Department of the Treasury <http://www.treasury.gov>.

89 Citigroup, *supra* note 83.

90 130A S Ct 876 (2010). See also Adam Liptak, "Justices, 5-4, Reject Corporate Campaign Spending Limit: Dissenters Argue that Ruling Will Corrupt Democracy," *The New York Times* (22 January 2010) A1, online: The New York Times <http://www.nytimes.com>.

An extensive consolidation in banking occurred following the repeal of the *GSA* by the *GLBA*. Between 1990 and 2005, more than 5,400 mergers occurred in the US banking industry, involving more than $5.0 trillion in banking assets.[91] Arthur E. Wilmarth, Jr. noted that "US and European banks took advantage of the progressive dismantling of the [*GSA*] by acquiring dozens of US securities firms … and large securities firms [in turn] made their own acquisitions.[92] The bank merger wave meant that the proportion of banking assets held by the 10 largest US banks more than doubled, from 25 percent in 1990 to 55 percent in 2005. Wall Street firms also secured bank-like powers by acquiring depository institutions insured by the Federal Deposit Insurance Corporation (FDIC), enabling them to offer FDIC-insured deposits and to make commercial and consumer loans.[93] By 2006, the four largest US securities firms—Merrill Lynch, Morgan Stanley, Goldman Sachs and Lehman Brothers—had effectively become "de facto universal banks" or shadow banks.[94]

Many have noted that the problematic mix of the two banking sectors was self-evident. Andrew Sheng, for example, stated "you cannot mix the culture of investment banking (where risk taking is key) and commercial banking (where prudence is vital) under one roof."[95] The repeal of regulatory firewalls under the *GSA* invited "massive contagion" between banking industry sectors.[96] Martin Wolf of the *Financial Times* observed "that financial liberalisation and financial crises go together like a horse and carriage."[97] Several experts have pointed to the shadow banking system as the "core of what happened" to cause

91 Arthur E Wilmarth, Jr, "The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis" (2009) 41 Conn L Rev 963 at 977.

92 *Ibid*.

93 *Ibid* at 977-8.

94 *Ibid* at 978.

95 Andrew Sheng, *From Asian to Global Financial Crisis: An Asian Regulator's View of Unfettered Finance in the 1990s and 2000s* (New York: Cambridge University Press, 2009) at 401.

96 *Ibid* at 326.

97 Martin Wolf, "This time will never be different," *Financial Times* (28 September 2009), online: Financial Times <http://www.ft.com>. On December 16, 2009, Senators John McCain and Maria Cantwell proposed legislation to Congress reinstating the *GSA* or a form of it, under which large banks "would be forced to return to the business of conventional banking, leaving the task of risktaking or management to others." Alison Vekshin, "U.S. Senators Propose Reinstating Glass-Steagall Act," *Bloomberg* (16 December 2009), online: Bloomberg.com <http://www.bloomberg.com>. The proposal sparked a renewed debate on whether the repeal of the *GSA* led to the current financial crisis. Regardless of one's stance, reactions on the feasibility of the proposal have been mixed, with some very strong dissents. These dissents reflect the loaded question of how practical a reconstruction of former legal structures would be once property has been allowed to disperse and co-mingle to such an extent. The proposed legislation has not moved forward. See *ibid*; Alison Vekshin & James Sterngold, "Reviving Glass-Steagall Means Escalating 'War' on Wall Street," *Businessweek* (27 December 2009), online: Businessweek.com <http://www.businessweek.com>; Michael Hirsh, "An Odd Post-Crash Couple," *Newsweek* (14 December 2009), online: The Daily Beast.com <http://www.thedailybeast.com/newsweek>.

the crisis.[98] The questionable relationship between Citigroup management and its regulators in the repeal of the *GSA* is only one of a multitude of factors leading up to the global financial crisis, but it is a telling one. The reliance of regulation to protect stakeholder interests under the shareholder primacy model is problematic, and ignores the realities of disinterested owners (who through computerized markets are able to own and then sell shares in fractions of a minute, among other things), the growing phenomenon of shareholder decisions being manipulated by vote buying through equity derivatives,[99] the singularly-focused and well-connected executives, as well as the regulators whose actions do not show a meaningful regard for broader stakeholder interests.

B. Originate-to-Distribute Model of Lending[100] and Repeal of Anti-Predatory Lending Legislation

The failure to protect broader stakeholder interests through regulation, a key tenet within Hansmann and Kraakman's definition of the shareholder primacy model, is further evidenced when examining the backstory behind the development of the originate-to-distribute model of lending (OTDM). An unregulated, over-the-counter (OTC) derivatives market permitted many corporate institutions to capitalize on inventive methods of generating income—and capitalize they did. The OTDM allowed financial institutions to reduce their capital charges and transfer the risks associated with securitized loans to a market hungry to buy them. The strategy worked as follows: (i) originate consumer mortgage loans; (ii) package the loans, in tranches, into mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs); (iii) create additional OTC derivatives whose values are derived from the underlying loans; and (iv) distribute the repackaged securities to investors.[101] Most institutions only held onto mortgages long enough to sell them to investors, which promoted a higher-risk environment for loan production.

In addition to creating a separation between the mortgagor-mortgagee relationship and its accompanying mortgage risks, originating financial institutions

98 See e.g. Paul Krugman, *The Return of Depression Economics and the Crisis of 2008* (New York: WW Norton & Company, 2009) at 163. See also Wilmarth, Jr, *supra* note 91; Financial Crisis Inquiry Commission, *supra* note 2 at 27-37; Katrina Brooker, "Citi's Creator, Alone with His Regrets," *The New York Times* (3 January 2010) BU1. But see Peter J Wallison, "Did the 'Repeal' of Glass-Steagall Have Any Role in the Financial Crisis? Not Guilty. Not Even Close," Policy Brief (2009-PB-07), Networks Financial Institute at Indiana State University, online: Networks Financial Institute <http://www.networksfinancialinstitute.org>.

99 Henry TC Hu and Bernard Black have outlined the negative potential effects that arise from so-called "empty voting" and "hidden (morphable) ownership," where derivatives have allowed investors to readily separate economic ownership of shares from voting rights. Hu & Black have produced a series of articles on the matter. For their inaugural landmark piece, see Henry TC Hu & Bernard Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership" (2006) 79 S Cal L Rev 811.

100 The first two paragraphs in this section describing the originate-to-distribute model of lending are derived from a longer account that appeared in Ford & Liao, *supra* note 72 at 903-6.

101 See Wilmarth, Jr, *supra* note 91 at 981.

sold mortgages immediately to investors and were therefore able to replenish their funds and issue more loans to generate greater transaction fees. The financial incentive was so great that it motivated corporations to (i) originate risky loans without screening borrowers and (ii) avoid post-loan monitoring of the mortgagees' behaviour because the loans were transferred to investors.[102] A potential mortgagee was previously required to provide documentary evidence of adequate income and assets to support the repayment of the loan. With time, however, the fierce competition between lending institutions lessened the requirements to a point where "No Income, No Asset" (NINA) mortgages were created. In these NINA mortgages, a potential mortgage borrower would not be required to provide any evidence of their income or assets to qualify for a loan. Of course, this development also meant that no information would be verified by the mortgage lender. As put by one former executive director at the mortgage trading desk of Morgan Stanley, "We're setting you up to lie. Something about that transaction feels very wrong … Unfortunately what happened, we did it because everybody else was doing it."[103]

How did the mortgage lending industry get to this point? A well-functioning shareholder primacy model recognizes that stakeholder interests are exclusively within the purview of the government, and stakeholder protection must be sought through contractual or regulatory means. Why were no stiff anti-predatory lending laws in place to, at the very least, curtail some of the worst corporate behaviours being exhibited by the industry? The easy answer would be to blame state and federal legislators for failing to govern effectively. However, powerful lobbying efforts by corporate institutions, just like those discussed in the preceding narrative, played a critical role in influencing regulatory inaction. These lobbying efforts prevented the implementation of regulations that could have contained reckless lending practices. More troubling, an International Monetary Fund (IMF) paper has provided empirical evidence supporting the correlation between lobbying activities by corporate and financial institutions on issues related to mortgage lending and securitization, and significantly riskier mortgage lending strategies by those institutions leading up to the crisis.[104]

Several subprime lenders and banking trade groups, particularly Ameriquest Mortgage Company (Ameriquest) but also "Citigroup Inc., Wells Fargo & Co., Countrywide Financial Corp. and the Mortgage Bankers Association, spent heavily on lobbying and political giving [such as donations and campaign contributions]… to defeat anti-predatory lending legislation"[105] in the

102 *Ibid* at 974.

103 Alex Blumberg, "355: The Giant Pool of Money Transcript" (5 May 2008) Interview of Mike Francis on *This American Life*, Chicago Public Radio Archives at 11, online: This American Life <http://www.thisamericanlife.org/radio-archives/episode/355/transcript>.

104 Prachi Mishra, Deniz Igan & Thierry Tressel, *A Fistful of Dollars: Lobbying and the Financial Crisis*, Working Paper No 09/287 (Washington, DC: IMF Publications, 2009), online: International Monetary Fund <http://www.imf.org>.

105 Glenn R Simpson, "Lender Lobbying Blitz Abetted Mortgage Mess," *The Wall Street Journal* (31 December 2007) B1.

run-up to the crisis. From 2002 through 2006, Ameriquest and its affiliates donated at least $20.5 million to state and federal political groups.[106] Hiring lobbyist Lisa Andrews as Senior Executive for Government Affairs at Ameriquest meant the company gained access to several lobbying firms dedicated to influencing legislation. During her tenure at Ameriquest, Andrews noted that, at her separately owned Washington public relations firm, Washington Communications Group Inc., she had "built a coalition of mortgage brokers, mortgage bankers, appraisers, title companies, and others involved in home mortgage lending to create a grass-roots lobbying campaign that produced 7,000 emails and faxes to state policymakers in a six-week time frame."[107] Andrews' husband, Wright Andrews, and his governmental relations firm Butera & Andrews, "collected at least $4 million in fees from the subprime industry from 2002 through 2006…."[108] These efforts to influence the state laws that governed the industry worked tremendously well. For example, consider how industry lobbying efforts influenced Georgia's anti-predatory legislation. On April 22, 2002, Georgia signed into law the *Georgia Fair Lending Act* (*GFLA*) which became effective on October 1, 2002.[109] Among other things, the *GFLA* required lenders to be able to prove that a refinancing of any home loan less than five years old would provide a "tangible net benefit to the borrower."[110] Ameriquest began lobbying the state legislature to remove this provision, arguing the standard was too vague.[111] The company began contributing to Georgia

106 *Ibid*. See also Paul Muolo & Mathew Padilla, *Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis* (Hoboken: John Wiley & Sons Inc, 2008) at 91-93 (which details the lobbying efforts of Ameriquest and the Arnall family). Ameriquest founder Roland Arnall and his wife contributed more than $5.0 million to political organizations that backed then-US President George W Bush. See Simpson, *supra* note 105. On August 1, 2005, then-President Bush officially appointed Roland Arnall ambassador to the Netherlands (approved by the Senate on February 9, 2006). See Kirstin Downey, "Bush Picks Ameriquest Owner as Ambassador," *The Washington Post* (29 July 2005), online: The Washington Post <http://www.washingtonpost.com> (for a report on the press release and the ensuing negative public reactions); "Bush Nominates Arnall as Hague Ambassador," *Expatica News* (1 August 2005), online: Expatica <http://www.expatica.com/nl/main.html>.

107 Simpson, *supra* note 105. Washington Communications Group no longer has a website.

108 *Ibid*. Wright Andrews was also involved in "three different subprime-industry trade groups: the National Home Equity Mortgage Association, of which Ameriquest was a member; the Coalition for Fair and Affordable Lending, which spent $6.3 million lobbying against state laws before it dissolved [in early 2007] …; and the Responsible Mortgage Lending Coalition."

109 OCGA tit 7 § 7-6A (2007) [*GFLA*]. See also Department of Banking and Finance, "Georgia Fair Lending Act Resources," online: Department of Banking and Finance <http://www.dbf.georgia.gov>. A helpful summary of the terms of the original *GFLA* can be found on the Federal Reserve Bank of Atlanta website, see "Georgia's Anti-Predatory Lending Law," online: Federal Reserve Bank of Atlanta <http://www.frbatlanta.org>.

110 *GFLA*, *supra* note 109, § 7-6A-4(a).

111 See Muolo & Padilla, *supra* note 106 at 91-93; Simpson, *supra* note 105. A white paper produced by the Georgia Credit Union Affiliates, the Community Bankers Association of Georgia and the Georgia Bankers Association outlines some of the concerns held by those who opposed the new legislation at the time. See "Georgia Fair Lending Act: The Unintended Consequences" (January 2003), online: Georgia Bankers Association <http://www.gabankers.com>.

politicians[112] and the subprime industry mounted a campaign against the rule in the *GFLA*.

In October 2002, Ameriquest announced it would stop doing business in Georgia until the law changed.[113] Other lenders also complained about the law, as did the Federal National Mortgage Association (commonly known as "Fannie Mae") and the Federal Home Loan Mortgage Corporation (commonly known as "Freddie Mac"). Both "announced plans to leave the 'high-cost loan' market in Georgia," with Freddie Mac declaring that it would stop purchasing those loans as of November 2002 and Fannie Mae as of January 2003.[114] Fannie Mae also announced that it would "conduct additional quality assurance reviews of mortgages secured by properties in Georgia and [would] require 'immediate' repurchase of those loans determined to be high-cost home loans under the *GFLA*, or other federal, state or local laws."[115] Shortly there after, Standard & Poor Corp. (S&P) and Fitch Ratings (Fitch) announced they would no longer assign credit ratings to many mortgage securities containing subprime loans from Georgia.[116] Both S&P and Fitch believed that if loans were found to be in violation of the law, the legal risk could carry the investors, potentially tainting the securities. S&P contended that under the new law, "liability for predatory lending practices does not stop with the lender guilty of the predatory practices but transfers to all purchasers of the mortgage, including purchasers who had no knowledge or role in the predatory lending."[117] Without credit ratings, such securities would have been virtually unmarketable. The change raised the possibility that subprime lenders would simply stop making loans in Georgia. Within months, the Georgia state government passed new amendments that eliminated the "tangible net benefit"[118] requirement opposed by the industry for nearly all loans.[119] The same scenario began to play out in other states, including

112 See e.g. Simpson, *supra* note 105 (which reports that according to records of the Georgia State Ethics Commission in December 2001, Ameriquest "donated $2,500 to Lt. Gov. Mark Taylor after he emerged as an influential figure in the debate …, [and then] with another $2,500 in September 2002") [these records are no longer available via the Internet as they are over five years old].

113 *Ibid*. Records of any such announcement are no longer available online.

114 Federal Reserve Bank of Atlanta, *supra* note 109. The original announcements are no longer available on Fannie Mae and Freddie Mac's websites.

115 *Ibid*.

116 See "S&P Comments on Georgia Fair Lending Act Announcement" *Business Wire* (24 January 2003), online: Business Library <http://findarticles.com> ["S&P Comments"]; Mortgage Bankers Association, News Release, "Fitch Ratings Declines to Rate Georgia Loans in RMBS Pools Considers Impact to Other Predatory Lending Legislation" (12 October 2005), online: Press Center <http://www.mortgagebankers.org/NewsandMedia/PressCenter/32158.htm>.

117 "S&P Comments," *supra* note 116.

118 Simpson, *supra* note 105.

119 The State Senate voted 29-26 in favour of amendments; the State House of Representatives passed the law, 148-25. See Mortgage Banking Association Business Alert,"Georgia Passes Fair Lending Act Amendments" (1 April 2003), online: All Business <http://www.allbusiness.com> (which reports that "[t]he bill clarifies ambiguities in the *GFLA* and repeals provisions that had caused many mortgage lenders to cease lending activities in Georgia since the *GFLA* became effective in October 2002"). For a timeline of the *GFLA*, see Community Investment Network, "Georgia Predatory Lending Laws Legislative History," online: <http://www.communityinvestmentnetwork.org/index.php?id=1684>.

New Jersey, Illinois, New York, Pennsylvania and Texas, whose anti-predatory lending laws were also rolled back.[120] This again is a marked example of how the shareholder primacy model provides an incomplete story of how non-shareholder stakeholders can be adequately protected through regulation.

The mass production of subprime mortgage loans by the mortgage lending industry allowed for the derivative producing machine of the OTDM to operate on overdrive. Cristie Ford and I have noted that "[b]y 2006, the U.S. housing market was resting on what some called a system of 'Ponzi finance' in which subprime borrowers kept taking out new loans from equity on their homes to pay off their existing mortgages on those same homes."[121] In January 2006, Ameriquest announced a $325 million settlement with state attorneys general, law enforcement agencies and financial regulators across the US over allegations of predatory lending practices used to encourage homeowners to refinance mortgages. These allegations "included misrepresenting and failing to disclose loan terms, charging excessive loan origination fees, and inflating appraisals to qualify borrowers for loans."[122] The settlement covered approximately 725,000 loans valued at more than $109 billion that were made by Ameriquest from January 1, 1999 to December 31, 2005.[123] In May 2006, Ameriquest announced that it was closing all of its retail offices. In September 2007, all of its mortgage assets were sold to Citigroup.[124]

Ameriquest's eventual fall may support the belief that market regulation again sufficed. Nevertheless, it should be noted that Ameriquest is only one example that researchers can point to in hindsight—it is impossible to guess how many similar actions from corporations have gone unprosecuted to date. Furthermore, Ameriquest's demise does not change how lobbying efforts rolled back anti-predatory lending laws intended to protect mortgage borrowers. Housing prices began to decline in mid-2006, and borrowers who bought more real estate than they

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120 See Muolo & Padilla, *supra* note 106 at 92; Simpson, *supra* note 105. The Mortgage Bankers Association website also lists a significant number of news releases issued from groups in the mortgage lending industry that lobbied against anti-predatory lending laws in several states, online: Mortgage Bankers Association <http://www.mortgagebankers.org>.

121 Ford & Liao, *supra* note 72 at 905.

122 New York State Office of the Attorney General, Press Release, "Governor Spitzer and Attorney General Cuomo Announce More Than 13,000 New Yorkers to Receive Settlements in Predatory Lending Case" (24 December 2007), online: New York State Office of the Attorney General <http://www.oag.state.ny.us>.

123 State of New York Banking Department, Press Release, "Banking Department Joins Regulators and Law Enforcement Officials from 48 Other States in Announcing Settlement Agreement with Ameriquest Mortgage Company" (23 January 2006), online: State of New York Banking Department <http://www.banking.state.ny.us/pr060123.htm>. In 2005, Ameriquest's employees also accused the company in the press. See Mike Hudson & E Scott Reckard, "Workers Say Lender Ran 'Boiler Rooms,'" *Los Angeles Times* (4 February 2005), online: Los Angeles Times <http://www.latimes.com> (where the authors indicate that critics stated the company "fabricated data, forged documents and hid fees," among other things).

124 Jonathan Stempel, "Ameriquest Closes, Citigroup Buys Mortgage Assets," *Reuters* (1 September 2007), online: Reuters <http://www.reuters.com>. See generally Financial Crisis Inquiry Commission, *supra* note 2.

could afford could not refinance and began defaulting on their loans. The increase in mortgage defaults and housing foreclosures translated into a sharp decline in the value of MBSs, CDOs and other bundled securities, and the subprime mortgage meltdown began.

There have been varied interpretations of how the collapse of the subprime mortgage market transformed into the broader financial crisis.[125] The generally accepted interpretation of events can briefly be described as follows. In the midst of the collapse, it was revealed that "too big to fail" institutions had engaged in a multitude of credit default swaps on those aforementioned MBSs, CDOs and other bundled securities. These securities were intended to insure investors against what these institutions believed to be the almost impossible event of default.[126] By some estimates, the collective exposure of institutional investors in mid-2007 exceeded even that of banks.[127] As the crisis continued to unfold, institutional investors in need of cash began to face a serious liquidity problem, but could not sell the asset-backed securities in their portfolios due to low liquidity levels in the market.[128] As a result, they turned to their more liquid holdings of corporate bonds. However, as Rob Goldsmith noted:

> [W]ith several mutual funds and other institutional bond investors also trying to liquidate their corporate bond holdings, the market for these, too, was flooded and so prices plunged. As a result, the cost to companies of obtaining financing by issuing corporate bonds increased. And, as a result of that, their ability to finance their operations was crippled, thus spreading the financial crisis to the real economy.[129]

At this juncture, it is worth noting an alternative explanation put forth by Gary B. Gorton on how the subprime mortgage collapse spun into the global financial crisis. First, Gorton argues that, despite popular belief, the originate-to-distribute model of lending was not an instigating factor in the crisis. He states:

125 Indeed, the Financial Crisis Inquiry Commission, which was put in place "to examine the causes, domestic and global, of the current financial and economic crisis in the United States" in accordance with section 5 of the *Fraud Enforcement and Recovery Act of 2009*, Pub L No 111-21, § 5, 123 Stat 1616-25, acknowledged, "[t]here [were] many competing views as to the causes of [the] crisis." Financial Crisis Inquiry Commission, *supra* note 2 at xxv. See e.g. *ibid* at 411-538 (for dissenting views in the Report by four members of the Commission).

126 See Adrian Blundell-Wignall, "Structured Products: Implications for Financial Markets" (2007) 93:2 Financial Market Trends 27 at 45, online: OECD <http://www.oecd.org>; Alberto Manconi, Massimo Massa & Ayako Yasuda, "The Role of Institutional Investors in Propagating the Financial Crisis of 2007-2008" (2012) 104 J Fin Econ 491 at 492, n 9.

127 *Ibid*.

128 *Ibid*.

129 Rob Goldsmith, "'Intoxicated' Institutional Investors: How the Financial Crisis Infected the Real Economy," *INSEAD Knowledge* (15 June 2010), online: INSEAD <http:/www.insead.edu>.

> Securitization generally is not the problem currently. It is not the cause of the crisis. Securitization is an efficient form of financing, and there is no evidence that there is a systematic agency problem in its functioning. Rather, the particular form of the design of subprime mortgages is at root the problem. It was highly sensitive to house prices, and this sensitivity was passed through to a variety of other financial structures.[130]

Gorton believes that the subprime mortgage market, by itself, is too small to cause a crisis of such magnitude.[131] Instead, he compares the collapse of the subprime market to an E. coli infection in a nation's beef supply.[132] The infection itself is only a small problem, but an ensuing panic can cause the entire beef industry to collapse. He contends that the shadow banking system is, "genuine banking and, [as] it turns out, [is] vulnerable to the same kind of bank runs as in previous U.S. history."[133] A banking panic occurs when "information insensitive" debt becomes "information sensitive" due to a shock.[134] He argues that the events starting in August 2007 can best be understood as a wholesale banking panic involving institutions, whereby "firms [withdrew] from other firms" (unlike the retail banking panics of the 19th and early 20th centuries, where individual depositors withdrew from their banks).[135] In the crisis, falling house prices caused a shock to subprime mortgage values. Large financial firms "ran" on other financial firms. These large financial firms refused to rollover their sale and repurchase agreements (repos) or to increase the repo margin (called a "haircut") after having grave doubts about the collateral that was being offered: securities-based residential mortgages.[136] This chain of events forced massive deleveraging and resulted in an insolvent banking system. Therefore, Gorton contends that the banking panic was *triggered*, and not caused, by the collapse of the subprime market. He admits, "[t]here is much work to be done to understand the ongoing panic, to formally test my (sometimes admittedly vague) conjectures, and it will be [*sic*] surely be some time before researchers can sort through the events."[137] Nevertheless, Gorton's research provides an interesting counterpoint to the widely accepted view that the originate-to-distribute model of lending played a causal role in the crisis.

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130 Gary B Gorton, *Slapped by the Invisible Hand: The Panic of 2007* (New York: Oxford University Press, 2010) at 146 [Gorton, *The Panic of 2007*]. Gorton provides a detailed analysis on subprime mortgage design at 61-114 (particularly at 74-81).

131 Gary B Gorton, "Questions and Answers about the Financial Crisis: Prepared for the U.S. Financial Crisis Inquiry Commission" (20 February 2010) [unpublished, archived at the Social Science Research Network] at 6, online: Social Science Research Network <http://www.ssrn.com>.

132 Gorton, *The Panic of 2007*, *supra* note 130 at 112-13. See also Gary B Gorton, "E-coli, Repo Madness, and the Financial Crisis" (2010) 45:3 Bus Econ 164.

133 Gorton, *The Panic of 2007*, *supra* note 130 at 6.

134 *Ibid* at 32-33.

135 *Ibid* at 16.

136 *Ibid* at 61-114.

137 *Ibid* at 145.

C. Developments Arising from the Crisis

The fallout from the crisis led to numerous calls for accountability. The OTC derivatives market, despite its long existence, was suddenly being referenced in the media as part of the "dark markets" that "fueled [the] meltdown."[138] "Dark" implied that the markets were not overseen by a specialized governing authority like the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). When asked who was to blame for the crisis, US Treasury Secretary Timothy F. Geithner did not place the blame on the mortgage lenders that had enticed borrowers to accept mortgages beyond their means. He did not cite greed on the part of the financial institutions or imprudence on the part of the borrowers. Instead, Secretary Geithner stated, "[t]he financial crisis was caused by significant gaps in oversight," and that "[o]ne of the reasons crisis can spread so rapidly… is the uncertainty people have in judging risk."[139]

The above-identified events from the global financial crisis provide a striking example of how large corporate institutions are almost regarded as beasts that need to be tamed,[140] with regulatory bodies acting as the lion tamers who are at fault if there is injury to the public. While it is certainly reasonable and necessary to have a level of expectation rest upon the state to govern corporate behaviour to the extent that it affects the wider community, the ability of institutions to disregard the impact their corporate actions have on stakeholders is discouraging. Furthermore, the level of influence these institutions wield on the very governing bodies that are supposed to regulate them, through lobbying efforts or otherwise, is most troubling.

Until the crisis, the OTDM may have been perceived by outsiders as an acceptable approach that furthered the goal of increasing profit or share value under the shareholder primacy model. As such, the managers were doing what they were supposed to do within one set of norms that guided their behaviour. The government failed by allowing these institutions to get carried away with their legally permitted (and arguably encouraged) activities. The OTDM, NINA mortgages, the greed of the mortgage lenders, imprudence of the mortgage borrowers, incessant lobbying by profit-maximizing corporations and over-hedging by financial products traders all played an undeniable role in the lead-up to the crisis. However, most of those involved have not been touched by the law because, despite "breathtakingly bad behavior" and "real dishonesty" of those involved,[141]

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138 David Cho & Zachary A Goldfarb, "U.S. Pushes Ahead with Derivatives Regulation," *The Washington Post* (14 May 2009) A01, online: The Washington Post <http://www.washingtonpost.com>.

139 *Ibid*.

140 This metaphor has been used in the past, the well-known reference being from Ralph Nader, Mark Green & Joel Seligman, *Taming the Giant Corporation* (New York: WW Norton & Company, 1976).

141 Cristie Ford, "New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation" (2010) 2 Wis L Rev 441 at 461.

no laws were broken.[142] The public's reaction to the crisis was to hold someone accountable, but the governing authorities were willing to allow both the law and regulators to shoulder much of the blame. Thus, the crisis has illustrated how corporate behaviour, influenced by the governance structure in capital markets, can have the inexplicable result of causing both the public and governmental authorities to hold market rules accountable for failing to restrict corporate conduct, rather than blaming the actual corporate conduct itself.

IV. COMPARING PERSPECTIVES IN THE AFTERMATH OF THE CRISIS

Looking back at the three perspectives identified by Deakin and Konzelmann following the scandals of 2001 and 2002 in Part II(B), one can see how there are contrasting notes this time around. The position of the first group, which held that market sanctions alone were effective disciplinary devices, cannot seriously be considered any longer in the wake of the global financial crisis. In fact, the crisis may have destroyed the very premise on which this position rests. In an article published in *The New York Times* in September of 2009, Paul Krugman criticizes economists like Olivier Blanchard, now Economic Counsellor (chief economist) at the IMF, for their declaration of a positive economic state prior to the financial crisis.[143] Blanchard wrote an article in 2008 declaring that "the state of macro[economics] is good,"[144] and in a tone reminiscent of Hansmann and Kraakman, argued that "there has been broad convergence in vision" and methodology for macroeconomics.[145] Krugman writes,

> The renewed romance with the idealized market was, to be sure, partly a response to shifting political winds, partly a response to financial incentives .... Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections

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142 On April 16, 2010, the SEC charged Goldman Sachs with fraud for placing financial bets on the prediction that the investments it created and sold through the originate-to-distribute model of lending would fail. See "Watch This Case," Editorial, *The New York Times* (17 April 2010) A16, online: The New York Times <http://www.nytimes.com>; Sewell Chan & Louise Story, "S.E.C. Settling its Complaints with Goldman: $550 Million Penalty in Subprime Case," *The New York Times* (16 July 2010) A1, online: The New York Times <http://www.nytimes.com>. On August 9, 2012, the US Justice Department stated that it would not bring fraud charges against Goldman Sachs for its role in the mortgage crisis. See Reed Albergotti & Elizabeth Rappaport, "US Not Seeking Goldman Charges," *The Wall Street Journal* (9 August 2012) C1, online: The Wall Street Journal <http://online.wsj.com>.

143 Paul Krugman, "How Did Economists Get it So Wrong?" *The New York Times* (2 September 2009) MM36, online: The New York Times <http://www.nytimes.com> [Krugman, "Economists"].

144 Olivier J Blanchard, "The State of Macro" (2009) 1 Annu Rev Econ 209 at 210.

145 *Ibid*; Hansmann & Kraakman, *supra* note3.

> of markets—especially financial markets—that can cause the economy's operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don't believe in regulation.[146]

Posner, however, has found the large apportionment of blame laid upon capitalism to be misdirected. In his analysis of the crisis, Posner admits that "[l]aissez-faire capitalism failed us,"[147] but on the question of whether the industry or the government was more responsible, Posner emphatically believes the responsibility lies with the government. For Posner, "[the] government allowed the preconditions of depression to develop and wreak havoc with the economy,"[148] and it was the government that provided "responses to the crisis [that] were late, slow, indecisive, and poorly articulated."[149] Directing a pointed attack at Krugman, Posner states: "[t]he journalists and politicians, and some who should know better, like the distinguished macroeconomist Paul Krugman, are engaged in an orgy of recrimination against Wall Street. They have the wrong target. The responsibility for building the fences that prevent an economic collapse as a result of risky lending devolves on the government."[150]

Posner has been careful to distance himself from scholars who have applied behavioural analysis in the autopsy of blame. He has insisted that those on Wall Street were acting rationally, calling the media coverage of Wall Street greed and extravagance as "ignorant" and "silly" and rhetorically asking: "What did reporters think businessmen were like?"[151] He insists that blame rests on the lack of regulation by the government, and not the rational actions conducted by individuals which ultimately led to the crisis. Posner states:

> By having over a period of decades largely deregulated banking, and credit generally, the government inadvertently allowed the rational self-interested decisions of private actors—bankers, mortgage brokers, real estate salesmen, homeowners, and others—to bring on a financial crisis that the government was unable to prevent from molting into a depression. A profound failure of the market was abetted by governmental inaction.[152]

146 Krugman, "Economists," *supra* note 143.
147 Richard A Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Cambridge, MA: Harvard University Press, 2009) at 236 [Posner, *Failure of Capitalism*].
148 *Ibid*.
149 *Ibid*.
150 *Ibid* at 285.
151 *Ibid* at xiii.
152 *Ibid* at 242-43.

Posner's position is helpful in highlighting many of the problematic arguments generally advanced by avid supporters of the shareholder primacy model. First, Posner has identified reckless behaviour—which was clearly evidenced in the OTDM and the NINA mortgages—as rational. Second, as the previous narratives have shown, Posner has ignored how large institutions are capable of invoking powerful and unrelenting lobbying efforts on US lawmakers when issues regarding their regulation and governance are at stake. Lastly, Posner's position seems to be an about-face on the Chicago School's usual free market position regarding the government's role in regulating industries, a position it maintained even after the Enron scandal.[153]

Posner has admitted that he and the Chicago School erroneously believed "that markets were perfect, which is to say self-regulating, and that government intervention in them almost always made things worse."[154] He has berated the three major CRAs—Moody's, S&P and Fitch—and argued that they should each lose their quasi-official status as Nationally Recognized Statistical Rating Organizations for their role in perpetuating the crisis.[155] Surprisingly, Posner suggests, among other things, that reinstating the *GSA* is a viable and realistic solution.[156] The Chicago School of law and economics may need to readjust itself to the new political and economic climate. If it does not readjust, the Chicago School's influence will weaken as other fields of study gain greater traction.

Still, Posner's strong reproach of governmental inaction during the crisis does not mean he shied away from recognizing that the crisis was also "a failure of capitalism"[157] and the unfettered market. Deakin and Konzelmann's first position examined in response to the scandals of 2001 and 2002—being the belief that laissez-faire market sanctions are sufficient in times of financial turmoil—is now on tenuous ground. It is easy to call Enron an aberration and leave things as the status quo. However, the global financial crisis cannot be called an aberration, a market hiccup or a normal bubble that burst. The US government's $700 billion bailout and stimulus package has significantly limited the viability of that argument. The crisis has thus caused many belonging in the first group, including Posner, to make a strong shift into the second group that is focused on improving corporate behaviour through the tightening of securities regulation.

In fear of the crisis causing the "second Great Depression,"[158] the US government first implemented emergency response legislation through the *American*

153 See e.g. Becker, *supra* note 55.

154 Richard A Posner, *The Crisis of Capitalist Democracy* (Cambridge, MA: Harvard University Press, 2010) at 331-32.

155 *Ibid* at 349-50.

156 *Ibid* at 353-54. But see *supra* note 97 (which discusses the problems with reinstating the *GSA*).

157 See Posner, *Failure of Capitalism*, *supra* note 147.

158 Eileen Ng, "Krugman: World Avoided Second Great Depression," *The Huffington Post* (10 August 2009), online: The Huffington Post <http://www.huffingtonpost.com>.

Housing Rescue and Foreclosure Prevention Act of 2008[159] and the *Emergency Economic Stabilization Act of 2008*,[160] the latter of which authorized the government's $700 billion bailout. Following these Acts, President Barack Obama announced his support of the "Volcker Rule," named after Paul Volcker, head of the President's Economic Recovery Advisory Board and former Chairman of the US Federal Reserve. The Volcker Rule specifically prohibits banks from engaging in proprietary trading that is not undertaken on behalf of its clients, and from owning or investing in a hedge fund or private equity fund. It also limits the liabilities that the largest banks can hold.[161]

Volcker's appointment has been heartening for many who are seeking more aggressive ways to reform Wall Street. As part of his argument that banks should be prevented from taking advantage of governmental safety nets in order to make speculative investments, Volcker has acknowledged the need for deep, sweeping and multifaceted structural reform in the financial services industry, while also pointing to reform measures that may substantially alter the internal governance of financial institutions.[162]

Volcker's participation in governmental reform efforts has led to numerous changes that have been adopted in the *Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA)*, which President Obama signed into law on July 21, 2010.[163] Its preamble states that the purposes of the Act are "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices."[164] Resonating with voices from Deakin and Konzelmann's second group, the legislation puts a great deal of faith in the watchful eye of regulators to prevent another financial crisis, "leav[ing] the financial industry largely intact but facing a more powerful

159 US, Bill HR 3221, 107th Cong, 2008 (engrossed within the enacted *Housing and Economic Recovery Act of 2008*, Pub L 110-289, 122 Stat 2654).

160 Pub L No 110-343, 122 Stat 3765.

161 *Ibid*. Five former US Treasury Secretaries endorsed the Volcker Rule in a Letter to the Editor in *The Wall Street Journal*. W Michael Blumenthal et al, "Congress Should Implement the Volcker Rule for Banks," *The Wall Street Journal* (22 February 2010), online: The Wall Street Journal <http://online.wsj.com>.

162 Paul Volcker, "How to Reform Our Financial System," *The New York Times* (31 January 2010) WK11, online: The New York Times <http://www.nytimes.com>. Volcker has also stated: "We ought to have some very large institutions whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit.... They ought to be the core of the credit and financial system. Those institutions should not engage in highly risky entrepreneurial activity." David Cho & Binyamin Appelbaum, "Obama's 'Volcker Rule' shifts power away from Geithner," *The Washington Post* (22 January 2010), online: The Washington Post <http://www.washingtonpost.com>.

163 Pub L No 111-203, 124 Stat 1376 (2010) [*DFA*]. After much political wrangling, the *DFA* was approved by the House of Representatives on June 30, 2010, and approved by the Senate on July 15, 2010. THOMAS: The Library of Congress, *Bill Summary & Status 111th Congress (2009-2010) H.R. 4173*.

164 *DFA*, *supra* note 163 at Preamble.

network of regulators who could impose limits on risky activities."[165] The Act creates new agencies to police consumer lending, financial products innovations and trading in the dark markets of complex derivatives. Consumer lending is now under the purview of a new consumer financial protection bureau,[166] while the SEC is granted authority to broaden the regulation of hedge funds and CRAs.[167] Many derivatives are now required to be traded through clearinghouses, and traders must disclose pricing data to encourage transparency and competition.[168] The Act also increases the regulatory powers of the Federal Reserve; establishes a systemic risk council to detect potential threats to the overall financial system; and provides new powers to constrain and even dismantle troubled companies, forcing creditors and shareholders to bear losses so taxpayers do not end up footing the bill.[169] Nevertheless, the Act still "leaves a vast number of details for regulators to work out," which some point out is "inevitably setting off another round of battles that could last for years."[170]

Prior to the final approval of the bill, a flurry of lobbying efforts and deal-making allowed several industries to escape many of the provisions found in the *DFA*. Intense lobbying efforts translated into automobile dealers receiving an exemption from oversight by the new consumer bureau, despite being "among the biggest originators of consumer credit in America…."[171] Dealers argued that the rules would place unnecessary restrictions on their financing businesses. The Obama administration opposed such an exemption, but gave in to these demands during negotiations. Most significantly, industry lobbyists made a concerted effort to push for a series of exemptions to the Volcker Rule that would allow banks to continue to operate businesses as investment funds that hold only client funds.[172] Asset management and insurance companies pushed for a carve-out to exclude them from the Act outright, succeeding in large part.[173] As well, Senator Scott Brown, the Republican representative from Massachusetts, pushed for an exemption from

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165 David Cho, Jia Lynn Yang & Brady Dennis, "Lawmakers Guide Dodd-Frank Bill for Wall Street Reform Into Homestretch," *The Washington Post* (26 June 2010), online: The Washington Post <http://www.washingtonpost.com>.

166 *DFA*, *supra* note 163, §§ 1011-18. See also Peter J Henning, "A New World Begins for Wall Street Oversight," *The New York Times* (19 July 2010), online: The New York Times Dealbook <http://dealbook.blogs.nytimes.com/2010/07/19/a-new-world-begins-for-wall-street-oversight/>.

167 *DFA*, *supra* note 163, §§ 401-416, 931-39H.

168 *Ibid*, §§ 701-74

169 *Ibid*, §§ 101-213.

170 Binyamin Appelbaum & David M Herszenhorn, "Financial Overhaul Signals Shift on Deregulation," *The New York Times* (16 July 2010) A1, online: The New York Times <http://www.nytimes.com>; Henning, *supra* note 166.

171 Michael Riley, "Auto Dealers Fight Regulatory Reform Bill," *The Denver Post* (11 May 2010), online: The Denver Post <http://www.denverpost.com/commented/ci_15058324?source=commented>.

172 Eric Dash & Nelson D Schwartz, "Bank Lobbyists Make a Run at Reform Measures," *The New York Times* (21 June 2010) B1, online: The New York Times <http://www.nytimes.com> (namely hedge funds and private equity units).

173 *Ibid*.

the Volcker Rule that would allow banks to continue to invest in hedge funds and private equity firms, which ultimately succeeded.[174] It was reported that Brown was largely focused on assisting the corporate interests of Boston-based money management giants like Fidelity Investments and State Street Corporation, but the exemption also allows many of the financial institutions at the core of the crisis to keep any assets or subsidiaries that would have violated such regulations.[175]

Volcker himself endorsed the final version of the *DFA*, "but unenthusiastically."[176] He believes that banks still have "too much wiggle room to repeat the behavior that threw the nation into crisis in the first place."[177] Both critics and endorsers alike have also contended that the Volcker Rule has been weakened to the point where it will likely be ineffective in its application.[178] Many have pointed out that the *DFA* leaves so much decision-making in the hands of regulators that it could lead to a field day for lobbyists in the financial industry.[179]

Unlike what was seen following the corporate and accounting scandals of 2001 and 2002, the US government has not capitalized on efforts to improve governance within the institutions that brought about the crisis. Other than allowing shareholders to have an advisory vote on executive compensation—which conceptually aligns with the principles behind the shareholder primacy model—there are no corporate governance reform measures addressed in this legislation, let alone any that challenge the present-day model. There are no regulations set to tighten internal governance, make boards more competent and accountable for complex risk-taking activity, improve internal risk management or address stakeholder interests in corporate decision-making. Any considerations regarding other structural corporate governance reform, as expressed in Deakin and Konzelmann's third group, do not appear in the legislation created in reaction to the crisis. President Obama indirectly said this himself, stating that "unless your

174 Stephen Gandel, "In Financial Reform, Rules Made to Be Broken," *TIME* (28 June 2010), online: TIME <http://www.time.com>. See also Yalman Onaran, "Volcker Said to Be Disappointed with Final Version of His Rule," *Bloomberg* (30 June 2010), online: Bloomberg <http://www.bloomberg.com>.

175 See Gandel, *supra* note 174; Dash & Schwartz, *supra* note 172.

176 Louis Uchitelle, "Volcker, Loud and Clear: Pushing for Stronger Reforms, and Regretting Decades of Silence," *The New York Times* (11 July 2010) BU1 [Uchitelle, "Loud and Clear"].

177 *Ibid*.

178 See e.g. William K Black, "Why the Financial Reform Bill Won't Prevent Another Crisis," *CNN Money* (26 July 2010), online: CNN Money <http://money.cnn.com/2010/07/18/news/economy/finreg_law_incentives_bill-black.fortune/index.htm> (which argues that the bill does not address perverse compensation incentives); Mark Thoma, "The Dodd-Frank Financial Reform Bill" *CBS Money Watch* (15 July 2010), online: CBS News <http://www.cbsnews.com> (which describes how the Volcker Rule has been so weakened by exemptions that it is likely to be ineffectual); Aline van Duyn & Francesco Guerrera, "Dodd-Frank Bill is No Glass-Steagall," *Financial Times* (27 June 2010), online: Financial Times <http://www.ft.com/cms> (which describes the bill as one "that came out of a 20-hour horse-trading session," and in which firms "have to navigate a maze of prohibitions"). But see Reid Cramer, "Dodd-Frank Financial Reform: The Rise of the Regulators," *The Huffington Post* (13 July 2010), online: The Huffington Post <http://www.huffingtonpost.com> (which argues that the bill "will actually go a long way to create … meaningful reform").

179 Dash & Schwartz, *supra* note 172.

business model depends on bilking people, there is little to fear from these new rules."[180]

Indeed, the corporate behaviour of these institutions may prove President Obama's words to be true. Wall Street firms have aggressively sought ways to get around restrictions in the *DFA*. For example, according to media reports, "UBS prepared a 20-page 'action plan' outlining various options [to curtail the effects of the Act], while senior managers at Goldman Sachs had preliminary discussions on eventually dropping its status as a federally insured bank, allowing it to escape several of the most stringent provisions in the new law."[181] It was also reported that "Wall Street trading floors are buzzing about creative ways to possibly limit the impact" of the Volcker Rule, with unidentified traders informing reporters that "it will be tricky for regulators to define what [legally] constitutes a proprietary trade as opposed to a reasonable hedge against looming risks. Therefore, banks might still be able to make big bets by simply classifying them differently."[182] Frank Partnoy commented: "Wall Street has always been very skilled at getting around rules, and this law will be no exception… Once you open up the door just a crack, Wall Street shoves the door open and runs right through it."[183] Volcker also stated that "[p]eople are nervous about the long-term outlook, and they should be."[184]

It seems that US culture is at least passively settled with the shareholder primacy model as it currently exists. Governments are responsible for adjusting legal rules to restrain certain incentives that guide the existing model. If corporate conduct causes negative ramifications to society without appropriate regulation to address it, the solution is to create reactionary law to prevent such conduct from recurring in the future. It suggests that a cyclical pattern of disaster and reactionary lawmaking will always accompany the financial markets if the shareholder primacy model is here to stay. This pattern is particularly concerning as innovative financial products are produced with a level of speed and complexity that has regulators struggling to keep up. After considering the regulatory overhaul plan when it was initially proposed by the Obama administration, even before it was whittled down by lobbying groups and partisan politics, Krugman already saw that it was not enough, stating that "[i]t seems all too likely that the industry will soon go back to playing the same games that got us into this mess in the first place."[185] If lasting change on a broader scale is expected, other pathways to reform—namely, those resonating from Deakin and Konzelmann's third group—need to be considered.

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180 Office of the Press Secretary, Press Release, "Remarks by the President on Wall Street Reform" (22 April 2010), online: The White House <http://www.whitehouse.gov>.

181 Dash & Schwartz, *supra* note 172.

182 *Ibid*.

183 *Ibid*.

184 Uchitelle, "Loud and Clear," *supra* note 176.

185 Paul Krugman, "Don't Cry for Wall Street," *The New York Times* (23 April 2010) A27, online: The New York Times <http://www.nytimes.com>.

V. RETHINKING CORPORATE GOVERNANCE REFORM

A. Borrowing Old and New Institutional Approaches

The focal point of this article is to shed new light onto old arguments that critique the shareholder primacy model, using modern financial calamities as the compelling backdrop. In the pursuit of an alternative corporate governance model, there may be value in reconsidering the issue by borrowing elements from both institutional law and economics and new institutional economics (NIE). This section first provides very brief descriptions of elements within the two fields that may assist as a starting point for reforming the shareholder primacy model, and then offers examples of structural reform in the business world.

Nicholas Mercuro and Steven G. Medema state that "[f]rom the Institutional perspective, law is fundamentally a matter of rights creation and re-creation."[186] The government is seen as playing a central and inevitable role within the process because "[r]ights are whatever interests government protects vis-à-vis other interests when there is a conflict."[187] Significance rests on the issue of whose rights are enabled through law, as well as on the subsequent structures that perpetuate those rights. Thus, "terms such as regulation, deregulation, and government intervention [are] misleading," as the critical issue "turns on whose interests government allows to be realized and who is able to use government for what ends."[188]

The recognition of governmental rights creation also means institutional scholars challenge their neoclassical counterparts on the notion of an ultimate efficient result, arguing that an outcome is efficient only with regard to an assumed initial structure of rights.[189] The way in which a structure is formed "will give rise to a particular set of prices, costs, outputs, and the like, and thus to a particular efficient allocation of resources."[190] In this sense, institutional scholars strongly contend that "[t]here is no independent test by which the law's solution can be said to be *the* efficient solution."[191] A structural change means a corresponding modification to what is regarded as most efficient. As Warren J. Samuels asserts, "[t]o argue that wealth maximization [or any other efficiency criterion] can determine rights serves only to mask a choice of which interests to protect as rights. Legal decisions or changes can be said to be efficient only from the point of view of the party whose

186 Mercuro & Medema, *supra* note 12 at 224.

187 Warren J Samuels, "Commentary: An Economic Perspective on the Compensation Problem" (1974) 21:1 Wayne L Rev 113 at 127.

188 Mercuro & Medema, *supra* note 12 at 225.

189 A Allan Schmid, "Law and Economics: An Institutional Perspective" in Nicholas Mercuro, ed, *Law and Economics* (Boston: Kluwer, 1989) 57 at 68-69.

190 Mercuro & Medema, *supra* note 12 at 227.

191 Warren J Samuels, "Maximization of Wealth as Justice: An Essay on Posnerian Law and Economics as Policy Analysis," Book Review of *The Economics of Justice* by Richard A Posner, (1981) 60 Tex L Rev 147 at 155.

interests are given effect ...."[192] Because the government and institutional structures are seen as primary sources through which control or power is effectuated, the main focus of institutional scholars is to understand how the governmental allocation of rights within such institutions shapes the performance of the economic system over time.[193]

The recognition of alternative efficient solutions, as well as the contingent nature of any "efficient" result on a presumed rights structure and definition of output, exposes the inherent normative elements embodied within the shareholder primacy model. The term "shareholder primacy" itself leaves little doubt as to which corporate actor is perceived as having the greatest legal and normative rights. Having share value as the principle measure of interest amplifies how "[t]he determination of a particular efficient solution involves a normative and selective choice as to whose interests will be accommodated, who will realize gains, and who will realize losses."[194] Alternative legal models that allocate rights differently, or include other methods of calculating output, will invariably point to different efficient outcomes.

NIE is also valuable to consider as it "consists of answering new questions, why economic institutions emerged the way they did and not otherwise; it merges into economic history, but brings sharper [microanalytic] ... reasoning to bear than had been customary."[195] NIE asserts, among other things, that "institutions do matter" and "the determinants of institutions are susceptible to analysis by the tools of economic theory."[196] There are several elements within NIE that overlap with behavioural approaches; many NIE scholars reject formal rational behaviour, and advocate models based on Simon's bounded rationality,[197] among others. The institutional component of this field may provide that crucial missing link between neoclassical and behavioural approaches that is needed for a structural reform of the existing governance model. NIE may help to answer the question,

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192 *Ibid* at 154.

193 Mercuro & Medema, *supra* note 12 at 224-26. Institutional scholars take a critical look at the measure in which neoclassical efficiency is calculated. For institutional scholars, "[t]he definition of 'output'—of what it is that one is to be efficient about—requires an antecedent normative specification as to the appropriate performance goal for society. Social output (the aggregate well-being of society), consumptive output (the value of goods from the consumer point of view), and productive output (the value of goods from the producer point of view, i.e., profits) are three examples of the alternatives that are available. The value-laden choice of a particular definition of output as the maxim, which in effect is the choice of a particular social welfare function where many are possible, will drive the decision as to what constitutes the efficient allocation." *Ibid* at 228. See also Warren J Samuels, "Normative Premises in Regulatory Theory" (1978) 1:1 J Post Keynesian Econ 100 at 102-4 (the ideas in the preceding quote from Mercuro & Medema are attributed to Samuels' 1978 piece).

194 Mercuro & Medema, *supra* note 12 at 229.

195 Kenneth J Arrow, "Reflections on the Essays" in George Feiwel, ed, *Arrow and the Foundations of the Theory of Economic Policy* (New York: New York University Press, 1987) 727 at 734.

196 R C O Matthews, "The Economics of Institutions and the Sources of Economic Growth" (1986) 96:384 The Econ J 903 at 903.

197 See Simon, *Administrative Behavior*, *supra* note 59 and Simon, *Models of Man*, *supra* note 59.

"why [do] less than optimal arrangements persist over time[?]"[198] And more importantly, how can these suboptimal arrangements be changed?

Walter W. Powell has argued that "the full power of the institutional perspective has yet to be realized due in part to ambiguities in some of the initial contributions to this line of work and to the fact that a somewhat stylized version of institutional theory—a restricted institutionalism—has thus far been explicated."[199] NIE's emphasis on environmental factors, power imbalances, political influences and economic arrangements are only some themes that may add considerable value when rethinking corporate governance reform. Admittedly, there is much more still to be developed in NIE; within the field there are several competing voices and ideas. But as Oliver Williamson put it, "NIE is informative and should be included as part of the reform calculus."[200]

There is friction within the two fields—institutional law and economics had its glory days in the 1920s and 1930s[201] but continues to resonate in law and economics scholarship, whereas NIE (which was coined by Oliver Williamson in the 1970s) has been gaining popularity in academic circles and claims have been made that "its best days lie ahead."[202] NIE seeks to differentiate itself from old institutional theory and offers vibrant discussions to present-day issues. This tension may prove useful to corporate governance reformists; elements from both approaches help to clarify and broaden the scope of the issues that are necessary to consider when establishing a theoretical basis for reform.The following sections examine reform efforts that are taking place to alter the current shareholder primacy model of the American business world.

B. "Other Constituency" Statutes and the B Corporation

Consideration of stakeholder interests has generally been allowed under several US state laws since as far back as the 1980s, when the takeover boom saw several states implement "other constituency" (also known as "nonshareholder constituency"[203] or "corporate constituency"[204]) legislation expressly permitting (and in

198 Walter W Powell, "Expanding the Scope of Institutional Analysis" in Walter W Powell & Paul J DiMaggio, eds, *The New Institutionalism in Organizational Analysis* (Chicago: University of Chicago Press, 1991) at 183.

199 *Ibid*.

200 Oliver Williamson, "The New Institutional Economics: Taking Stock, Looking Ahead" (2000) 38:3 J Econ Literature 595 at 610.

201 John F Bell, *A History of Economic Thought* (New York: Ronald, 1967) at 568, cited in Mercuro & Medema, *supra* note 12 at 208.

202 Williamson, *supra* note 200 at 611.

203 Stephen M Bainbridge, "Interpreting Nonshareholder Constituency Statutes" (1992) 19:3 Pepp L Rev 971 [Bainbridge, "Nonshareholder Constituencies"].

204 Lawrence E Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes" (1992) 70:3 Tex L Rev 579.

at least one state, requiring[205]) directors to consider stakeholders in their decision-making.[206] Over 40 states have implemented such legislation.[207]

B Lab is a Philadelphia-based non-profit organization that has capitalized on the other constituency statutes. The self-imposed and privately regulated B Corporation rating system and certification represents an attempt to establish a new form of socially-minded corporation "which harnesses the power of private enterprise to create public benefit."[208] The B Corporation uses available state laws to form its base. A company must already be incorporated in a state with an other constituency statute, or must re-incorporate in a jurisdiction with such a statute in order to become a B Corporation.[209] The B Corporation is attempting to "use the power of business to solve social and environmental problems."[210] At the time of this article, there are 635 US B Corporations, with the number steadily increasing.[211]

In order to become a B Corporation, a company is first required to take a B Impact Assessment which asks socially-minded questions relating to accountability, employees, consumers, community and the environment.[212] B Lab's governance-related questions strongly imply support for greater stakeholder-based and board-controlled management. A corporation is certified once an acceptable score is obtained under their Rating System, and the company is required to submit supporting documents for a portion of the answers.[213] B Lab relies on this certification and a separate auditing system to ensure B Corporations are pursuing and achieving their social mandates. Within an allotted time following certification, B Corporations are also required to amend their articles of incorporation to permit directors to consider more than just shareholder interests when carrying out their duties.[214]

205 *Connecticut Business Corporation Act*, Conn Stat tit 33 § 33-600-33-998 (2011) [*Connecticut Act*].

206 See also Andrew Keay, "Moving towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado about Little?" (2011) 22:1 Eur Bus L Rev 1 (for examples of wider interests groups, which includes community and societal considerations); Bainbridge, "Nonshareholder Constituencies," *supra* note 203; Mitchell, *supra* note 204.

207 Kathleen Hale, "Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes" (2003) 45:3 Ariz L Rev 823 at 833, n 78.

208 B Corporation, *Declaration of Interdependence*, online: B Corporation <http://www.bcorporation.net/declaration>.

209 B Corporation, *The Legal Requirement*, online: B Corporation <http://www.bcorporation.net/become/legal>.

210 B Corporation, *What is a B Corp?*, online: B Corporation <http://www.bcorporation.net/about>.

211 B Corporation, *FAQ*, online: B Corporation <http://www.bcorporation.net/faq> (for a point of reference, in August 2008, there were 120 B Corporations).

212 See e.g. B Corporation, *B Impact Assessment 2010*, online: B Corporation <http://www.bcorporation.net/resources/bcorp/documents/2010-B-Impact-Assessment%20(1).pdf>. Participants also receive questions specific to their industry.

213 B Corporation, *Become a B Corporation*, online: B Corporation <http://www.bcorporation.net/become-a-b-Corp>.

214 *Ibid*.

It is important to include stakeholder interests in directorial decision-making during potential change of control scenarios, and explicitly indicate that directors may select an offer with a lower share price based on stakeholder interests in order to carve out any implications arising from the landmark decision in *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*[215] (*Revlon*). In the case, the Supreme Court of Delaware held that directors owe a fiduciary duty to maximize shareholder value in takeover contexts, regardless of nonshareholder interests. The *Revlon* decision is generally regarded as one of the leading judicial precedent in support of the shareholder primacy model, and B Lab has elected to address the matter head-on. To date, there have been no legal challenges to any of B Lab's suggested amendments to company articles.

While the numbers are impressive given the grassroots nature of this phenomenon, the number of B Corporations is infinitesimally small when compared to the amount of corporations existing in the United States, which, according to the US Census Bureau, totals over 27 million businesses.[216] Dana Brakman Reiser cautions that "it remains to be seen whether this system will have strong teeth."[217] She comments that:

> [T]he B corporation form realistically offers only moral, rather than legal, assurances to non-shareholder constituencies and social interests. Stakeholders have no structural rights in governance, and no additional parties are granted standing to litigate. B corporation directors are empowered to act in the interests of other constituencies; whether they do so will depend on their own desires or feelings of moral obligation.[218]

Given that B Lab is a private organization, it does not have the authority to manipulate existing legal structures. Nevertheless, the B Impact Assessment goes to the core of the business purpose and mission, and addresses stakeholder interests and sustainability concerns. Corporations may choose to become B Corporations so they can align themselves with like-minded companies, and the B Corporation branding may "draw in directors committed to a blended mission and investors willing to enforce it."[219] It could one day be a certification popularly recognizable to consumers.

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215 506 A2d 173, ALR 4th 157 (Del Sup Ct 1985) [*Revlon*].

216 United States Department of Commerce, *Statistics about Business Size (including Small Business) from the U.S. Census Bureau*, online: United States Census Bureau <http://www.census.gov/econ/smallbus.html>. This number is as of 2009. More recent statistics are unavailable.

217 Dana Brakman Reiser, "Governing and Financing Blended Enterprise" (2010) 85 Chicago-Kent L Rev 619 at 643.

218 *Ibid* at 642.

219 *Ibid* at 643.

B Corporation advocates have been involved in encouraging state governments, such as those in Maryland and Vermont (which will be examined in the next section), to change their corporate laws to create the legal infrastructure necessary for business/mission hybrid corporations. As a strategic movement that has tapped on the shoulders of business leaders and politicians for support, the B Corporation may become meaningful in changing the way corporations are perceived to do business.

C. State Benefit Corporations

In 2010, the states of Maryland and Vermont each passed "benefit corporation" legislation, facilitating new corporate structures designed to create both social benefits and shareholder value.[220] Maryland's benefit corporation laws took effect on October 1, 2010[221] and Vermont's on July 11, 2011.[222] Several states have followed suit.[223] There are no tax incentives attributed with these laws.

The laws passed in Maryland and Vermont both state that the purpose of a benefit corporation is to create a general public benefit, which is defined as "a material positive impact on society and the environment, as measured by a third-party standard, through activities that promote [some] combination of specific public benefits.[224] A corporation seeking benefit corporation status in either state must include or make a clear and prominent statement in its articles that it is a benefit corporation."[225] Unlike B Lab's certification, there are no specific criteria to qualify as a Maryland or Vermont benefit corporation so long as proper company

220 Corporate Social Responsibility Newswire, "Maryland First State in Union to Pass Benefit Corporation Legislation" (14 April 2010), online: Corporate Social Responsibility Newswire <http://www.csrwire.com>; Outdoor Industry Association, "Vermont Becomes Second State to Pass B Corporation Legislation" (2 June 2010), online: Outdoor Industry Association <http://www.outdoorindustry.org>.

221 *Corporations and Associations*, Md Code Ann tit 5 § 5-6C-01 (2010) [*Maryland Act*].

222 *Vermont Benefit Corporations Act*, Vt Stat tit 11A § 21 (2011) [*Vermont Act*].

223 In addition to Maryland and Vermont, at the time of this article, benefit corporation legislation had been enacted in California, Hawaii, Illinois, Massachusetts, Louisiana, New Jersey, New York, South Carolina and Virginia, and introduced in Pennsylvania, Colorado and Washington, DC. State by State Status, *State by State Legislative Status*, online: Benefit Corp Information Center <http://www.benefitcorp.net>.

224 *Maryland Act*, *supra* note 221, § 5-6C-01(c); *Vermont Act*, *supra* note 222, § 21.03(4). 'Third-party standard' under the *Vermont Act* means "a standard for defining, reporting, and assessing best practices in corporate social and environmental performance that: (A) is developed by a person or entity that is independent of the benefit corporation; and (B) is transparent because the following information about the standard is publicly available or accessible: (i) the factors considered when measuring the performance of a business; (ii) the relative weightings of those factors; and (iii) the identity of the persons who developed and control changes to the standard and the process by which those changes were made." *Ibid*, § 21.03(8). Maryland has similar provisions with some *de minimis* differences in wording. See *Maryland Act*, *supra* note 221, § 5-6C-01(e).

225 *Ibid*, § 5-6C-03, § 5-6C-05; *Vermont Act*, *supra* note 222 at § 21.05. If a corporation elects to withdraw from its benefit corporation status, it must obtain two-thirds shareholder approval to amend its articles and delete the benefit corporation statement. The *Vermont Act* requires a statement from the board to explain the reasons why status is being terminated and the effect such termination will have on its shareholders. *Vermont Act*, *supra* note 222, § 21.07(1).

approvals have been met. Both states refer to their existing state corporate laws to fill any holes in the benefit corporation laws.

A significant aspect of the benefit corporation laws is the codification of stakeholder interests in directorial decision-making. Both Maryland and Vermont outline factors to be considered by a director when determining what is in the best interests of the benefit corporation, which in traditional corporate law and practice has referred only to shareholder value. In Maryland, benefit corporation legislation stipulates that a director is required to "consider the effects of any action or decision not to act on:"

> (1) the stockholders of the benefit corporation;
> (2) the employees and workforce of the benefit corporation and the subsidiaries and suppliers of the benefit corporation;
> (3) the interests of customers as beneficiaries of the general or specific public benefit purposes of the benefit corporation;
> (4) community and societal considerations, including those of any community in which offices or facilities of the benefit corporation or the subsidiaries or suppliers of the benefit corporation are located; and
> (5) the local and global environment.[226]

Vermont has an additional sixth factor, encompassing "the long-term and short-term interests of the benefit corporation, including the possibility that those interests may be best served by the continued independence of the benefit corporation."[227] In contrast to the standard articulated in *Revlon*, this addition provides substantially the same protection as a similar provision offered by the B Corporation model by relieving directors of the duties to maximize shareholder value in a takeover situation. The explicit inclusion may offer some symbolic vindication for the state of Vermont, home of the socially-minded ice cream business, Ben & Jerry's Homemade, Inc. (popularly known as Ben & Jerry's), whose board in 2000 had multiple offers to purchase the company but had no choice but to sell to the highest offer or risk a shareholder lawsuit. The much-publicized takeover by the British-Dutch conglomerate Unilever hit a nerve for many in Vermont, and the social enterprise sector in general.[228]

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226 *Maryland Act*, *supra* note 221, § 5-6C-07(a)(1). Vermont has similar provisions with some *de minimis* differences in wording. See *Vermont Act*, *supra* note 222, § 21.09(a).

227 *Ibid*, § 21.09(a)(1)(F).

228 Ben & Jerry's Homemade, Press Release, "Ben & Jerry's and Unilever to Join Forces" (12 April 2000), online: Ben & Jerry's <http://www.lickglobalwarming.org/company/media-center/press/archives.cfm>. The much publicized takeover of Ben & Jerry's Homemade by Unilever is a frequent bitter example cited by social entrepreneurs. See e.g. Dave Gram, "States Move to Let Firms Pursue Social Mission," *The Seattle Times* (11 April 2010). But see Anthony Page & Robert A Katz, "Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon" (2010) 35 Vt L Rev 211 (which argues that Ben & Jerry's had strict anti-takeover defenses that their board declined to test, and that negative reactions to the sale of social enterprises may be misguided as such sales may create more opportunities for social enterprises to do good work).

In Maryland, the director has no duty (fiduciary or otherwise) to a person who is a general public beneficiary of the benefit corporation. Vermont, however, has actually gone a step further in expanding the definition of fiduciary duties for their directors.[229] Vermont directors have fiduciary duties only to those persons entitled to bring about enforcement proceedings against the benefit corporation, who have specifically been identified as:

> (1) a shareholder that would otherwise be entitled to commence or maintain a proceeding in the right of the benefit corporation on any basis;
> (2) a director of the corporation;
> (3) a person or group of persons that owns beneficially or of record 10 percent or more of the equity interests in an entity of which the benefit corporation is a subsidiary; or
> (4) such other persons as may be specified in the articles of incorporation of the benefit corporation.[230]

A benefit enforcement proceeding means a claim or action against a director or officer for failing to pursue the public benefit purpose set forth in its articles, or for violating any duty in the statute. While the expansion may seem slight, it is important. Shareholders, and shareholders of any parent company, can bring proceedings against the benefit corporation for violating the broader, codified stakeholder interests. Furthermore, a benefit corporation also has the freedom to specifically include any other persons with rights to bring proceedings in their articles.[231]

Both Maryland and Vermont require benefit corporations to be responsible for creating an annual benefit report, with Vermont requiring board approval prior to the report being sent out to shareholders.[232] The report in both states is required

229 *Vermont Act*, *supra* note 222 at § 21.09(e).

230 *Ibid* at § 21.13(b).

231 Vermont's expansion of duties thus has required setting out proper parameters of the directors' duties. Directors are not required to give priority to the interest of any particular person or group over the interests of any other person or group unless the benefit corporation has stated its intention of giving priority in its articles. See *Vermont Act*, *supra* note 222, § 21.09(a)(3). Directors are also not subject to a different or higher standard of care when decisions may affect the control of the benefit corporation, *ibid*, § 21.09(a)(4). As well, a director is not liable for the failure of a benefit corporation to create general or specific public benefit. In both states, directors have the same immunity from liability as directors of those corporations generally.

232 *Maryland Act*, *supra* note 221, § 5-6C-08(a); *Vermont Act*, *supra* note 222, § 21.14(a). Vermont has also created the requirement for one member of the board of directors to be designated as a benefit director. The benefit director is required to prepare an annual statement detailing whether, in the opinion of the director, the company acted in accordance with its benefit purpose in all material respects during the period covered by the report. If the benefit director believes the corporation or its directors or officers failed in its mission, then the statement should include a description of the ways in which they failed to so act. See *ibid*, § 21.10.

to include: (1) a description of how the benefit corporation pursued a public benefit during the year and the extent to which the public benefit was created; (2) any circumstances that hindered the creation of the public benefit; and (3) an assessment of the societal and environmental performance of the benefit corporation, prepared in accordance with a third-party standard.[233] Vermont also requires the inclusion of the amount of compensation paid to each director and the name of each shareholder owning five percent or more of the shares.[234] These additions add a heightened level of transparency and accountability that echoes some of the disclosure requirements of public companies.[235]

The development of these benefit corporation laws promotes a more stakeholder-based model with supporting infrastructure to encourage an active level of social responsibility. In combination with the B Corporation certification, which provides a normative component through its Rating System, a potential solution has been created to combat negative corporate behaviour that may be damaging to broader community, environmental and other stakeholder interests.

D. Way Forward

State-led initiatives that attempt to reform the shareholder primacy model are a step in the right direction. It is important to realize, however, that state-led reform is vulnerable to federal legislative authority. This is despite the "internal affairs" doctrine, which has been articulated in federal decisions as implying that states hold the power "to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."[236] Mark J. Roe has detailed how the federal government has frequently breached the doctrine separating state and federal powers.[237] He notes how this federal encroachment has been done formally, such as under the *SOX Act* and related initiatives that affect board structure and authority, and "informally when federal authorities, under the guise of regulating external corporate action—say, disclosure to securities markets—effectively

233 Vermont has also required a statement of the specific goals or outcomes, and actions that can be taken to attain them while improving its social and environmental performance. See *Vermont Act*, *supra* note 222, § 21.14(a)(1)(D). See also *supra* note 224 (for more on the third-party standard).

234 *Ibid* at § 21.14(a)(4)-(7).

235 This annual benefit report is to be delivered to each shareholder within 120 days following the end of the benefit corporation's fiscal year. See *Vermont Act*, *supra* note 222, § 21.14(b) (which states that Vermont also allows delivery to be at the same time that the benefit corporation delivers any other annual report to its shareholders). Vermont's legislation also states that, after reasonable opportunity for review, the shareholders of the benefit corporation must either approve or reject the annual benefit report by majority vote at the annual meeting of shareholders or at a special meeting held for that purpose. If the benefit corporation has a public website, the benefit corporation is required to post its most recent benefit report on the public portion of its website. See *ibid*, § 21.14(d). See also *Maryland Act*, *supra* note 221, § 5-6C-08(b), (c).

236 *CTS Corporation v Dynamics Corporation of America*, 481 US 69, 107 S ct 1637 at 1650, 95 L Ed (2d) 67 (1987).

237 Mark J Roe, "Delaware's Competition" (2003) 117:2 Harv L Rev 588.

assume control over the underlying governance structure of the corporation …."[238] Reform at the state level is compelling, but in order to permanently recalibrate existing power structures, there must be agreement, or at least passive acceptance, at the federal level. As Roe put it, "[w]hat remains with the states is the corporate law that the federal players tolerate, and what gets reversed is that which they do not."[239] Therefore, when considering alternative approaches, multifaceted reform efforts at both the state and federal level may be required to reconfigure efficiency within corporate structures, as "[t]he structure of corporate law [is inevitably] a mixed federal-state one…."[240]

Critiques by old and new institutional scholars of the Chicago School approach are effective in deconstructing the efficiency premises on which the shareholder primacy model stands. Through the neoclassical law and economics lens, "singular solutions" are given to issues which "reflect only one particular set of value premises and one particular conception of the facts, benefits, and costs at issue …," whereas institutional approaches "by recognizing the multiplicity of potential solutions and underlying value premises, [attempt] to flesh out the alternative possibilities that are open to society in the ongoing social construction and reconstruction of legal-economic reality."[241] Institutional and new institutional critiques draw attention to the prospect of alternative structures in which corporations can thrive—structures that do not require the concept of (and, indeed, desire for) efficiency to be thrown out. Instead, efficiency can be normatively reconceptualized to move beyond the narrowness of increasing share value, and broadened into the social context in which corporations clearly hold formidable power and influence.

Workable solutions, and their accompanying measures of achievement, continue to be a source of contention for those in the field of corporate law. But considering alternative approaches reawakens oneself to the possibilities that are available. Broader reform efforts should be empowered by new corporate structures created by state governments that allow for the dual corporate mission of creating profit and social benefit. There is presently the opportunity to reassess long-held beliefs in corporate law; indeed, reconsidering the existing corporate governance model may never be as timely as now.

VI. CONCLUSION

This article provides a contemporary macro-level analysis on the longstanding debate for and against shareholder primacy. It identifies and organizes key scholarly perspectives within the debate and tracks their evolution alongside the volatile

238 *Ibid* at 597.

239 *Ibid* at 644.

240 *Ibid* at 644-45.

241 Mercuro & Medema, *supra* note 12 at 240.

financial environment that has defined the world's entrance into the 21st century. Topical narratives from within the global financial crisis illustrate how reform efforts in the wake of the crisis have been too limited in scope. Time and again we have seen how large public institutions, while operating within the confines of the law, focus on profit maximization and increasing share value. Then, following calamitous events, important figures scrutinize what went wrong and reform efforts take place.[242] Reform efforts targeted at the financial market level are indeed necessary, but there is a disservice in classifying the crisis as a one-off event resulting from specific failures in financial regulation, since legislative changes become limited to addressing only those concerns. This article draws upon the financial crisis as an example of an ongoing dysfunction in the high-level governance model of corporate and financial institutions. The legal and ideological support of the shareholder primacy model of governance has laid the groundwork for corporate behaviour that heavily influences regulatory inaction and perpetuates the likelihood of future crises.

Across the Atlantic, there have been indications that European regulators are aware that their existing corporate governance model will need to be reformed. A green paper produced by the European Commission (EC) outlining several governance initiatives states: "[t]he financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least."[243] As a direct result of the crisis, the EC announced the launch of a broader review of corporate governance within publicly listed companies in general.[244] In the US, however, negligible governance reform measures found within the financial regulatory overhaul mean that very little will change in the way US corporate and financial institutions involved in the crisis will ultimately govern themselves. The US government has placed a high priority on modifying securities regulation to curtail specific market behavior without any changes to address the flaws within the existing governance model itself. This is despite evidence that governance structures designed to prevent events such as the mortgage meltdown have not only failed, but have incentivized the obstruction of efficient regulation.

Governance reform operates on two levels. The first level of reform attempts to make the actors in an existing model more accountable to the roles they are supposed to play in that model. The other level reconsiders the very model itself. It asks, what are the legal principles that we want to guide our corporate laws?

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242 See Uchitelle, "Loud and Clear," *supra* note 176 (where Paul Volcker, sharing this view, was quoted saying, "There is a certain circularity in all this business .... You have a crisis, followed by some kind of reform, for better or worse, and things go well for a while, and then you have another crisis").

243 European Commission, *Corporate Governance in Financial Institutions and Remuneration Policies* (Brussels: European Commission, June 2010) at 8, online: European Commission, Green Papers <http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf>.

244 *Ibid* at 9-19.

After all, the devastating financial effects from the crisis not only remind us that humans and structures are fallible, but they also signify that something is seriously amiss with the perceived efficiencies embodied in the dominant corporate model. The model accepted as the norm has justified selfish human behavior, while ignoring the broader community that corporations inevitably impact. This article provides a starting point to reconfigure the conversation. It points to alternative approaches, and provides examples where corporate structures are being manipulated in state laws to encompass broader stakeholder interests in corporate decision-making. These are steps in the right direction. Corporate governance reform needs to be made a part of any sweeping overhaul of the financial system, which moves beyond reinforcing the shareholder primacy model. As we move forward in the 21st century, it is time to rethink the governance design of the modern corporate institution.