In Defence of the Corporation

Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE

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Richard A Epstein

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He has been a member of the American Academy of Arts and Sciences since 1985 and a Senior Fellow of the Center for Clinical Medical Ethics at the University of Chicago Medical School. He served as editor of the *Journal of Legal Studies* from 1981 to 1991, and as editor of the *Journal of Law and Economics* from 1991 to 2001.

His books include *Skepticism and Freedom: A Modern Case for Classical Liberalism* (University of Chicago, 2003), *Cases and Materials on Torts* (Aspen Law and Business, 7th edition 2000), *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (Perseus Books, 1998), *Mortal Peril: Our Inalienable Right to Health Care* (Addison Wesley, 1997), *Simple Rules for a Complex World* (Harvard, 1995), *Bargaining with the State* (Princeton, 1993), *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992), *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985) and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects. He has taught courses in civil procedure, communications, constitutional law, contracts, corporations, patents, individual, estate and corporate taxation, Roman law, criminal law, health law and policy, legal history, labour law, property, real estate development and finance, jurisprudence, land use planning, torts and workers' compensation.

In Defence of the Corporation

In this modern age of global commerce, it seems odd that I have been asked to address the topic 'In defence of the corporation'. Even the most ardent critic of the corporation would not take the position that the corporate form should be dismissed as an ill-conceived venture of modernity so that it would be for the better to be rid of it and return to being a nation of artisans. As a first approximation, the success of the corporation can be measured by the extent of the assets that are controlled through that form of business entity. Here, and everywhere else in the world, the corporation has been enormously successful in attracting and retaining capital investment. The survival of the fittest in economic affairs is not a test to be lightly ignored.

How did this come about? One answer lies in the expansion of the number of enterprises that are entitled to assume the corporate form. The corporation is, as a legal entity, a business that only the state can create. Originally, when corporations were specially chartered institutions, the state conferred corporate status only on select individuals. It was necessary to appeal to the Crown or a branch of the state to obtain a charter. One of the great liberalisations of the nineteenth century was that anybody who could file the appropriate papers could get the benefits of the corporate form as a matter of right. What started as an exercise of political intrigue became a routine ministerial act. This process of democratisation tended to eliminate many of the monopoly elements associated with using the corporate form, because all businesses could then get the key advantages of limited liability and easily alienable interests. The decline of the special charter was a comprehensive legal reform that has produced enormous benefits.

However, while all are happy with the open nature of the corporate form, many critics have challenged aspects of the corporate structure, and have pressed for changes to current rules and practices. Would these changes make a good device better or worse? I discuss three issues that are raised by the question of regulation. These are:

- limited corporate liability – a defining feature of the corporation;
- the exchange and alienability of corporate shares; and
- questions of corporate governance.

I make special reference to the so-called US Sarbanes-Oxley Act, the Public Company Accounting and Investor Protection Act 2002. This complex statute was passed in the wake of the Enron and Tyco scandals, but its mysterious contours are no mere intellectual curiosity for New Zealand businesses. The United States has massive territorial ambitions for its statutes, and if New Zealand companies want to be listed in the United States, or perhaps just enter into affiliation agreements with US corporations, they will be caught in this web. The Act has the potential to apply to transactions in New Zealand and everywhere else throughout the world. So, if you do not already know about Sarbanes-Oxley, you will learn about it one way or another.

Limited liability

Limited liability is, in many ways, the distinctive feature of the corporation. Why does it have this particular character? To answer that question, ask this one first: would it be possible, using the basic device of a liberal society – voluntary exchange based on a limited set of property rights – to create limited liability, that is, the ability of the corporation to insulate its shareholders from claims made against it either in respect of the contracts that it enters into or, more controversially, the torts that it commits?

The answer is no. The reason is that all voluntary transfers of property or contractual arrangements are characterised by the conservation of rights as against external agents. Thus, if two entities enter into a contract with each other, the sum and substance of the rights that they hold against the rest of the world cannot be increased by virtue of any agreement among themselves. If that were not so, then A and B would be able to enter into an agreement

that imposed burdens on C without C's consent. The general rule that no voluntary arrangement can impose liabilities on third parties – the doctrine of the privity of contract, which protects strangers to the contract – sounds like a technical rule, but it is in fact one of the building blocks of civilisation. It follows that if one creates a corporation by gathering a group of investors and then announces that once investors have contributed money to the corporation the rest of their assets will be safe, such an agreement will be unenforceable against third parties. So why does the state involve itself in a way that gives special protection to the corporate interests involved? Why does this not count as a classic example of a special privilege given by law to the rich and the anointed?

Well, for a start, there is no privileged class of people. Subject to a few rule-based restrictions, anyone can form a corporation, there is no rationing, no discretionary decisions by government are required, and existing corporations have no say in preventing a fresh group of entrepreneurs from forming a new corporation. This standard process makes registering a corporation look more like a statutory right than a privilege.

Moreover, the issue with a special privilege does not turn solely on whether it exists, but, more critically, on whether it can be justified. The best way to think about that problem is to consider the alternative. Assume that we decide to stick to the uncompromising libertarian framework that does not allow for limited liability. What sort of ventures will be undertaken? People who go into business are enormously chary about choosing their partners, precisely because they know that the principle of mutual agency exposes all the assets of one to the potential derelictions of the other.

This principle has important implications as we consider the scale of various enterprises. Consider a small, professional service firm with two or three partners. If you select the right partners and get the right insurance, for the most part you can be reasonably confident that your exposure can be handled by private means. But it is not possible to raise funds for larger ventures that involve extensive capital obligations from only two or three people known to each other. Capital has to be attracted from hundreds and thousands of individuals willing to pool resources on the appropriate scale.

Each of these individuals will ask, 'do I wish to trust my investment to a group of people I do not know who could vote over my objection to employ it in strange ways? Do I want to contribute $10,000 to a particular venture if I can expose myself to $1 million of liability?'. The answer is clear: the risk-return ratio is too unfavourable. The wealthier the person, the greater the risk. All too often it will be better to pass.

Suppose a few individuals succeed in getting a venture going but that it is a shaky business with limited assets. Any outside party may have recourse against each and all of them personally. What if the harms that they cause are far in excess of the resources they have committed to the joint venture? The victim has the benefit of unlimited personal liability but complete undersatisfaction with respect to the firm's obligations. On the other hand, large corporations that have emerged by virtue of their ability to attract capital have greater concentrations of wealth in the limited liability form than could be obtained from ordinary persons in the absence of limited liability. Hence, limited liability not only works for the benefit of the parties to the transaction but, by virtue of the fact that it pools larger and larger amounts of assets together, it works in most cases for the protection of other individuals as well.

That last proposition deserves closer examination. There are two main sorts of claims to be considered. The first is contract claims arising from consensual arrangements such as the sale of goods or lease of property. The second is tort claims when the corporation's officers or employees engage in conduct that causes harm, remediable under the tort law, to third parties.

How does legal liability under a limited liability regime stack up in each of these situations? In the case of contract, the answer is clear. Suppose that the corporation has insufficient assets. That familiar situation is no different from an individual having insufficient assets. If a creditor wants guarantees there are ways in which he or she could arrange to secure them. The corporation could post some sort of fidelity bond, or the creditor could seek personal guarantees from the individuals behind the corporation. Of these devices, the one that is preferable will depend upon the perceived risk. If the risk is that the controllers of the corporation secrete assets and transfer them

out to other individuals, personal guarantees are appropriate. If the concern is the general sufficiency of funds, one might want fidelity bonds. However, if real caution is required, both forms of protection might be sought. The point is that as long as the individual contracting parties understand the nature of the risk that they face, they should be able to make arrangements in advance on whatever terms they see fit. If each party to these extended voluntary transactions is content, then, as usual, we have social improvement through mutual exchange.

When it comes to tort liability, there could be a much more serious issue. If a limited liability corporation engages in dangerous activities, there is always the risk that the assets of the firm will not be sufficient to meet the liabilities incurred as a result of its unilateral conduct. Under these circumstances, there is a genuine externality – too little provision to protect other people. But the same risk arises every day in respect of automobile accidents – namely that an automobile will cause damage that the owner cannot indemnify. The issue of tort insolvency is not unique to the corporation.

The solution in the case of automobile accidents is that those who use the public highways have to take out a minimum level of insurance cover to protect other persons. When it comes to corporations, the same kind of arrangement is possible. Indeed, personal liability supported by insurance is advantageous from the third party's point of view because liability insurance provides a separate revenue stream reserved for tort creditors, which cannot be appropriated by other creditors in the case of bankruptcy. In addition, the law needs to make some refinements to deal with more complex situations in which the corporate form could be abused. There has to be a way of preventing groups of related companies from transferring assets from one to another to defeat creditors. That is part of the law of fraudulent conveyances.

An important reason why limited liability has prospered for over a century, and indeed has been extended to certain forms of partnerships, is that this framework does well in combating the externality risk. Limited liability may be a system that does not follow from standard libertarian contractual principles, but it can be justified in terms of its overall benefits, including to strangers, even with mandatory backing.

Share trading

The second key feature of corporations is the alienability of shares, which raises issues having to do with insider trading on the one hand and the takeover market on the other. With fungible and standardised shares there is a thick market, comparisons are possible, and organised bidding, buying and selling can take place. This process generates immense advantages, because if people know they have a ready market into which they can sell their shares, they will be more willing to take the risk of investing. A promoter putting together a business would normally want shares to be fully alienable, on the basis that people are unlikely to put their money into a venture unless they think they have a fair assurance of getting it out.

So why might restraints on alienation be justified? This is not a unique issue for corporate law, for it constantly arises in property law more generally. In property law, restraints on alienation come in two varieties. The first consists of restraints imposed by statute and the second by contract – through agreement by the parties to a particular transaction. My own bias is to think the former kind of regulations are more problematic than the latter, but it would count as excessive dogmatism to say that statutory restraints were never justified.

Let us consider a couple of examples where it makes perfectly good sense to impose restrictions, at least if they are properly executed. In water law, riparian interests under the old English system are an example of multiple private claims to a common-pool asset. If you allow free alienation of interests in a common-pool asset, there is a risk that the alienee will make more intensive use of the asset than the alienor, thereby creating a surcharge on the common pool. This poses a threat of a serious externality that has to be dealt with. The English system was ingenious: it allowed the alienation of riparian interests but only as part of a transaction in which the underlying land was also transferred. The theory was that if alienation of the usufructuary right separate from the land was allowed, the amount of consumption would increase and the river would be over-extracted or over-fished. So, restrictions are justified in this case in order to manage the coordination problem. For

small rivers on large estates with single owners, the coordination problem disappears, so that free alienation of the water in whatever form is again appropriate.

A second example of risks for third parties that might be heightened by alienation and warrant a response is gun control. If anyone can buy or sell a gun, then that includes felons. On the likely supposition that once a gun gets into the hands of the wrong person, the chances of a violent act will increase, the state has a legitimate interest in intervening. The restrictions on selling alcohol to minors can be justified in the same way. So, in the case of state-imposed restraints on alienation, the appropriate question is whether intervention gives anticipatory relief against the kind of externality that would justify a tort remedy if the conduct actually occurred. If that remedy is in fact available, but might well prove unavailing, the proper response is then to impose the restraints on alienation that will forestall the risk.

In the case of corporations these situations are not common, hence it is the private contractual restraint on alienation that becomes the focus of the analysis. Are there circumstances in which a business might do better if it reversed, either in whole or in part, the common-law rule that, in general, all assets and property are freely alienable? This problem has some similarities with the water issues. If a corporation has multiple shareholders who subject its assets to multiple claims, there is always the question of whether alienation by one would impose a surcharge or additional risk upon other holders, justifying restrictions on alienation.

It is useful in this context to divide corporations into two kinds: the private or closely held corporation where a few individuals, often within the same family or friends, own most of the shares; and the publicly traded corporation where no single individual or small group of individuals holds even a control block. In the case of the closely held corporation, restraints on alienation turn out to be perfectly sensible. The shareholders are often also the managers. If one shareholder sells a 20 percent block and brings somebody else into the firm who does not get along with the other owners, a nightmarish situation could result from divided authority.

For some purposes, therefore, the closely held corporation should be analogised with the partnership. The general rule in partnership law is that interests in a partnership are not freely assignable because of the potential impacts on the remaining partners. The services involved are too personal, so that rules that deal with fungible financial interests do not apply. In this context, restraints on alienation simply reflect the fact that key elements of the business partnership carry over to closely held corporations that occupy the same business niche. Hence, we see restrictions on the sale of shares and requirements for prior approval. In the event of death or disability the remaining shareholders may want a pre-emptive right to buy out a shareholding. In a large publicly traded corporation, on the other hand, the death of an individual shareholder does not make any difference to the remaining shareholders. A trustee or a successor in title will use the shares in the same way as the original shareholder. It follows that in the case of public stocks there is a strong presumption in favour of freedom of alienation. Indeed, one can go further. Most public corporations have only one class or a very few classes of stocks. The more complex the capital structure, the more difficult it is to value the various interests. Simplification thus eases alienation, which in turn makes the shares more valuable.

Insider trading

The general bias in favour of free trade does not cover all situations. Thus, in large corporations many problems swirl around the contested question of who can trade and under what circumstances, which in turn brings up the issue of insider trading. The question is whether or not to put any prohibitions on the ability of insiders to a corporation to trade their shares without disclosing all the private information on which they make their decision either to buy or sell. The conventional view is that asymmetry of information is essentially concealment. Concealment is regarded as fraud. Fraud is a criminal offence.

I think that this progression offers an erroneous analysis of a much more nuanced problem. I am much more tolerant of insider trading because I think

of the problem in a different way. Dennis Carlton and Daniel Fischel, in their article 'The Regulation of Insider Trading' (1983, 35 *Stanford Law Review* 857), asked the right question. In theory, the issuer of an initial public offering has two choices. One is to issue the shares on the open market and adopt the prohibitions on insider trading found in the US statutes or their equivalents in the United Kingdom or New Zealand. The other is to adopt a regime that allows every officer and employee of the corporation to trade to their heart's content on whatever information they privately know. Under which system will potential investors pay the highest price for a share?

Now, true libertarians might translate their suspicion of government power into a programme that simply gets rid of all restrictions. However, observation of the way companies actually work suggests that shareholders and insiders might find solid reasons to put some restraints on the actions that shareholders or insiders may take. The key point here is not that we know the right answer in all cases given the different opportunities and constellations of control in different corporations, but that even if we cannot generate one rule that is good for all businesses at all times, we can identify a principle of discovery that will help us in seeking the right answer. So certain businesses that are sensitive to insider information may well want to impose restrictions, particularly on lower-level employees but perhaps on higher ones as well.

Henry Manne, an expert on insider trading and dean emeritus of the George Mason School of Law, has suggested that allowing employees to trade on the strength of insider information constitutes a form of remuneration that will benefit other shareholders by reducing the amount of salary that has to be paid in cash from corporate assets. One response is that the amount of information an employee has and the employee's ability to gain or lose from insider trading is not necessarily proportionate to the value of the work the employee supplies to the firm. A low-level employee who manages to acquire information and has a rich uncle can make a fortune using inside information, where the relationship between that gain and the remuneration function is very weak. Thus, there may well be reasons for restraints on

alienation, the creation of option programmes, periods for vesting and so forth. Each limits the amount of gain that any particular employer can get from what he or she knows. The programme is likely to tie the compensation to the benefits supplied, just as sound business practice dictates.

Nonetheless, the restrictions appropriate to each situation are much more likely to be generated in a firm-specific way than in a global way. The notorious US Securities and Exchange Commission Rule 10(b)(5), for example, does not require employees to file financial statements with the general counsel of the corporation so that their trades in shares can be examined. However, investment banks frequently impose such requirements. Nor do insider trading laws typically prevent trading in stocks up to 10 days before and 10 days after the filing of a quarterly report, but many companies impose those kinds of restrictions. The point is not that problems do not arise but that there are private solutions that can handle them. The private responses can take into account differences in local environments. The statutory solutions cannot.

It may be said that this contractual regime exposes investors to the risk that directors and key officers in a firm could acquire shares under one set of terms and then change the insider trading rules without anything close to the unanimous consent of shareholders. Still, the answer is not regulation but to announce at the outset which of the provisions within the corporate charter are entrenched as a kind of constitutional arrangement and which of them can be varied by a simple vote of a majority of the board of directors. To be forewarned in these cases is to be forearmed, and the sophistication of capital markets will handle events that follow.

Finally, it may be objected that everybody in the capital markets is not sophisticated and that we need insider trading laws to protect the small investor. My answer to that is emphatic. I am a small investor. I have not bought or sold an individual company share in the last twenty-odd years. The correct approach for someone not willing or able to monitor company performance closely is to invest in mutual funds or hire a financial adviser. These methods of self-protection, which are not costly, will be far more

effective than those imposed by the state. However, by interfering in the operation of the market to protect individual investors, who are moderately well off and moderately well informed, regulators make the market less efficient for institutional investors, who in fact are often the representatives of the really small and unsophisticated investors.

Takeovers

The second major question about restraints on alienation of shares arises in the context of company takeovers. I gave a talk 'Controlling Company Takeovers: By Regulation or by Contract?' on my visit to New Zealand in 1999. Takeovers were, of course, a subject of huge controversy in the United States from the early 1980s through to the early 1990s. With a few exceptions, the topic has been relatively dormant since then. There have been a vast number of corporate reorganisations but most of them have been entirely friendly transactions.

Should there be special rules to govern external takeovers? Here again, there are both public and private solutions. Under US law, there are restrictions that say, for example, that once a shareholder acquires 10 percent of the stock of a corporation the shareholder has to announce the size of his or her holding. Under the Williams Act, the 1968 amendment to the Securities and Exchange Act 1934, certain disclosures have to be made and notice and pause periods have to be observed. Restrictions that vary only in detail are to be found in the New Zealand Takeovers Code and the New Zealand Exchange's Listing Rules. I do not see any reason to impose these protections by law. The question is whether or not the firm ought to impose them.

Back in 1981, Frank Easterbrook and Daniel Fischel wrote a famous article called 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981, 94 *Harvard Law Review,* 1161). Their basic prescription was complete passivity. The appropriate role for management under such circumstances, they argued, is simply to stand aside to allow a new team to replace the lazy and inefficient incumbents and make sure that assets are transferred, in good Chicago fashion, from lower to higher valued uses. For

a while I was persuaded by that line, but I have come to believe that it is wrong, if not in result, then in approach. It is wrong, not because a passive management response may not be the optimal strategy in some cases, but because the structural analysis appropriate to this question is identical to the analysis of the insider trading situation.

Imagine you are forming a new corporation and the question is whether or not, in the face of an unsolicited takeover, you would want to stipulate complete management passivity. There is a conundrum here. You are not a single actor – there are many diverse shareholders. If the individual shares can all be sold in voluntary transactions, something of a prisoner's dilemma arises. Everybody might say, 'I would love to hold out for a higher price cooperatively, but since I think control will pass without me I had better jump rather than wait until it is too late to make any difference'. That turns out to be a problem that is not unique to the takeover situation. Assume that you have one of two situations: either a corporation that is owned by one and only one person, or any kind of asset – say a distinctive country home – that is in private hands with a single owner. If you follow the Easterbook and Fischel view then the moment an offer arrives the optimal strategy is to take it, at least if it is at or above the prevailing market price. But no one would say that if you put your house up for sale you are under an obligation to accept the first offer above an honest valuation. There is no situation in which there is a duty to sell in response to the first offer. In fact, whenever there are assets that have distinctive qualities there is going to be bargaining over the surplus because the exact price cannot be set solely by reference to a market for the good. You can react to a good offer by deciding to take it while it is open or you could decide that if the bidder is willing to pay X, he or she may be willing to pay 1.1X if you hold on. How can an outsider say which is the optimal strategy? There is every possibility that a second or third offer might be worth more than a first, or, better still, that some other bidder will enter and create a competitive auction.

Many of the restrictive devices, such as the poison pill, illustrate the point that, at the outset, shareholders face a potential prisoner's dilemma and want to put in place a way of holding out in a coordinated fashion. How might

this be achieved? Obviously it is difficult to get injunctions restraining the sale of individual stocks. The collective solution, allowed in the United States but not in New Zealand, is to issue more shares to friendly parties so as to dilute the value of those that have already been issued. We all understand that a share is really a fractional claim against a particular set of assets. If new shares can be issued, the value of a particular shareholding can be reduced. The vendor thought the sale involved, say, a 1 percent interest, but, after the dilution, the purchaser may end up with only one-tenth of 1 percent. That which you can buy you cannot keep.

Studies show that in the actual takeover market it is not necessarily slothful management teams that engage in these kinds of practices. In fact, the shareholders of the acquired corporation typically do much better out of takeovers than the shareholders of the acquiring corporation, given these kinds of defences and a competitive market for corporate control.

An alternative method of raising capital while retaining control is to issue non-voting shares. Many exchanges are reluctant to allow multiple classes of shares because the subsequent issue of a second class of shares may impact on the value of the first. The basic rule is that any transaction between the corporation and its shareholders can be deconstructed into a transaction between fellow shareholders, and if there are multiple classes of stock it may be difficult to see whether one class is benefiting at the expense of another.

There are, however, situations in which the issue of non-voting shares makes perfect sense. Google, the world wide web search engine company, has recently floated, and is running a public auction for its new shares that do not give control. Is it appropriate to tell Google that this is or is not the right way of doing things? No. The situation is perfectly transparent and each of us can decide whether or not we want to invest in a non-voting share. Indeed, although many predicted that the Google bubble would quickly burst, over the first four months of its life the market price more than doubled from the time of the initial auction. (Although at a price earnings ratio of over 400, this euphoria could easily wear off.) Alternatively, a company may wish to have all the voting shares on the open market but give a large tranche of non-voting shares to a charitable foundation, as did Henry Ford. That way

the business will be managed and capitalised in the usual manner and the trustees of the foundation will benefit from its success.

Policymakers should not worry about all the complications of limited liability. There is no necessity for rules imposed by law preventing the issue of different classes of stock. Provided the rules have unanimous consent at the outset, all subsequent actions by the shareholders, or their successors in title, will be in accordance with the rules of the game. If there is fraud or misrepresentation, that is best dealt with by criminal prosecution or civil suit, not by comprehensive regulation of the permissible set of underlying terms. The appropriate default rule is that no defensive measures such as poison pills should be allowed unless they are in the company's original constitution or are inserted according to whatever rules the company's constitution has for amendment.

Corporate governance

The third problem after insider trading and takeovers is corporate governance. This issue is enormously complicated. Whether we look at the history of voluntary organisations or of nation states, we find a trade-off for which there is no single, effective answer. One the one hand, if we pursue efficiency by giving power to take decisive action to one or two highly informed people, they will have the opportunity to pursue their own interests, rather than those of the group. No citizen or shareholder prospers under that kind of exploitive regime. On the other hand, if you have a deliberative body in which other individuals can guard against precipitous action, dithering and delay may allow all sorts of business opportunities to be lost. There is no way of eliminating both of these risks simultaneously. What most corporations try to do when entering the capital markets is develop rules whereby large structural decisions like the sale of an entire business require the approval of a board of directors or even a vote of shareholders, whereas low-level decisions made with greater frequency are delegated to executive management.

The distribution of the control interests of the shareholders, their risk preferences and the regulatory environment that the firm operates in all mean that the standard model I have outlined indicates that the soundest approach

should again allow for firm choice. The question then is what, if anything, can the beneficent hand of the state do to improve this situation? In the pre-Sarbanes-Oxley world, there was always a demand for some statutory minimum terms. Self-dealing by a block of shareholders, for example, was prohibited. But the standard practice in the United States with regard to both trusts and corporations was to reduce the number of statutory minimum terms as much as possible and to regard the corporation as essentially a nexus of contracts. One of the reasons for confidence that this was the way to go was that these decisions were made by each state, and competitive federalism would have soon pointed to the best course. If it turned out that there was a so-called 'race to the bottom' then one would expect that some states would hold themselves out as better places to incorporate, where shareholders would enjoy greater protections with fewer exposures to risk.

The interesting point is that we do not find laws like Sarbanes-Oxley being passed by any of the individual states because if, say, Delaware passed such a statute it would lose its corporate business tomorrow. As it happens, Delaware became a favoured state for incorporation because Woodrow Wilson, later to become president of the United States, was a misguided corporate reformer in New Jersey, which once had the dominant market for charters in the late nineteenth century. As a result of his 'reforms', many corporations went over the river to Delaware to avoid having to operate in accordance with his new rules. For a country like New Zealand, its very smallness means that it is in a similarly vulnerable position to a state under competitive federalism. New Zealand is highly dependent upon its ability to attract foreign capital. It should be readily apparent whether New Zealand regulation is attracting or deterring inward investment just as it becomes apparent to individual state governments under competitive federalism.

When we come to the great scandals of the late 1990s, particularly Enron, Tyco and WorldCom, what response ought there to be? The simplistic one is to say that governance decisions must be taken away from corporations and, in the US context, even from the states and dealt with at the federal level. This means, however, that the benefit of competition between jurisdictions as a way of finding the right set of rules is lost. Instead, we end up in the

hands of a monolithic group of legislators. It is also clear that when the Sarbanes-Oxley Act was passed in the summer of 2002 it was in response to intense political pressures to 'do something' to strike back at the miscreants. There were a number of sober people, even federal administrators, who thought that this was a mistake but could not resist the popular public and media pressure. When the legislation was enacted they hoped that its effects would be mitigated by the way in which it was administered by the SEC and other agencies. However, given the political processes that select the people who run these agencies, those popular pressures do not diminish after passage; indeed they tend to get stronger. So what we are finding in the United States is an aggressive application of the statute and a lot of low-level bubbling discontent with the results.

Two examples illustrate how the one-size-fits-all mentality can create serious dislocations in corporate governance. The first relates to independent directors and the second to the peculiar status of the audit committee.

Independent directors are now regarded as some kind of holy water that can be sprinkled over a corporation to save it from all sorts of intrigue on the part of its staff. If we analyse the matter properly it is clear that the optimal number of independent directors depends upon two things. One is the nature of the business. The second is not whether independent directors are in some abstract sense desirable, but rather the relationship between the marginal benefit and marginal cost of an additional independent director. There is a standard trade-off that has to be made between independence and expertise. Independent directors will tend to be people from other industries or companies who may not know much about the firm and its distinctive local culture. The executive officers of the firm may well be able to pull the wool over an independent director's eyes precisely because he or she will have insufficient day-to-day involvement. But, without any independent directors there is the risk of a cabal being formed that will benefit itself at the expense of shareholders.

So the question is which of these risks is greater and why? Given the powerful forces pulling in both directions, there is never likely to be any empirical proof that corporations that have large numbers of independent

directors consistently perform better than others. In the United States, the evidence on whether independent directors add value for shareholders is quite unclear, yet the media and political elites portray the dominance of independent directors as self-evidently virtuous. This is despite the failure of the independent prosecutor model, which was based on precisely the same premises. The fact that some amount of a good thing is worth having does not mean that more of that thing is better. The law of diminishing returns applies to independent directors as it does everywhere else. What matters is the costs and benefits of having more or less at the appropriate margins, and for that decentralised decisions are, generally speaking, superior to those made at the centre.

The second illustration of the perils of legislative prescription concerns audit committees, which are now given inordinate power under the Sarbanes-Oxley Act. They are essentially a fifth column implanted into the firm for regulatory purposes that the firm nonetheless has to pay for. I posed the following question when I was teaching a seminar on corporate responsibility soon after the Sarbanes-Oxley Act was passed. If there is a legal disagreement between the audit committee and the chief executive officer of a corporation, could a single general counsel working for the firm resolve the dispute between them? The general view was that each side would need its own lawyer. Once we take that position it is clear that we have one firm lodged inside a second, not one cohesive firm.

There are other problems. The amount of work required of the audit committee bears no necessary relationship to the benefit it is able to provide. The rules that the statute imposes for selection of the members of the committee give no guarantee that the right people will be found to serve on it. Indeed, many eminent professors of accounting cannot serve on audit committees because they do not have the requisite level of practical experience.

In fact, I would go further and question whether accounting standards and auditing of company accounts should be prescribed by statute. Any form of mandatory audit will run into problems, such as defining what an audit consists of and who is entitled to carry it out. The resulting one-size-fits-all approach

obstructs the creation of audit mechanisms tailored to the needs of individual firms. These needs vary according to its size, the nature of its business and other factors. In a competitive market for capital, firms have incentives to provide safeguards such as audits to protect investors. Does additional regulation, having regard to its costs, create net benefits for investors?

My conclusion is that mandated rules seem to be at variance with the optimal voluntary solutions and were enacted for the worst of all possible reasons. What the politicians did was take three disasters – Enron, Tyco and WorldCom – and reverse engineer them, despite the fact that everybody admitted that what took place in these firms was punishable under the criminal laws already in place at the state and federal level. In doing so, the lawmakers upset the internal relations in hundreds of firms that operated perfectly well under the old rules. For a number of reasons this rising trend is going to be a troublesome development for corporations, not only in the United States but across the world.

The first is that it will make it more difficult to get corporate directors than it used to be. Compensation figures are going up because the liability is greater and the time commitments larger. If seasoned hands opt not to serve on boards it may well be that we will get inferior people in their place. We must remember that it is not just the liability side we have to be concerned about. There is also the quality of judgment in taking business decisions where no liability issues happen to be at stake. The selection effects of these rules are extremely important.

The second reason for concern comes from the often-forgotten fact that most of the mighty corporations of today started off as tiny, closely held corporations a long time ago. A question to ask is how the frequency and timing of initial public offerings will be influenced by the incentives created by the Sarbanes-Oxley Act. There already is some empirical evidence that companies are waiting a little longer before they decide to go public. Offerors demand slightly higher prices for securities to offset the additional costs and risks. If the previous decisions were made with an eye to optimisation, then the new rules will necessarily distort behaviour. This means, in effect, that venture capital that was turning over, say, three times in a period of two years

may only cycle twice in that time. The whole point of an initial public offering, of course, is that sophisticated risk takers can get into ventures when they are high risk and get out of them when the ventures become more stable. If that turnover time is slowed down, the upshot will be to slow down the rate of innovation in the United States and around the world.

Thirdly, when people or companies in New Zealand want to invest in the United States today they have to have a primer on the Sarbanes-Oxley Act. Articles now appear in financial magazines warning people of the dangers. That will deter New Zealand investors and harm their interests, and, as a result, it will hurt the United States by reducing the inflow of foreign capital.

Finally, all this focus on ensuring that accountants and chief executives sign the books in the right fashion diverts attention from more effective measures to prevent fraud, such as rigorous personnel procedures, staff rotations and internal checking mechanisms. None of these measures, which a competent fraud consultant would recommend, are to be found in the Sarbanes-Oxley Act. In fact, like all such regulation, the Act is designed to fight the last fraud, not the next, and the fear remains that its elaborate safeguards will be circumvented by new ideas or technology.

Laws governing corporations and the securities they issue are almost always targeted at easily visible outrages. No system will produce an error-free universe. A complicated economy with thousands of firms is going to produce its share of disasters, whatever the legal rules. However, before responding to the obvious events that attract so much public attention, we should always consider the indirect effects of regulations on all the other marginal decisions on which the success of the corporate enterprise depends. It is a serious mistake to attend to the defects and ignore the less obvious virtues of the existing system.

People who are close to business have a sense of these defects and virtues. People who do not work in corporations but in government and other 'opinion forming' institutions do not get that sense of balance. We must regain it in the modern debate over corporate governance.