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Norms & Corporate Law: Introduction

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NORMS & CORPORATE LAW

INTRODUCTION

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Norms are an essential element of human conduct. We have always known that they guide behavior and that they are important in this role. They represent those behavioral rules and standards that are primarily, if not exclusively, enforced by the parties themselves. But until recently, writing about legal rules and standards was of much greater interest to the legal academy.

In recent years, the legal academy's interest in norms has reawakened. Since the seminal conference at Penn in February 1996,¹ substantial additional work has been done in the area.² Much of this literature deals with societal norms, the norms of atomistic actors

¹ Symposium, *Law, Economics, & Norms*, 144 U. PA. L. REV. 1643 (1996).

² See, e.g., Symposium, *Social Norms, Social Meaning, and the Economic Analysis of Law*, 27 J. LEGAL STUD. 537 (1998).

interacting with other individual actors, or with the nonlegal behavioral norms of parties who are contracting with each other.

The interest in norms is now being felt in corporate law.³ Changing the context to a corporate setting changes the role that norms play. Corporate norms operate inside an organization. Thus, corporate norms share the greatest affinity with workplace norms, which are also inside an organization. Corporate norms are distinctive because they do not deal with third parties colliding with each other in a societal context or second parties interacting with each other in a contracting context.

Thinking about the role of norms in a corporate setting is critical for several reasons. Inside the corporation second-party relationships reign, but the relationships are importantly, indeed primarily, non-contractual. For example, behavioral rules and standards for corporate actors are provided by corporate culture and are essentially norm-based. Much of what goes on in the corporate boardroom varies among companies and follows corporate-specific practice.

Clearly, legal rules matter too, not only in establishing the corporation's charter and bylaws, but also in setting standards of behavior for directors and executive officers. At the same time, corporate law is more a set of default and enabling terms rather than mandatory terms. With great latitude, corporations can still follow their own norms and still do it "right."

An attention to norms in the corporate setting thus highlights the interaction between law and norms and between legal enforcement and private enforcement in a more intensive fashion than in other areas. Investigating the role played by norms may thus help explain a number of the major issues and puzzles of corporate law. Norms may help explain the manner in which the law, in the absence of bright line rules, influences corporate governance. Norms may also explain why standards rather than rules work well in a corporate setting. Indeed, norms may justify the prevalence of aspirational judicial standards that are far from the actual standards that the courts enforce.

Norms may also help to explain a fact that we often tell our students: namely, that corporate lawyers are rarely litigators but instead are frequently dealmakers and counselors to the board of directors. Norms may explain why there are so few cases. Norms may also pro-

³ See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

vide a way of understanding the "dark matter" of corporate law, namely, the cases that are not brought.

For those primarily interested in norms as a research agenda, it is an opportunity to understand how norms play out in an institutional context by considering the specific and reasonably well understood case of the corporation. For those primarily interested in the theory of the firm or of corporations, it may help explain the role of self-enforcing contracts.

Attention to norms in a corporate setting should also highlight another research agenda: the growing attention by corporate finance specialists to the roles of corporate culture and of trust in the theory of the firm, work that fits into an already established economics literature on self-enforcing agreements. The parallels between this economics-based literature and the legal literature on norms run very deep, but have often gone unappreciated. An objective in organizing the conference was to bring these literatures closer together.

For the two of us, attention to norms in a corporate setting was a logical extension of our earlier joint paper on *The Enforceability of Norms and the Employment Relationship*⁴ and of our separate work on the role of norms in corporate law and of self-enforcing rules in the theory of the firm.⁵

Consequently, for a variety of reasons, the time was ripe for a conference that focused on the topic of norms in a corporate setting. This issue is the result of that conference. The conference and the Symposium issue have three major sections.

The first part of the issue concerns the general relationship between corporate law and "norms." In our article, we try to provide a general account of the role that corporate law plays in facilitating self-governance by nonlegally enforced rules and standards.⁶ In Oliver Hart's article, he examines the difficulties of incorporating norms into theories of the firm and the extent to which norm analysis has enriched those theories.⁷ Robert Cooter and Melvin Eisenberg provide a

⁴ Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913 (1996).

⁵ Rock, *supra* note 3; Michael L. Wachter & Randall D. Wright, *The Economics of Internal Labor Markets*, 29 INDUS. REL. 240 (1990); Oliver E. Williamson, Michael L. Wachter, & Jeffrey E. Harris, *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON. 250 (1975).

⁶ Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

⁷ Oliver Hart, *Norms and the Theory of the Firm*, 149 U. PA. L. REV. 1701 (2001).

general taxonomy of the way social norms operate in organizations and the ways in which the state conscripts organizations to promote adherence to general social norms.⁸ Margaret Blair and Lynn Stout focus on the role of trust and trustworthiness in corporate law, arguing that, to the extent that people internalize norms of trustworthiness, the law can back off.⁹ Finally, David Skeel focuses on the role that shame and shaming play in corporate law.¹⁰ The section closes with Marcel Kahan's probing critique of the potential of a norms approach to elucidating problems of corporate law.¹¹

The second part of the issue examines the use of norms to explain specific aspects of corporate law. Saul Levmore examines the puzzle of why firms do not issue indexed stock options even though their incentive properties clearly trump nonindexed options, and he argues that indexed options would conflict with a deeply held institutional norm of shared fortunes.¹² David Schizer is somewhat skeptical of this answer, focusing instead on the tax treatment as an alternative explanation.¹³ Eric Talley focuses on the emergence and incorporation of disclosure norms into mandatory securities law requirements.¹⁴ Finally, Paul Mahoney and Chris Sanchirico examine the evolution of norms and the conditions under which efficient norms will prevail.¹⁵

In the third part of the issue, attention shifts to the international and comparative dimension. Mark Roe examines the connection between a shareholder primacy norm, social wealth maximization, and the competitiveness of product markets.¹⁶ Curtis Milhaupt studies the evolution of nonlegal rules in Japanese corporate governance.¹⁷ Ber-

⁸ Robert Cooter & Melvin A. Eisenberg, *Fairness, Character, and Efficiency in Firms*, 149 U. PA. L. REV. 1717 (2001).

⁹ Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001).

¹⁰ David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001).

¹¹ Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869 (2001).

¹² Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901 (2001).

¹³ David M. Schizer, *Tax Constraints on Indexed Options*, 149 U. PA. L. REV. 1941 (2001).

¹⁴ Eric Talley, *Disclosure Norms*, 149 U. PA. L. REV. 1955 (2001).

¹⁵ Paul Mahoney & Chris Sanchirico, *Competing Norms and Social Evolution: Is the Fittest Norm Efficient?*, 149 U. PA. L. REV. 2027 (2001).

¹⁶ Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063 (2001).

¹⁷ Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083 (2001).

nard Black tests for the significance of norms on firm value by examining the effect of (nonlegally enforced) governance practices on firm value in Russia, where the background legal protections are extremely weak.¹⁸ John Coffee, starting from the observation that private benefits of control vary across jurisdictions, argues that compliance with nonlegally enforceable social norms can significantly affect market value and that innovative legal engineering to develop credible signals of such compliance may be one of the most important services that the corporate attorney can perform for her client.¹⁹

Although the articles were written from very different perspectives, several themes emerged. First, and most prominently, the articles examine the complex relationship between legal and nonlegal enforceability, between "law" and "norms." People took very different views. Our article argues that important parts of corporate law can be understood as establishing a structure within which nonlegally enforced self-governance can thrive. By contrast, Cooter and Eisenberg focus on the ways in which the law influences intrafirm behavior, co-opting the firms to enforce general social norms. Blair and Stout, in focusing on trust and trustworthiness, see the relationship differently, with the internalization of norms of trust reducing the pressure on the law to intervene. Black and Coffee, in different ways, each can be understood as examining the value of norms when the law is unenforced or, comparatively, when the level of legal protections are similar but the private benefits of control vary. Skeel, by contrast, in examining the role of shame and shaming, views such practices as potential supplements or substitutes for legal sanctions. Levmore has a still different view of the relationship, seeing nonlegal norms as exercising almost a gravitational pull on observed practices. In particular, on his analysis, it is nonlegal norms that explain the otherwise inexplicable choice of incentive compensation, a choice that the law does not dictate. Finally, Talley sees the relationship still differently. Where an efficient norm of disclosure emerges, incorporating it into the mandatory disclosure regime of the securities laws is a way of entrenching it, spreading it, and gaining the benefits of standardization. Put differently, the law can be the midwife of norms, and norms and law can be, and at various points are, both substitutes and complements.

A second theme is the question whether and how "norms analysis"

¹⁸ Bernard Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 U. PA. L. REV. 2131 (2001).

¹⁹ John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151 (2001).

helps in understanding how corporate governance works. Here, again, the articles take different approaches and generate different conclusions. At one end is Kahan, who is skeptical of the entire enterprise, unconvinced that norms analysis adds anything to standard economic analysis. Levmore, on the other hand, sees norms analysis as promising in precisely those situations in which standard economic analysis cannot explain what we observe. Black and Coffee, in different ways, each look at whether norms "matter" in understanding when and how *law* matters, and at the relation between law and corporate governance. Our article, by contrast, argues that norms matter in understanding the structure of corporate law doctrine.

A third theme is whether and when corporate norms are likely to be efficient. Mahoney and Sanchirico, using evolutionary game theory, argue that there often will be little reason to expect norms that survive to be efficient. Roe argues that the shareholder primacy norm will be stable only when markets are competitive, for otherwise there is no reason to think that maximizing shareholder value will enhance social welfare.

Coming out of each of these themes is the recurring issue of legal involvement in norm governance. How do the courts know when behavior is self-governed or law-governed? Is a mixed system stable? What is the role of law in a mixed system world? Does the corporate legal regime support or undermine norm governance?

As a starting point, there was agreement that norm scholars need to agree on a definition of the term "norm" and on a framework for analyzing the effect of norms on behavior. While almost everyone at the symposium agreed that the core principle is that norms are primarily or entirely self-governing, some use the term norms to describe relationships where the option of judicial enforcement remains should private enforcement prove inadequate. The example used is contract law, in which, in a variety of circumstances, the norms that contracting parties develop take on the force of contractual agreements.

Our position is that it is better to classify and treat the legal-enforcing and self-governing norm cases separately. Although many interesting issues arise in the case of norms that take on the force of contract, the framework for understanding them is already well provided in contract law. A theory of norms, we believe, adds little. On the other hand, for norms that are entirely self-governing, there is a need for a conceptual framework that explicates norm governance.

In our article, we suggest the term NLERS, or nonlegally enforce-

able rules and standards, to replace the term norms. NLERS may be an inelegant term and another might be better. But as toilers in the vineyard of corporate law scholarship, we need to be clear whether we are talking about a noncontractual or a contractual agreement. If behavior is adhered to through a privately enforced system of rewards and penalties, it is a norm or NLERS. If enforcement includes even a judicial backstop, the agreement is contractual and should be interpreted in that framework.

The confusing tendency of corporate scholars to use the term norms interchangeably to represent both legally enforceable and self-governing relationships parallels the economics usage of the term "self-enforcing contracts." Economists easily converse among themselves when using terms like "implicit contracts" and "self-enforcing contracts." But, of course, the term "contract" is misleading at best if the reference is to a self-governing arrangement. The economics literature has largely escaped the confusion by ducking the issue of legal enforceability as outside of the model. The economics analysis focuses almost entirely on the self-enforcing qualities of the agreement. Reputational effects (that is, third-party enforcement by private actors) are often included so that the arrangements are better described as self-governing rather than self-enforcing. But judicial enforcement is unnecessary. Indeed, the principal finding of this literature is that specific arrangements often exist that can be enforced entirely by the parties themselves. Arrangements self-govern if they cannot be violated profitably by a would-be opportunistic actor since in violating the agreement, the transgressing party necessarily loses more than she gains.

The beauty of such arrangements is that there is no role for legal enforcement even if the arrangement was set up by a contract. Consequently, the economics literature did not need to differentiate between privately and judicially enforced arrangements. In this model-driven world, a legal system is simply not included in the model.

The principal-agent model that has been widely adopted by legal scholars has the same roots in contractual completeness. The principal spends resources on monitoring the agent and the agent bonds her behavior. A primary result of the principal-agent model is that when monitored or bonded, the agent acts entirely in the interests of the principal. Since the agent always acts in an incentive-compatible manner when monitored or bonded, there is no role for law enforcement. In the original article by Jensen and Meckling, the presence of a legal system is acknowledged in a footnote indicating that the ra-

tionale for a legal system might be enforcing contracts.²⁰

An additional key result of the model is that monitoring and bonding are incompletely protective of the principal; that is, a residual set of options is available to the agent. The upshot is the "agency problem." When such options arise, the agent's behavior is still entirely predictable—she acts in her own interests rather than those of the principal. The existence of the residual category is not a market failure and only reflects resource scarcity—in this case the scarcity of information.

Within the four walls of the model, there is still no role for legal enforcement to bring the agent into line when incompletely monitored or bonded. This fact is generally forgotten in the corporate academic literature that interprets the model as providing a justification for judicial intervention to handle the residual agency problem. At most, the model can be read as favoring a role for the law in lowering the cost of the parties' monitoring and bonding efforts by enforcing their agreements as contracts, should that prove necessary.

But what happens when such agreements are understood to be intentionally incomplete, as is almost certainly the case of the relationship between the shareholders and the directors and executive officers? Should judicial activists step in or should it be left to the parties to sort out? As noted above, formal models, such as the principal-agent model, are remarkably silent on such issues. The issue has been addressed in the incomplete contracting literature, where the law responds to contractual incompleteness with forbearance and narrow interpretation of whatever contracts do exist.²¹

The issue has also been addressed in the economists' and corporate finance theorists' theory of the firm. In this literature, the actors, whether executive officers, employees, or others, are continuously interacting in a context in which the frequent interactions are also connected and evolving. Governance issues are resolved by establishing a hierarchy with a set of rules and standards. In the firm's hierarchical environment, continuing participants reward good play and penalize bad play by relying on these rules and standards of behavior. Moreover, in this transaction-intensive environment, contract writing is prohibitively expensive.

²⁰ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 311 n.14 (1976).

²¹ See, e.g., Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992).

A major result of this literature is that transaction costs provide the rationale for bringing activities inside the firm. Intrafirm contracting is generally inefficient; interfirm contracting is not.

The choice between using the firm or using the market thus carries with it a choice of governance mechanisms. The relationships that are brought inside the firm are thus precisely those relationships that are best governed by self-governing arrangements. With only a touch of overstatement, market transactions are governed by contract and are judicially enforceable, while firm transactions are self-governed and are self-enforced, perhaps with the added protection of reputational effects. Taken literally, the boundaries of the firm represent a demarcation line or jurisdictional boundary, dividing judicially enforced market transactions from nonjudicially enforced internal firm transactions.

How does norm or NLERS governance fit into this story? What do we mean when we assert that conduct within the firm is governed by NLERS? What do NLERS add to the traditional story that agents or corporate executives are constrained by markets, whether capital markets, product markets, or labor markets? Isn't norm behavior little more than self-interest based on market discipline?

With respect to self-interest, the answer is "yes." Self-governing arrangements work because it is in the interest of the parties to behave within the spirit of the NLERS. More specifically, norms work best when a party that would act opportunistically cannot do so without suffering a wealth or utility loss. That is, NLERS transform agents' incentives so that they will find it in their self-interest to abide by the rule.

In this regard, the discipline of NLERS plays the same role as the discipline of the legal system in enforcing contracts. Each is a mechanism for protecting the integrity of a transaction. One works in markets, the other in firms. Most of the time, it will be in the self-interest of a firm to fulfill its contractual obligations. Contracts are written to provide incentives for the parties to perform without legal intervention. Sometimes, however, the performing party will perform only when legal sanctions are included in the profit calculus. Hence, the costs of judicial penalties are added in when the performing party decides to perform.

What plays the same role as legal sanctions inside the firm? The answer is the parties' own norm enforcement. Remember that activities are brought inside the firm when interactions are intense, connected, and evolving. On the one hand, these conditions make con-

tract writing prohibitively expensive so that judicial enforcement is not a real option. At the same time, those same conditions that make contract writing prohibitively expensive have another effect. They are precisely the same conditions that make norm governance more likely to succeed. It is in frequently repeated games that the parties can effectively reward good play and penalize bad play. Consequently, norm governance when used inside the corporation has a highly effective set of rewards and penalties. Judicial enforcement is much less likely to be needed.

Norm governance is also present in contracting relationships outside of the firm. However, the conditions that make intrafirm norm governance successful inside the firm are precisely those that are missing in interfirm norm governance. In contracting relationships, judicial enforcement is required simply because norm governance is less likely to be sufficiently protective of the integrity of the parties' transactions.

In our article, we use the example of the CEO who might want to buy a sports team as a vanity play even though the transaction would have a negative effect on shareholder value. The CEO's vanity would not be checked by the discipline of the product market. Similarly, although the stock price might drop a couple of points, that would not be enough to put the company into play, insulating the purchase from the discipline of the capital market. Yet, we find relatively few of these types of purchases. The explanation is the deterrence effect of norm governance. Although boards of directors will often approve virtually all proposals brought before them that can be shown to maximize shareholder value, very few that can only be explained as vanity plays are even brought before the board. When the sanctions for breaching the NLERS are taken into account, the CEO is discouraged from pursuing the investment because she would be identified as a bad norms player.

Notice that if contracts were utilized inside the firm, the result might well be more vanity plays. The reason is the difficulty in contracting over all states of the world in intensive long-term relationships. Sooner or later, the CEO intent on a vanity play could trigger a state of the world that would fall outside of the contract. If good play were defined by living with the contract, the CEO would incorrectly be labeled a good player.

A separate, but equally critical, question is the role of law when relationships are norm-governed. As a preliminary question, can norm-governance be an intermediate structure between nonlegally enforce-

ing and legally enforcing relationships? We believe the answer is no, which explains our adoption of a definition (NLERS) that makes that point clearly. If the courts are there as a safety net, then the norm's self-governing controls are more likely to give way as the disappointed party seeks the protection of the underlying judicial safety net and the formal contract that supports it. Even if such contracts were feasible, in the sense that the court has the ability to observe and verify facts and outcomes, they would be undesirable. It is simply more difficult to sustain self-governing controls when the parties can bypass them when it suits their interests. Consequently, for norms that are meant to be truly self-governing—that is, NLERS—the court must be careful not to undermine them. The boundaries of NLERS governance must serve as a jurisdictional boundary to be effective.

This, however, does not mean that NLERS and law need to work in two entirely separate spheres. First of all, in a descriptive sense, such a claim would be incorrect. Corporation law is a set of rules and standards, and even when they are defaults or enabling, they can be judicially enforced. The interplay of law in the form of enforceable rules and standards and NLERS is subtle, but it is critical for the corporation to be successful.

From our perspective, corporate law can be understood as a remarkably sophisticated mechanism for maximizing shareholder value. Since the corporation is largely governed by NLERS, corporate law can also be described as a remarkably sophisticated mechanism for facilitating governance by NLERS. As a central tenet, corporate law creates and is protective of the corporation's hierarchical structure. Legal rules provide the default settings through which centralized management operates and non-pro-rata distributions are prohibited (a combination of *ex ante* rules and the *ex post* duty of loyalty). Both create incentives for the controlling shareholders to maximize the value of the firm. The corporate form also mitigates the potential for opportunism by the board of directors and controlling shareholders toward noncontrolling shareholders. In providing for the hierarchical exercise of business judgment, almost entirely unimpeded by legal restraints, the corporate form protects centralized management from potential opportunism by minority shareholders and other stakeholder groups. In doing so, it is attentive to the firm's boundary as a jurisdictional boundary, within which NLERS governance predominates.

In closing, we believe that legal governance and norm governance of corporations must work side by side. Consequently, we believe that

the structure of corporate law, whether embodied in statute or case law, is more fully understood if the effects of norm governance are included in the analysis. But the full picture and understanding of this issue are still in the future. So are a host of related questions that have been raised in the various articles in the Symposium. We hope that this issue sparks continuing interest in the critical role of norm governance in corporate law.