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COST-BENEFIT ANALYSIS OF THE BUSINESS JUDGMENT RULE: A CRITIQUE IN LIGHT OF THE FINANCIAL MELTDOWN

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ABSTRACT

In 2008, the United States—indeed the whole world—suffered a devastating financial meltdown. We know now that a significant cause of the meltdown was that, in the face of numerous red flags, the managers of several venerable financial firms decided to take tremendous risks in the subprime mortgage market, and the directors of these firms did little or nothing to stop them. However, despite their actions, these managers and directors face little or no risk of personal liability because they are shielded by the business judgment rule and other liability-reducing mechanisms, such as director exculpation statutes. Given the magnitude of the recent financial meltdown, this article calls for a reexamination of the arguments for and against shielding corporate managers and directors from virtually all personal liability.

After providing background on the business judgment rule and director exculpation statutes, this article recasts the prominent arguments for and against the business judgment rule as cost-benefit arguments. On one hand, most pro-business judgment rule arguments focus on the benefits of shielding directors from liability risk, namely enhancing shareholder wealth. On the other hand, most critiques of the business judgment rule endeavor to show that

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the costs of shielding directors from liability risk are greater than generally assumed. Instead of entering this debate, this article rejects the cost-benefit framework altogether. Drawing upon arguments developed by critical legal scholars, the article claims that cost-benefit analysis is indeterminate. Because cost-benefit analysis is indeterminate, it is impossible to determine whether the costs of increasing directors’ liability risk outweigh the benefits. Cost-benefit analysis can just as readily lead to the conclusion that the benefits outweigh the costs. Therefore, due to their reliance on cost-benefit analysis, the pro-business judgment rule arguments fail to justify the rule.

I. INTRODUCTION

In the summer of 2008, the United States suffered a spectacular financial meltdown. Since then, Americans collectively have lost trillions of dollars, and millions have lost their jobs and their homes. Additionally, incalculable damage was inflicted on both the global economy and the public’s confidence in the future of and trust in the financial system. The causes of this disaster are now fairly well understood. One of the most significant causes was that, in the face of numerous red flags, the managers of several large and venerable financial firms decided to take on tremendous amounts of risk in the subprime mortgage market, and the directors

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3 JOHN GILLESPIE & DAVID ZWEIG, MONEY FOR NOTHING 60 (2010) (describing communities, which were vibrant before the 2008 crash, where vacant houses have been turned into “methamphetamine labs” and swimming pools have turned into “mosquito breeding pits”).

4 Id. at 44 (explaining that, due to the U.S. stock market crash, “[t]he estimated global costs in total financial market losses amounted to a staggering $50 trillion for the year”).

5 Id. at 17.

6 Id. at 1–28 (describing how some officers and directors at major financial institutions were aware of the riskiness of the subprime mortgage market and caused their firms to invest heavily in it anyway, while others remained oblivious despite the warning signs); see also In re Citigroup, Inc. S’holders Derivative Litig., No. 07 Civ. 9841, 2009 WL 2610746, at *5–6 (S.D.N.Y. Aug. 23, 2009) (where plaintiffs claimed that various red flags should have alerted Citigroup’s directors to the riskiness of the subprime mortgage market).
of these firms did little or nothing to stop them. However, even though they exercised such little caution in exposing their firms to such high levels of risk, the managers and directors responsible for the decisions that led to the financial meltdown will probably not suffer any personal liability.

While directors technically owe a fiduciary duty to exercise care in making business decisions, the business judgment rule and director exculpation statutes almost entirely shield directors from risk of personal liability for breaching that duty. Typically, the business judgment rule and director exculpation statutes are defended with the same battery of policy arguments. The following are three of the most frequently recurring policy arguments: (1) if directors’ liability risk were increased, directors would be overly deterred from taking entrepreneurial risks; (2) if directors’ liability risk were increased, current directors and director candidates would be overly deterred from serving as directors; and (3) market mechanisms, namely the market for capital and the market for corporate control, already provide sufficient incentives for directors to exercise care. Fundamentally,
All three of these arguments employ a cost-benefit framework. All of them purport to show that the business judgment rule and director exculpation statutes are efficient because increasing directors’ risk of personal liability would impose significant costs on shareholders.

Given the magnitude of the recent financial meltdown, however, a reconsideration of the desirability of shielding directors from nearly all liability risk is in order. The business judgment rule has already been criticized on a number of grounds. For the most part, the existing critiques employ the same cost-benefit framework used by the pro-business judgment rule arguments. Whereas the pro-business judgment rule arguments focus on the costs of increasing directors’ liability risk, most of the existing critiques focus on the benefits, endeavoring to show that the benefits of increasing directors’ liability risk would be much greater than previously thought.14 While such critiques can serve as counterweights to the pro-business judgment rule arguments, they do not definitively show that the pro-business judgment rule arguments fail to justify the rule. To do so, a critique of the business judgment rule based upon cost-benefit analysis would have to actually demonstrate that the business judgment rule’s costs exceed its benefits, which would require “catalog[ing] all of the costs and benefits associated with directors’ liability for lack of care,”15 quantifying them, and adding them up. Otherwise, such a critique “cannot by itself lead to any strong normative conclusion one way or the other.”16 However, putting aside for the moment that it might not be possible to perform such a calculation in a determinate and objective manner,17 performing the calculation would pose an empirical problem of Herculean proportions.

perspective of investors” and “create the kind of firm, governance structure, and securities people value”).

14 See, e.g., Fairfax, supra note 7, at 455 (arguing that the benefits of preventing major corporations from collapsing outweigh the costs of increasing directors’ liability risk); Lynn A. Stout, In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule, 96 NW. U. L. REV. 675, 678 (2002) (arguing that insights from the social science research on altruism suggest that judicial review of directors’ decision-making procedures could have significant, previously unacknowledged benefits).


16 Id.

In contrast, a few critiques of the business judgment rule reject the cost-benefit framework altogether. Some of these critiques challenge the basic assumptions or value judgments underlying the arguments for the business judgment rule,\(^{18}\) while others find logical contradictions or untenable distinctions within them.\(^{19}\) Either way, these critiques are more effective in rebutting the pro-business judgment rule arguments because they avoid the herculean task of determining whether the business judgment rule’s costs actually outweigh its benefits.

However, none of the existing critiques of the business judgment rule make the claim that cost-benefit analysis is indeterminate, and therefore the pro-business judgment rule arguments fail to justify the rule due to their reliance on the cost-benefit framework. The claim that cost-benefit analysis is indeterminate is part of a collection of arguments developed by critical legal studies (“CLS”) scholars to critique the “law and economics” movement.\(^{20}\) Essentially, the argument is that cost-benefit analysis yields multiple correct answers\(^{21}\) to questions like, “Do the costs of a given legal rule outweigh its benefits?” One analyst performing a cost-benefit calculation could conclude that costs outweigh benefits, while another analyst performing the same calculation could conclude that benefits outweigh costs, and both analysts could be equally correct.\(^{22}\) This line of critique has been applied to several areas of law, such as contract, tort, property,\(^{23}\) and administrative law,\(^{24}\) but it apparently has not been applied to corporate law.\(^{25}\) I


\(^{19}\) See Gerald E. Frug, The Ideology of Bureaucracy in American Law, 97 Harv. L. Rev. 1276, 1286 (1984) (arguing that all of the pro-business judgment rule arguments attempt to draw an untenable distinction between objectivity and subjectivity).

\(^{20}\) See Kennedy, Law and Economics, supra note 17, at 469 (explaining that CLS scholars have generated several critiques of “mainstream law and economics,” a movement that advances the view that cost-benefit analysis provides “a nonpolitical, objective, determinate method” for determining what legal rule should be adopted).


\(^{22}\) Id.

\(^{23}\) See generally id. at 423–29 (critiquing the attempt to use cost-benefit analysis to determine the optimum allocation entitlements in contract, tort, and property law).

\(^{24}\) See generally FRANK ACKERMAN & LISA HEINZERLING, PRICELESS 35–40 (2004) (setting out several critiques of the use of cost-benefit analysis in the administrative law context, many of which can be characterized as claims that cost-benefit analysis is indeterminate in various ways, and therefore its conclusions are political rather than objective).

argue that, when this critique is applied to the three common policy arguments for the business judgment rule identified above, it shows that they fail to demonstrate that the business judgment rule is efficient.

In Part II of this article, I explain how the business judgment rule and director exculpation statutes operate to shield directors from personal liability for breaches of the fiduciary duty of care. In Part III, I set out the three policy arguments commonly made on behalf of the business judgment rule. I argue that, at bottom, all three arguments are cost-benefit arguments. In Part IV, I describe prominent existing critiques of the business judgment rule and discuss their limitations. In Part V, I describe the CLS critique of law and economics, particularly the argument that cost-benefit analysis is indeterminate. In Part VI, I apply the argument that cost-benefit analysis is indeterminate to the three common policy arguments for the business judgment rule. I conclude that, due to the indeterminacy of cost-benefit analysis, it is impossible to determine whether the costs of increasing directors’ liability risk outweigh the benefits. Instead, cost-benefit analysis can just as readily lead to the conclusion that the benefits outweigh the costs. Therefore, the three common policy arguments for the business judgment rule fail to show that the rule is optimal from the standpoint of economic efficiency. Finally, in Part VII, I suggest some ways to extend this style of critique to other corporate law rules.

II. THE BUSINESS JUDGMENT RULE AND DIRECTOR EXCULPATION STATUTES

A central problem of corporate law is that, because directors do not own the corporations that they manage, “they may have insufficient incentive to perform their duties carefully.”26 In response to this problem, the law imposes on directors a fiduciary duty of care, which is meant to deter them “from making uninformed or careless decisions.”27 The duty of care is usually

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27 Id. at 8–9; see also Michael P. Dooley, Two Models of Corporate Governance, 47 BUS. LAW. 461, 468–69 (1992) (explaining that, in additional to shareholder voting, “the law affords additional protective provisions in the form of the fiduciary duties of care and loyalty” in response to the “two faces of the general problem of opportunism” on the part of corporate directors).
framed as a requirement that directors use the same degree of care in managing the corporation as a “reasonably prudent person” would use under the circumstances. Put this way, the duty of care sounds like the negligence standard in tort. It seems to require that directors’ conduct satisfy an objective, “reasonable man” standard, just like the conduct of doctors, lawyers, and other professionals. However, unlike other professionals, directors are almost entirely shielded from risk of personal liability by (A) the business judgment rule, and (B) exculpation statutes. As a result, directors’ conduct is evaluated under a far more lenient standard of review.

A. The Business Judgment Rule

The business judgment rule has existed for nearly two centuries and has been almost universally adopted throughout the United States. While courts and commentators disagree to some extent about the proper way to formulate the business judgment rule, its general thrust is fairly easy to encapsulate. Essentially, the rule requires courts to use a much more lenient standard than objective negligence when reviewing the disinterested business decisions of corporate directors, thereby shielding directors from risk of personal liability.

The Delaware courts formulate the business judgment rule as “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the

28 Dibadj, supra note 9, at 484.
29 Id.
31 Id. (observing that, unlike all other professionals, corporate directors are protected by a special “business judgment rule,” and arguing that no sound policy arguments justify making such a distinction).
34 Letsou, supra note 32, at 179–81.
35 Id. at 180–82.
36 I have provided Delaware’s formulation of the business judgment rule due to Delaware’s particularly significant role in corporate law. See generally Omari Scott Simmons, Branding the Small Wonder: Delaware’s Dominance and the Market for Corporate Law, 42 U. RICH. L. REV. 1129, 1129 (2008).
company.” Unless plaintiffs can rebut this presumption, directors’ decisions “will be respected by the courts,” meaning directors will face no personal liability. In cases where plaintiffs solely allege that directors violated their duty of care, “the presumption established by the business judgment rule is all but impossible to overcome.”

To overcome the presumption, plaintiffs can challenge either the substance of the directors’ decision or the procedures that the directors used in reaching their decision. When challenging the substance of the decision, plaintiffs must show that it was so irrational that “no reasonable business person would have made the decision.” However, this so-called “waste” test is so difficult to satisfy that many commentators describe it as a judicial refusal to evaluate the substantive merits of a board’s decision at all. Alternatively, when challenging the procedures that the directors used in reaching their decision, plaintiffs must show “that the board was grossly negligent in informing itself of all material information reasonably available to it before acting.” While this “gross negligence” test is less difficult for plaintiffs to satisfy than the “waste” test, it is still an extremely lenient standard of review. Gross negligence has been defined in various ways, such as “reckless indifference to or a deliberate disregard of the stockholders,” or “without the bounds of reason.” In any event, it certainly is more lenient than the standard negligence test.

In sum, on one hand, the law imposes a duty of care on directors because it suspects that they lack sufficient incentives to exercise adequate care in making business decisions. However, on the other hand, the business judgment rule protects directors against

38 Id.
39 Letsou, supra note 32, at 179.
40 Id.
41 See id. at 180 (explaining that, to the author’s knowledge, the waste test has never been satisfied); Stout, supra note 14, at 675 (explaining that Delaware has effectively adopted a ban on judicial review of the substance of directors’ business decisions in duty of care cases).
42 Letsou, supra note 32, at 179–80 (citing Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000)); see also Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (establishing gross negligence as “the proper standard for determining whether a business judgment reached by a board of directors was an informed one”).
44 Id. (quoting Gimbal v. Signal Co., Inc., 316 A.2d 599, 615 (Del. Ch. 1974), aff’d, 316 A.2d 619 (Del. 1974)).
45 See Gevirtz, supra note 30, at 299, 300 (explaining that Delaware has not explained exactly how ordinary negligence differs from gross negligence, but that gross negligence obviously is meant to connote “some worse level of dereliction”).
personal liability for breaches of the duty of care in almost all cases. When plaintiffs challenge the substance of a board’s decision, they must show that the decision was so irrational that it constituted a waste of assets. When plaintiffs challenge the procedures that a board used in reaching a decision, they must show that such procedures were “grossly negligent.” As a result, the duty of care is “in fact little more than eloquent rhetorical flourish” that does little to increase directors’ “incentives to act with care.”

B. Director Exculpation Statutes

In addition to the business judgment rule, many directors are shielded by exculpatory charter provisions authorized by state statute, which are a much more recent phenomenon. State legislatures enacted director exculpation statutes largely in response to “[t]he 1985 Delaware Supreme Court decision in Smith v. Van Gorkom.” Before Van Gorkom, “[c]orporate attorneys had long believed that, even though both a duty of care and loyalty were owed to shareholders, the business judgment rule effectively precluded the imposition of personal liability on directors for a breach of the duty of care.” However, this conventional wisdom changed with Van Gorkom, where the court “found the directors liable based solely on the breaches of the duty of care.” The decision “instigated fears and concerns from many quarters” and “spurred some state legislatures into action.” Delaware quickly adopted a statute permitting corporations to adopt charter provisions that exculpate directors for breaching their fiduciary duties. Today, “[a]ll fifty states have implemented some version of Delaware’s approach, and virtually all of the nation’s largest corporations include these exculpatory provisions in their

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46 See Letsou, supra note 32, at 179.
47 See id. at 179–80 & n.3; see also Brehm, 746 A.2d at 263 (discussing the judicial standard for determination of corporate waste).
48 See Brehm, 746 A.2d at 259.
49 See Brehm, supra note 9, at 483.
50 Id. at 486 (quoting Mark J. Loewenstein, The Quiet Transformation of Corporate Law, 57 SMU L. Rev. 353, 378 (2004)).
51 See Drury, supra note 10, at 103–04.
52 See id. at 103.
53 Id. at 105.
54 Id. at 107.
55 Id. at 103, 107.
56 Id. at 103.
Delaware’s exculpation statute, section 102(b)(7), allows corporations to adopt charter provisions “eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director.” However, it does not permit total director exculpation. Section 102(b)(7) specifically prohibits provisions that eliminate or limit director liability for, among other things, “acts or omissions not in good faith.” Therefore, even if a corporation’s charter contains an exculpation provision, plaintiffs can still attempt a claim against its directors by arguing that they acted in bad faith. However, bad faith is even more difficult to demonstrate than gross negligence under the business judgment rule. Plaintiffs must show “conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care.” Examples of bad faith include when a director “intentionally acts with a purpose other than that of advancing the best interests of the corporation, . . . acts with the intent to violate applicable positive law, or . . . intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” In sum, director exculpation statutes do not completely shield directors from personal liability, but they clearly create a difficult obstacle for plaintiffs to overcome. Exculpation statutes “move[] the bar from negligent behavior to deliberately indifferent, egregious, subversive, or knowing behavior, and thereby raise[ ] issues related to the motives of the actors.”

In addition to authorizing exculpatory charter provisions, state statutes also generally permit corporations to “indemnify directors for the expense of litigation” and “purchase insurance that covers

57 Id. at 103–04.
59 Mae Kuykendall, Assessment and Evaluation: Retheorizing the Evolving Rules of Director Liability, 8 J.L. & POL’Y 1, 15–17 (1999) (observing that exculpation statutes do not allow for total exculpation, meaning exculpation even for intentional wrongful acts, because legislators remain concerned to some extent about director accountability).
60 tit. 8, § 102(b)(7).
61 Compare Drury, supra note 10, at 129–37 (arguing that the increase in “bad faith” claims should be viewed as a cost that weighs against director exculpation statutes), with Sale, supra note 7, at 488 (arguing that the increase in “bad faith” claims should be viewed as a positive development and that a robust duty to act in “good faith” could help deter directors from engaging in wrongful conduct).
63 In re Walt Disney, 906 A.2d at 67.
64 Sale, supra note 7, at 488.
some of the litigation costs in defending corporate directors and possible liabilities.\textsuperscript{65} Exculpation provisions, indemnification, and insurance all operate to shield directors from liability risk to varying extents.\textsuperscript{66} Also, the demand requirement for shareholder derivative suits can provide directors with yet another layer of protection against personal liability.\textsuperscript{67} A full consideration of the nuances of all of these liability risk-reducing mechanisms is beyond the scope of this article. I discuss director exculpation statutes alongside the business judgment rule because their effects are, in the end, quite similar. Both the business judgment rule and director exculpation statutes require plaintiffs to make a showing far beyond mere negligence in order to prevail against directors for breach of the duty of care; bad faith in the case of exculpation statutes, and either procedural gross negligence or substantive irrationality in the case of the business judgment rule.

III. THREE COMMON POLICY ARGUMENTS FOR THE BUSINESS JUDGMENT RULE AND EXCULPATION STATUTES

Over the years, innumerable policy arguments have been made on behalf of the business judgment rule, both in court opinions and in the academic literature, and exculpation statutes typically have been defended on the same grounds.\textsuperscript{68} I make no attempt to address the entire gamut of policy arguments for the business judgment rule and exculpation statutes.\textsuperscript{69} Instead, I focus on three of the most

\textsuperscript{65} Kuykendall, supra note 59, at 6–7.
\textsuperscript{66} See Drury, supra note 10, at 117–18 (arguing that indemnification and insurance provide directors with less protection than outright exculpation because “the indemnification statute expressly prohibits directors from receiving protection if the harm is caused to the corporation itself,” and “insurance companies provide a meaningful, third-party check” by limiting the extent of coverage).
\textsuperscript{67} See Donald C. Langevoort, On Leaving Corporate Executives “Naked, Homeless and Without Wheels”: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability, 42 WAKE FOREST L. REV. 627, 647 (2007) (explaining that the demand requirement can pose a significant hurdle to shareholder suits against directors because “the corporation’s independent directors” may “recommend termination of the derivative suit as a matter of business judgment”).
\textsuperscript{68} See Drury, supra note 10, at 113 (observing that the arguments for exculpation statutes “mimic those” made “in favor of the business judgment rule”); see also Bjerre, supra note 10, at 801–15 (using policy arguments typically made for the business judgment rule to defend director exculpation statutes).
\textsuperscript{69} For example, a prominent argument for the business judgment rule that I do not intend to address is the argument that courts lack the institutional competence to judge the substantive merits of directors’ business decisions. Additionally, I do not intend to address the argument that courts are susceptible to hindsight bias which is mitigated by the business judgment rule. For a statement of these policy arguments, see Allen, Jacobs & Strine, supra note 11, at 454–55. But see Gevurtz, supra note 30, at 304–05 (arguing that these policy
common arguments: (A) if directors’ risk of liability were increased, directors would be overly deterred from taking entrepreneurial risks; (B) if directors’ risk of liability were increased, current directors and director candidates would be overly deterred from serving as directors; and (C) market mechanisms, namely the market for capital and the market for control, already provide sufficient incentives for directors to exercise care. As this section explains, all three of these arguments are essentially cost-benefit arguments. They purport to show that the business judgment rule and director exculpation statutes are efficient because increasing directors’ liability risk would impose tremendous costs on shareholders.

A. Over-Deterrence of Entrepreneurial Risk-Taking

The business judgment rule is often defended on the grounds that, if the threat of personal liability were increased, directors would be overly deterred from taking entrepreneurial risks. Put differently, the business judgment rule provides the socially optimal level of deterrence against director carelessness and incentivizes just the right amount of risk-taking.

A simple version of this argument appeals to the widely-shared notion that businessmen should be bold. It asserts that increased liability risk would make directors “too cautious,” and “[i]n business, at least, caution is not always the virtue it’s often made out to be, but rather a costly vice.”\(^{70}\) This version of the argument tells us little about whether the business judgment rule provides the socially optimal level of deterrence, because it focuses solely on the likely costs of increased liability risk and ignores the likely benefits. Certainly, foregone profits would be a likely cost of increased liability risk. Directors may well decide not to undertake some risky ventures that would have been profitable. However, avoided losses would likely be a benefit of increased liability risk because directors would exercise more caution in making business decisions.\(^{71}\) So, this version of the argument is question-begging on arguments do not justify treating directors differently from other professionals because courts are just as incompetent at judging the conduct of doctors, engineers, and other technical professionals, and courts are just as likely to be susceptible to hindsight bias in other kinds of cases).


\(^{71}\) See Fairfax, supra note 7, at 433–34 (arguing that a corporate director is precisely the type of actor likely to modify his or her behavior and use additional care in response to
its face. The appeal of the idea that directors should be bold merely raises the question, “How bold?”

A more sophisticated version of the argument explains that the business judgment rule incentivizes just the right amount of risk-taking because it helps to align directors’ risk preferences with shareholders’ risk preferences, assuming that most shareholders are diversified. Diversified shareholders “are indifferent to the levels of diversifiable risk associated with different projects.”

They “view projects with identical levels of market risk and identical levels of expected returns as equivalent, even if the projects have very different levels of diversifiable risk.” For example, suppose that a corporation can choose between two potential projects. Project A has a 90% chance of yielding $1000, and therefore has an expected value of $900. Project B has a 10% chance of yielding $9100, and therefore has an expected value of $910. A diversified shareholder would prefer that the corporation undertake Project B because it has a higher expected value. The fact that Project B also “involves considerably more uncertainty for the particular firm making the investment” is unimportant because diversified shareholders are not concerned about the level of diversifiable risk associated with particular firms.

In contrast, directors would be sensitive to diversifiable risk if they were not protected by the business judgment rule. Without the business judgment rule, directors would face an increased risk of personal liability for deciding to undertake extremely risky projects. Therefore, they likely “would . . . prefer projects with lower overall risks to those with higher overall risks, even when the project with the higher overall risk also had the higher net present value.” By shielding directors from risk of personal liability, the business judgment rule helps to make directors indifferent to diversifiable risk. It enables directors to ignore the levels of diversifiable risk associated with various investment options and focus on expected value, just as diversified shareholders would like.

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72 Letsou, supra note 32, at 204; see also Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (arguing that “it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions” because “shareholders can reduce the volatility of risk by diversifying their holdings”).

73 Letsou, supra note 32, at 204.

74 Id.

75 Id. at 205.

76 Id.

77 Id.
According to this version of the argument, the business judgment rule is efficient because aligning directors’ risk preferences with shareholders’ risk preferences furthers the goal of shareholder wealth maximization. If directors are free to ignore diversifiable risk and focus solely on expected value, “diversified shareholders will see the present value of their investment portfolios increase with each investment decision.”

Admittedly, shielding directors from liability risk also weakens their incentives to carefully consider their decisions. Therefore, the gains in shareholder wealth are reduced to some extent by losses associated with director carelessness. However, proponents of the business judgment rule are confident that the gains outweigh the losses over all.

In sum, this argument for the business judgment rule claims that the rule incentivizes the socially optimal level of risk-taking because, if directors faced increased liability risk, they would be more risk adverse than shareholders would like, assuming that most shareholders are diversified. By shielding directors from liability, the business judgment rule enables directors to ignore the diversifiable risks associated with various investment options and focus on expected value, which increases shareholder wealth.

B. Over-Deterrence of Director Service

The business judgment rule is also often defended on the grounds that, if directors’ risk of personal liability were increased, current directors and director candidates would be overly deterred from serving as directors. A simple version of this argument assumes that director compensation would remain the same despite the increase in liability risk. As a result, the liability risk “could be highly disproportionate to the incentives for serving as a director.”

The “[l]iability for an imprudent decision could be in the millions,”

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78 Id. at 204.
79 Id. at 205.
80 Id. at 206.
81 The argument also assumes that the only alternative to shielding directors from nearly all liability risk is exposing directors to multi-million, or even multi-billion, dollar damages. See Allen, Jacobs & Strine, supra note 11, at 455 (arguing that, if the standard of review for directors’ decisions were heightened, “[l]iability for an imprudent decision could be in the millions”). However, exposing directors to massive damages is not an inevitable consequence of subjecting directors’ decisions to a tougher standard of review. See, e.g., Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639, 641–43 (1996) (arguing that, in the context of federal securities litigation, damage caps could be used to calibrate the level of deterrence achieved by litigation and ensure that directors’ liability risk would not be “draconian”).
82 See Allen, Jacobs & Strine, supra note 11, at 455.
but outside directors rarely receive annual fees commensurate with liability risk of that magnitude.\textsuperscript{83} Therefore, reducing the protections of the business judgment rule “would make it more difficult to attract qualified candidates as outside directors.”\textsuperscript{84} In other words, if directors’ risk of liability were increased, current directors and director candidates would refuse to serve.

A more sophisticated version of the argument relaxes the assumption that director compensation would remain the same. On this view, shareholders are purchasers of directors’ management services. Protection from personal liability risk is simply one form of compensation that shareholders can use to pay directors, along with cash, securities, reputational benefits, and so on.\textsuperscript{85} Currently, the vast majority of directors receive protection from liability risk (through the business judgment rule, exculpation statutes, insurance, indemnification, and so on) as part of their overall compensation.\textsuperscript{86} Conceivably, however, shareholders could pay directors additional cash in exchange for a tougher standard of review for duty of care violations.\textsuperscript{87}

Changing the law to impose additional liability risk on directors would essentially prevent shareholders from using protection from liability risk as a form of compensation. In the short term, the change would reduce directors’ overall pay—directors would be subject to additional liability risk but still receive the same amount of other compensation. Soon, however, directors would demand additional compensation to make up for the increased risk,\textsuperscript{88} thereby passing along at least some of the costs of the increased risk

\textsuperscript{83} *Id.*

\textsuperscript{84} *Id.*

\textsuperscript{85} See Kuykendall, *supra* note 59, at 11 (describing reduced liability risk as a form of compensation).

\textsuperscript{86} See Drury, *supra* note 10, at 103–04 (describing widespread inclusion of director exculpation provisions in the charters of major public companies); Langevoort, *Human Nature, supra* note 15, at 818 (describing adoption of the business judgment rule as nearly universal).

\textsuperscript{87} See Easterbrook & Fischel, *supra* note 13, at 1430 (describing existing corporate governance doctrines, such as the business judgment rule, as default rules out of which shareholders could contract).

\textsuperscript{88} See Langevoort, *Human Nature, supra* note 15, at 818 (arguing that a likely consequence of increasing directors’ liability risk is that directors would demand “increased insurance, indemnification rights, and compensation for the residual risk”). While directors might well demand that the corporation procure more expensive insurance to guard against the increased risk, there are limits to the amount of coverage that insurance companies would be willing to provide. See Drury, *supra* note 10, at 117–18 (explaining that “[b]y defining the scope of coverage, setting the financial limits of the policy, and determining the premium,” the insurance company “has the ability to set forth its conception of good governance and incentivize board members to live up to this conception”).
to the rest of the corporate enterprise. The extent to which directors would be able to pass along the costs of the increased risk—whether all, some, or none—is a thorny empirical question depending on a number of factors. For instance, a director’s ability or willingness to leave might depend on whether the director is an inside or an outside director, and whether increasing directors’ liability risk also increases the reputational compensation associated with director service. However, for the sake of argument, we can assume that most corporate directors are the type of economic actors capable of passing along increased costs to their consumers. Therefore, the claim that directors will refuse to serve if their liability risk is increased amounts to the claim that directors have sufficient economic bargaining power to walk away unless they receive additional compensation. So, shareholders will end up paying directors in some form or another. Without a change in the legal regime, shareholders will pay directors partly with protection from liability risk. With a change, directors will receive additional cash, securities, reputational benefits, and so on. Therefore, the only question is whether it is efficient to prohibit shareholders from using protection from liability risk as a form of compensation.

A proponent of the business judgment rule would argue that it is inefficient to prohibit shareholders from using protection from liability risk to compensate directors. As between shareholders and directors, shareholders are the more efficient risk-bearers. When it comes to their own liability, directors are risk averse and therefore will likely want a significant amount of compensation to take on additional risk. In contrast, shareholders can “diversify away much of the risk . . . associated with acts of their agents.”

89 See Duncan Kennedy, Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power, 41 Md. L. Rev. 563, 604–14 (1982) [hereinafter Kennedy, Distributive and Paternalist Motives] (arguing that the distributive effects of a compulsory contract term cannot be predicted across the board, but instead will vary from market to market based on conditions specific to each market).

90 See Fairfax, supra note 7, at 452 (arguing that, “while there are reports of isolated director resignations” in response to stepped-up liability risk, “no real study of the impact that enhanced liability has on directors’ willingness to serve exists,” and “there are some reasons to believe that directors may be willing to serve even in the face of potential increased liability”).


92 Dooley, supra note 27, at 467 (“Where the residual claimants are not expected to run the firm and especially when they are many in number . . . their function becomes specialized to risk-bearing.”).

93 Letsou, supra note 32, at 182.
Therefore, shareholders should find it cheaper to pay directors with protection from liability risk, rather than with cash or other compensation. Put differently, requiring shareholders to use cash to compensate directors, and requiring directors to bear some of the risk associated with their own carelessness, results in inaccurate pricing of directors’ services.\(^94\) In sum, according to this argument for the business judgment rule, increasing directors’ liability risk would be inefficient because it would force shareholders to pay directors with cash or other compensation, though shareholders normally would find it cheaper to pay directors with protection from liability.\(^95\)

C. Existence of Market Mechanisms that Control Directors’ Actions

Finally, the business judgment rule is often defended on the grounds that market mechanisms already incentivize directors to exercise the right amount of care in making business decisions.\(^96\) Therefore, the business judgment rule and director exculpation statutes promote economic efficiency by preventing the government—courts in particular—from intruding into the free market and distorting incentives.\(^97\)

\(^94\) Kuykendall, supra note 59, at 13 (characterizing the view that risk reduction is a form of compensation as the view that “[i]instead of resorting to damages, the corporation could create an efficient contract that priced the risk of negligence to the satisfaction of the parties”).

\(^95\) Another argument commonly made for the business judgment rule is that, instead of paying directors more, shareholders might substitute high quality directors with low quality directors, which can be thought of as another way that the cost of increasing directors’ liability risk could get passed along to the corporate entity. See, e.g., Langevoort, Human Nature, supra note 15, at 818 (explaining that a common argument for the business judgment rule is that “good people” would refuse to serve if directors’ liability risk were increased). However, it is not clear that the current system incentivizes corporations to retain high quality directors in the first place. On the contrary, “[b]oard members are selected from . . . a relatively narrow, elite group with homogenous backgrounds, values, and worldviews,” “women and minorities are still shockingly underrepresented,” and “[b]oads lack diversity . . . in their members’ range of relevant experiences, in their personalities, and in how they perceive and deal with business issues.” Gillespie & Zweig, supra note 3, at 30–31. Also, many corporations populate their boards with directors who already serve on numerous other boards, which can make it difficult for them to perform their duties with care. See Eliezer M. Fich & Anil Shivdasani, Are Busy Boards Effective Monitors?, (Eur. Corp. Governance Inst., Fin., Working Paper No. 55/2004, 2004), available at http://ssrn.com/abstract=607364. Therefore, while increasing directors’ liability risk might lead to different people serving as directors, it is not clear that these people would be low quality compared to the people who currently serve. Due to these complexities, this issue is beyond the scope of this article.

\(^96\) See Dooley, supra note 27, at 525 (arguing that “the principal deterrent to management misbehavior” comes from “competitive forces in the product market, in the internal and external markets for managers and, ultimately, in the market for corporate control”); Bjerre, supra note 10, at 798 (making the argument on behalf of exculpation statutes).

\(^97\) But see Frug, supra note 19, at 1365–66 (recognizing the logical circularity of using the
According to one version of the argument, market forces drive the directors of widely-traded companies to exercise adequate care in making business judgments. If directors act carelessly, the price of their company’s stock will fall. Because “[r]ational investors will only entrust their funds to firms in whose management they have confidence, firms that are known to have careless directors will not attract investors, or will only attract them at a discounted price.”

When a company is widely traded, investors will discover whether its directors are careless, even in the absence of a catastrophic failure, because “[p]rofessional investors and investment advisors continuously monitor the performance of a firm and its directors.”

If a company’s stock price falls low enough, the company could become an attractive target for a hostile takeover, and the current directors would likely lose their jobs. Therefore, “very little . . . would be lost by outright abolition of the legal duty of care and its accompanying threat of a law suit.” Because market incentives drive directors to exercise “an appropriate degree of care,” fiduciary duties are merely “arbitrary and wasteful judicial artifacts.”

According to a second version of the argument, market forces drive directors to select the corporate governance rules that shareholders desire, including the business judgment rule and director exculpation provisions. The governance rules adopted by a particular corporation comprise a contract between the corporation’s managers and its shareholders. Admittedly, shareholders are too disorganized and widely dispersed to actually bargain over the contract’s terms. The corporation’s directors set the contract’s terms and offer it to shareholders on a take-it-or-leave-it basis.

free market to justify a legal rule that gives directors tremendous discretion, given that outcomes in the market are substantially determined by the background legal rules that constitute the market).


99 Bjerre, supra note 10, at 798; but see William W. Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 659 (2010) (explaining that, for various reasons, a company’s stock price may not always reflect the full extent of the risk to which the company is exposed); Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 487 (1985) (observing that, in close corporations, shareholders lack the ability to discipline management by selling their shares, but the business judgment rule applies nonetheless).

100 Bjerre, supra note 10, at 799.
101 Id. at 798–800.
102 Id. at 797.
103 Id.
104 Easterbrook & Fischel, supra note 13, at 1426–27.
105 Id. at 1429–30.
106 Id. at 1429.
However, the lack of actual bargaining is unproblematic because directors are driven by market forces to offer terms that investors will find attractive.\textsuperscript{107} A corporation’s “securities are products to as great an extent as the sewing machines or other things the firm makes.”\textsuperscript{108} The price that a corporation’s securities fetch in the market “reflects the value of the firm’s governance and related rules.”\textsuperscript{109} So, if directors offer corporate governance terms that investors find unattractive or abusive, then investors will “simply pay less for the paper [that] the firms issue,”\textsuperscript{110} and the price of the companies’ securities will fall. As mentioned above, if the price falls low enough, the company may become an attractive takeover target, and the directors may lose their jobs.\textsuperscript{111} Therefore, directors have strong incentives to “establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure.”\textsuperscript{112} Directors may have the power to establish the terms of the corporate contract, but the market imposes “a limit on managers’ efforts to enrich themselves at investors’ expense.”\textsuperscript{113}

This version of the argument suggests that, if shareholders wanted courts to evaluate directors’ business judgments under a stricter standard of review, then directors would be driven by market forces to contract out of the business judgment rule. Contracting out of the business judgment rule, perhaps through a corporate charter provision, would increase share value. Similarly, it suggests that directors would be driven to not adopt charter provisions exculpating themselves from liability for breaching their fiduciary duties. However, we actually see nearly universal adoption of the business judgment rule and widespread inclusion of director exculpation provisions in corporate charters.\textsuperscript{114} Therefore, so the argument goes, changing the law to impose additional liability risk on directors would override the wishes of shareholders as expressed in the market, thereby reducing the value of their

\textsuperscript{107} Id. at 1429–30; see also Kennedy, Distributive and Paternalist Motives, supra note 89, at 614–20 (arguing against “unequal bargaining power” as a justification for mandatory, non-disclaimable contract and tort duties designed to redistribute wealth to supposedly powerless interest groups).

\textsuperscript{108} Easterbrook & Fischel, supra note 13, at 1419–20.

\textsuperscript{109} Id. at 1431–32.

\textsuperscript{110} Id. at 1419.

\textsuperscript{111} Id. at 1420.

\textsuperscript{112} Id.

\textsuperscript{113} Id. at 1419.

\textsuperscript{114} See Drury, supra note 10, at 103–04 (describing the inclusion of exculpation provisions in the charters of virtually all major companies); Langevoort, Human Nature, supra note 15, at 818 (describing adoption of the business judgment rule as nearly universal).
IV. EXISTING CRITIQUES OF THE BUSINESS JUDGMENT RULE

The business judgment rule has already been criticized on a number of grounds. For the most part, the existing critiques remain within the cost-benefit framework used by the three arguments for the business judgment rule discussed above. These critiques attack the business judgment rule on the grounds that, for one reason or another, the benefits of increasing directors’ liability risk would be greater than previously thought. As I argue below, while these critiques may serve as counterweights to the arguments for the business judgment rule, they fail to definitively disprove them. In contrast, a few existing critiques of the business judgment rule reject the cost-benefit framework altogether. Some of these critiques challenge the basic assumptions or value judgments underlying the pro-business judgment rule arguments, while others identify logical contradictions or faulty distinctions within them. Because these critiques reject cost-benefit analysis, they are more effective in rebutting the pro-business judgment rule arguments.

A. Critiques that Accept the Cost-Benefit Framework

Most of the existing critiques of the business judgment rule employ the same cost-benefit framework used by the arguments commonly made in support of the business judgment rule. According to these critiques, increasing directors’ risk of liability could have significantly greater benefits than previously thought. Therefore, the outcome of the cost-benefit analysis might actually favor increasing directors’ liability risk.

For example, after the Enron and WorldCom scandals, some scholars argued that director carelessness can cause serious harm and that increasing directors’ liability risk could yield the benefit of deterring careless conduct. According to Lisa Fairfax, the failure of Enron’s directors to exercise due care was a significant cause of

115 See Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (arguing that “shareholders to a very real degree voluntarily undertake the risk of bad business judgment” because “investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers”). But see Drury, supra note 10, at 118 (arguing that, as an empirical matter, Delaware corporations generally fell in value after the Delaware legislature authorized corporations to adopt charter provisions exculpating directors from personal liability and directors rushed to amend their charters to include such provisions).

116 See Fairfax, supra note 7, at 394–96; Sale, supra note 7, at 456–57.
the company’s spectacular collapse. Enron’s directors “sign[ed] off on company reports with limited or no knowledge of their contents,” “made decisions regarding highly complex transactions after only brief consideration of the issues critical to those transactions,” and “merely rubber-stamped management’s decisions.” While many other factors also contributed to Enron’s collapse, the failure of directors to exercise care is “particularly problematic” because “directors serve as one of the primary, and possibly final, checks on misbehavior within” the firm. Fairfax concludes that, because financial collapse can cause such significant harm, we should increase directors’ liability risk to deter them from allowing financial collapses in the future. Fairfax admits that “imposing legal liability on directors may entail some costs,” but argues that “given the importance of legal liability to the regulation of director conduct, such costs must be absorbed.” In other words, Fairfax accepts cost-benefit analysis as the appropriate framework for determining whether directors should be shielded from liability risk. She believes that the cost-benefit calculation ultimately favors increasing directors’ liability risk because the benefits of preventing future financial meltdowns are so significant.

Similarly, Hillary Sale argues that the Enron and WorldCom scandals were caused in significant part by “the inability—or unwillingness—of officer and director fiduciaries to manage faithfully.” To address this problem, she argues that Delaware should establish a robust “duty of good faith” and use it to impose liability on directors for “non-conflicted but deliberately indifferent behavior and transactions.” The benefit of creating such a duty would be “the ex ante role it can play in changing the behavior and incentives of corporate fiduciaries.” In other words, Sale believes that exposing directors to additional liability risk via a new duty of good faith would yield significant benefits—namely deterring the kind of conduct that led to the collapse of Enron and WorldCom—and presumably these benefits outweigh whatever costs are associated with increasing directors’ liability risk.

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117 See Fairfax, supra note 7, at 400.
118 Id. at 399.
119 Id. at 400.
120 Id. at 449 (arguing for “the need to ensure that legal liability represents a component of the framework for regulating corporate conduct”).
121 Id. at 455.
122 Sale, supra note 7, at 461–62.
123 Id. at 488.
124 Id. at 494.
Additionally, Lynn Stout draws on social science research to show that judicial review of the procedures that directors use in making business decisions could yield significant benefits that so far have been overlooked.\textsuperscript{125} According to Stout, directors are not merely “rational actors concerned only with improving their own welfare.”\textsuperscript{126} Instead, the corporate board should be viewed as a “social institution . . . premised on the belief that directors are motivated, at least in part, by altruism.”\textsuperscript{127} Social science research indicates that “altruistic behavior becomes less likely as the personal sacrifice involved in behaving altruistically increases.”\textsuperscript{128} By reviewing the decision-making procedures that directors follow in making business decisions, courts can reduce “the marginal personal cost associated with altruistic director behavior,” particularly the effort required to gather information and comprehend the issues facing the firm, and the social cost of confronting the firm’s management.\textsuperscript{129} By reducing these costs for directors, judicial review of directors’ decision-making procedures would ultimately increase the likelihood that directors would altruistically engage in information gathering and management confrontation activities on behalf of shareholders.\textsuperscript{130} Stout recognizes that judicial review might also “impose[] substantial costs on firms and shareholders,” but observes that “one of the first lessons of economics is that some costs are worth incurring.”\textsuperscript{131} In other words, her argument for judicial review employs a cost-benefit framework. When the social science research on altruism is taken into account, Stout suggests, our revised estimate of the benefits of judicial review may well exceed our estimate of its costs.

\textsuperscript{125} Stout, supra note 14, at 678. Stout frames her argument as a defense of the business judgment rule, but the substance of her argument actually weighs in favor of judicial review of directors’ business decisions. See id. Her article is a defense of the business judgment rule in the sense that she opposes those who argue that courts should engage in no review. See id. See also Antony Page, \textit{Unconscious Bias and the Limits of Director Independence}, 2009 U. Ill. L. Rev. 237, 239–40 (2009) (arguing that the usual assumption that disinterested directors make informed business decisions in good faith may not be justified because social psychology research suggests that directors are affected by numerous unconscious biases they “can neither identify nor control”); Fraidin, supra note 26, at 5–6 (arguing that some judicial review of directors’ decision-making procedures would lead to higher quality decisions if courts based their review on the insights of social psychology regarding effective group decision-making).

\textsuperscript{126} Stout, supra note 14, at 677.

\textsuperscript{127} Id.

\textsuperscript{128} Id. at 678.

\textsuperscript{129} Id.

\textsuperscript{130} Id.

\textsuperscript{131} Id. at 676.
Finally, Franklin Gevurtz criticizes the business judgment rule by pointing out the discrepancy between the law’s treatment of corporate directors and its treatment of other professionals, such as doctors and lawyers.\textsuperscript{132} On one hand, directors are shielded by the business judgment rule from nearly all risk of personal liability. On the other hand, the conduct of all other professionals is evaluated under the regular negligence standard. Gevurtz argues that this discrepancy is not justified by any sound policy arguments.\textsuperscript{133} All of the “problems created by director liability for ordinary negligence parallel the problems of negligence liability for many other groups.”\textsuperscript{134} Therefore, Gevurtz suggests that either corporate directors should be evaluated under the regular negligence standard or all other professionals should be evaluated under the lenient standard that currently applies to directors.\textsuperscript{135} To determine which standard should be universally adopted, Gevurtz suggests that we should engage in cost-benefit analysis. He admits that, in the end, cost-benefit analysis might lead us to conclude that the negligence standard in tort is inefficient.\textsuperscript{136} We might instead decide that “[a] more efficient way to achieve compensation is simply for individuals to purchase medical, disability and property-loss insurance.”\textsuperscript{137}

In sum, these critiques accept cost-benefit analysis as the appropriate framework for evaluating the business judgment rule. Whereas the pro-business judgment rule arguments emphasize the costs of increasing directors’ liability risk, these critiques respond by emphasizing the benefits. While such critiques can serve as counterweights to the arguments for the business judgment rule, they do not definitively disprove them. To disprove the pro-business judgment rule arguments, a critique based in cost-benefit analysis would have to show that the benefits of increasing directors’ liability risk actually outweigh the costs. This would require “catalog[ing] all of the costs and benefits associated with directors’ liability for lack of care,”\textsuperscript{138} assigning values to them, and doing the math. Otherwise, such a critique “cannot by itself lead to any strong normative conclusion one way or the other.”\textsuperscript{139} However, putting

\textsuperscript{132} Gevurtz, supra note 30, at 295.
\textsuperscript{133} Id. at 304–05.
\textsuperscript{134} Id. at 336.
\textsuperscript{135} Id. at 318.
\textsuperscript{136} Id.
\textsuperscript{137} Id. at 319.
\textsuperscript{138} Langevoort, Human Nature, supra note 15, at 829.
\textsuperscript{139} Id.
aside for the moment that it might not be possible to perform such a calculation in a determinate and objective manner,\textsuperscript{140} performing the calculation would be “an empirical matter of hopeless complexity.”\textsuperscript{141} Just as critics of the business judgment rule can use social science to find additional benefits of increasing directors’ liability risk, proponents of the business judgment rule can use it to find even more costs.\textsuperscript{142} Therefore, to definitively rebut the arguments commonly provided for the business judgment rule, one must consider critiques that reject the cost-benefit framework altogether.

\textbf{B. Critiques that Reject the Cost-Benefit Framework}

A few of the existing critiques of the business judgment rule reject the cost-benefit framework altogether. Some of these critiques challenge the basic assumptions underlying the pro-business judgment rule arguments, while others proceed by identifying logical contradictions or faulty distinctions within them. Either way, these critiques are more effective in rebutting the pro-business judgment rule arguments because they avoid the herculean task of determining whether the business judgment rule’s costs actually outweigh its benefits.

For example, Daniel Greenwood rejects a basic assumption underlying cost-benefit analysis—the assumption that the legitimacy of the legal doctrine turns on whether it maximizes wealth. Instead, according to Greenwood, legitimacy flows from “the will of the people.”\textsuperscript{143} A system of government is legitimate to

\textsuperscript{140} See Kennedy, \textit{Law and Economics}, supra note 17, at 469–70 (describing several arguments to this effect).


\textsuperscript{142} See Langevoort, \textit{Human Nature}, supra note 15, at 823–28 (arguing that, when one considers social reality inside the board room rather than assuming that directors are rational economic actors, one finds that increasing directors’ risk of liability entails even more costs than previously thought); see also Donald C. Langevoort, \textit{Opening the Black Box of “Corporate Culture” in Law and Economics}, 162 J. INST’L & THEORETICAL ECON. 80, 91–93 (2006) (arguing that corporate culture can significantly increase the costs of monitoring and can reduce the law’s deterrence capacity).

\textsuperscript{143} Greenwood, \textit{Markets and Democracy}, supra note 18, at 42. Of course, such a critique is persuasive only in so far as the critic’s audience accepts the external source of value (democracy, in this case) offered by the critic. Greenwood asserts that democracy is legitimating and wealth maximization is not, which is a contestable proposition. \textit{See id.} at 41–43.
the extent that the governed have chosen it for themselves. If the will of the people is the true source of legitimacy, Greenwood argues, then corporate law is quite illegitimate because its “content is determined by” forces largely outside of the political process, such as “the market for corporate control and the internal norms of a self-replicating system.” Therefore, even if the common policy arguments for the business judgment rule are correct—the rule promotes wealth maximization by aligning the risk preferences of directors and shareholders or by allowing market forces to determine the contents of the corporate contract—they fail to legitimate the business judgment rule. Wealth maximization does not legitimate, democracy does. Similarly, Kent Greenfield and John Nilsson argue against the assumption that wealth maximization should be the law’s sole objective. The human experience is characterized by numerous incommensurable, non-fungible values. Therefore, basing one’s decisions on a single value, such as wealth maximization, and excluding all other values from consideration is “childish, obtuse, or insane.”

In contrast, Gerald Frug critiques various arguments for the business judgment rule by identifying a faulty distinction within them. According to Frug, all of the arguments for the business judgment rule attempt to draw a distinction between objective and subjective, and this distinction never holds up.

For instance,

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144 Id. at 41.
145 Id.
146 Id. at 45 (arguing that “the market-based system” for determining the contents of corporate law “hinders the political debate that could properly balance the values of economic growth against its costs: increased relative inequality, mobility and change, and, most importantly, the devaluing of human effort”).
148 Id. at 808–12. Interestingly, although Greenfield and Nilsson reject wealth maximization, they conclude that their argument weighs in favor of the business judgment rule. Id. at 858–59. Without the business judgment rule, directors would be required to focus solely on maximizing shareholder wealth, which is precisely the type of reasoning that they consider “insane.” Id. at 808–12. The business judgment rule provides directors with breathing room to consider other values that conflict with shareholder wealth maximization. Id. at 816–24. However, Greenfield and Nilsson ignore the fact that the business judgment rule is typically viewed as a mechanism for enhancing shareholder wealth by encouraging directors to take risks and exposing director decision-making to market forces. See id. at 813–58.
149 Frug, supra note 19, at 1286–87. For another example of an internal critique of corporate law doctrines, though not of the business judgment rule in particular, see Branson, supra note 25, at 96–97 (arguing that Delaware’s corporate law is indeterminate because of the conflict between the equal dignity rule and the Schnell doctrine, and therefore Delaware’s courts are logically free to decide corporate law cases however they please).
proponents of the business judgment rule often argue that courts should defer to directors because directors have more expertise in making business decisions. Frug also finds that this argument fails because it requires an ability to draw a distinction between objective decisions based on expertise, and subjective decisions based on whim, and this distinction cannot be drawn. So, instead of providing “a way to decide whether a concrete bureaucratic activity should be approved or condemned,” the argument merely creates “a structure that lawyers can use to formulate arguments for and against the activity under review.” Lawyers can argue back and forth about whether directors relied on their expertise and used proper discretion, or whether their decision was the arbitrary “result of a throw of the dice.” Additionally, the business judgment rule is often defended on the grounds that objective market mechanisms—such as the market for capital and the market for corporate control—limit directors’ subjective discretion. According to Frug, this argument assumes that stock price provides an objective standard for judging management’s performance, when actually stock price embodies a number of subjective, normative judgments. First, stockholders are “human beings with many conflicting desires” other than “profit maximization.” Therefore, by forcing directors to focus solely on increasing stock price, market mechanisms might force managers to take actions that stockholders “as consumers or workers . . . may well detest.” Second, stock price might merely reflect the subjective judgments of the policymakers who decided what legal rules should constitute the market in which stocks are exchanged. Markets are constituted by particular sets of background legal rules. By selecting different background rules, policymakers create different markets that produce different outcomes. For example, policymakers can reduce the premium that shareholders can expect to receive in tender offers by “consistently plac[ing] entitlements in the hands of the acquiring managers rather than in
the hands of the selling shareholders.”\textsuperscript{160} Therefore, an objective and legitimating “free market” does not produce stock prices.\textsuperscript{161} They are produced in a particular market, one of many “alternative possible markets”\textsuperscript{162} chosen by the state.

In sum, these critiques avoid the monumental task of cataloging all of the costs and benefits associated with increasing directors’ liability risk because they reject the cost-benefit framework altogether. As a result, they do a better job rebutting the arguments commonly provided for the business judgment rule. However, none of these critiques makes the claim that cost-benefit analysis is indeterminate, and therefore the pro-business judgment rule arguments fail due to their reliance on the cost-benefit framework. The argument that cost-benefit analysis is indeterminate is part of a collection of arguments developed by CLS scholars to critique the law and economics movement.\textsuperscript{163} I argue that, when this critique is applied to the arguments commonly made in support of the business judgment rule, it shows that they fail to justify the rule. Part V, below, introduces the CLS critique of law and economics, and describes the claim that cost-benefit analysis is indeterminate.

V. THE CRITIQUE OF “LAW AND ECONOMICS” IN CRITICAL LEGAL STUDIES

As discussed above, the most effective existing critiques of the business judgment rule are those that reject the cost-benefit framework employed by the pro-business judgment rule arguments. However, none of the existing critiques makes the claim that cost-benefit analysis is indeterminate, and therefore the pro-business judgment rule arguments fail due to their reliance on the cost-benefit framework. This line of critique is part of a collection of arguments developed by CLS scholars to critique the law and economics movement.\textsuperscript{164} While it has been applied to several other areas of law,\textsuperscript{165} it appears that no one has yet applied it to corporate

\textsuperscript{160} Id. at 1365.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
\textsuperscript{163} See Kennedy, Law and Economics, supra note 17, at 465.
\textsuperscript{164} See id.
\textsuperscript{165} See generally ACKERMAN \& HEINZERLING, supra note 24, at 35–40 (setting out several critiques of the use of cost-benefit analysis in the administrative law context, many of which can be characterized as claims that cost-benefit analysis is indeterminate, and therefore that its conclusions are political rather than objective).
According to the law and economics movement, "courts should make market-defining private law rules according to the Kaldor-Hicks definition of efficiency, leaving distributional questions to legislatively enacted tax and transfer programs."\(^{167}\) In other words, courts should engage in cost-benefit analysis; they should adopt the legal rule with the greatest benefits and the fewest costs, regardless of distributional consequences.\(^{168}\) On this view, the business judgment rule should be adopted if, overall, the benefits of almost entirely shielding directors from personal liability outweigh the costs.\(^{169}\) In response to this view, CLS scholars have developed a collection of arguments designed to show that cost-benefit analysis is "a bad idea, practically unworkable, incoherent on its own terms, and just as open to alternating liberal and conservative ideological manipulation as the open-ended policy analysis it was supposed to replace."\(^{170}\)

One of these CLS arguments is Duncan Kennedy’s argument that cost-benefit analysis is indeterminate.\(^{171}\) According to this argument, one analyst performing a cost-benefit calculation could conclude that costs outweigh benefits, while another analyst performing the same calculation could conclude that benefits outweigh costs, and both analysts would be equally correct.\(^{172}\)

Kennedy’s argument that cost-benefit analysis is indeterminate has two steps. First, when performing a cost-benefit calculation to decide whether the law should encourage or discourage an activity, an analyst must begin by identifying all of the activity’s costs and benefits. This requires the analyst to consider not only the activity’s direct costs and benefits, but also any externalities associated with it, including emotional harms and moral outrage.\(^{173}\) Second, after identifying all of the activity’s costs and benefits, the analyst must assign numeric values to each of them in order to perform a comparison. Nothing within the cost-benefit analysis determines whether the analyst should use "offer price" (the price

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\(^{166}\) See Branson, supra note 25, at 87 ("Realism and indeterminacy have yet to touch corporate law.").

\(^{167}\) Kennedy, Law and Economics, supra note 17, at 465.

\(^{168}\) Id. at 469 (explaining that a legal rule is Kaldor-Hicks efficient if it “maximizes the dollar value of output, regardless of the distributive consequences”).

\(^{169}\) As discussed in Parts III and IV above, three of the arguments commonly made in support of the business judgment rule, and also many critiques of the business judgment rule, operate within this cost-benefit framework.

\(^{170}\) Kennedy, Law and Economics, supra note 17, at 465.

\(^{171}\) Kennedy, Cost-Benefit Analysis, supra note 21, at 407.

\(^{172}\) Id.

\(^{173}\) Id. at 398–99.
an individual would be willing to pay to obtain a benefit or avoid a cost) or “asking price” (the price the same individual would accept to give up a benefit or suffer a cost) in assigning values to costs and benefits.\textsuperscript{174} However, as an empirical matter, offer prices and asking prices can diverge significantly.\textsuperscript{175} Therefore, in the process of performing a cost-benefit calculation, an analyst must make choices, and these choices can dramatically skew the outcome of the calculation in one direction or another.\textsuperscript{176} Therefore, even if a tremendously skilled analyst could catalogue all of the costs and benefits of a particular activity, a cost-benefit analysis of the activity could yield multiple, equally correct outcomes.

\textbf{A. Consideration of Externalities in the Cost-Benefit Calculation}

According to Kennedy, to perform a cost-benefit calculation to decide whether the law should encourage or discourage an activity, an analyst must begin by identifying all of the activity’s costs and benefits, including all of its externalities. Because of insights flowing from the Coase Theorem, the need to consider externalities introduces tremendous complexity into the cost-benefit calculation.\textsuperscript{177} According to the Coase Theorem, assuming “no transaction costs and perfect competition,” rational economic actors will freely bargain to the most efficient outcome regardless of the allocation of legal entitlements.\textsuperscript{178} For example, suppose a tire factory is legally entitled to produce air pollution, which irritates the citizens of a nearby town. In the absence of transaction costs, the citizens will pay the factory owner to shut down if the value of their collective irritation exceeds the value of tire production. Alternatively, suppose the citizens are legally entitled to shut down pollution-producing factories, but the value of tire production exceeds the value of the citizens’ collective irritation. In the absence of transaction costs, the factory owner will pay the citizens to waive their right to shut down the factory. However, in reality, transaction costs do exist and often prevent all affected parties from bargaining to the most efficient outcome.\textsuperscript{179} For instance, the factory might continue polluting, even though the costs of irritation

\textsuperscript{174} Id. at 401.
\textsuperscript{175} Id.
\textsuperscript{176} See id.
\textsuperscript{177} Id. at 398.
\textsuperscript{178} Id. at 396.
\textsuperscript{179} Id. at 397.
exceed the benefits of tire production, because transaction costs prevent the citizens from organizing. In such cases, the Coase Theorem suggests that legal entitlements should be altered so that outcomes “correspond to the one[s] that bargaining would have produced.” 180 If the right to pollute is allocated to the factory owner, he will over-engage in tire production because he will not feel any of the costs externalized to the citizens. Giving the citizens a right to shut down the factory yields the efficient outcome because, in the absence of transaction costs, the citizens would have bought out the factory owner.

In other words, according to the Coase Theorem, an externality is any “cost, associated with an activity, which is not reflected in the activity’s price because transaction costs prevent those on whom the loss falls from making a contract with whoever might prevent it.” 181 Under this definition, the “universe of externalities” is quite vast—it includes everything from “physical impacts” to “adverse psychological reaction[s],” “aesthetic externalities,” and “moral impact[s].” 182 Returning to the tire factory example, suppose that air pollution not only irritates nearby citizens, but also morally offends a vast number of environmentalists, and aesthetically displeases even more naturalists. If so, the sum of the externalities felt by the environmentalists and naturalists could be quite significant, even if each person feels only a little harmed.

B. Choosing Between “Offer Price” and “Asking Price”

After an analyst identifies all of the costs and benefits of an activity, Kennedy argues that the analyst must next assign a numeric value to each of them. 183 However, there are multiple correct procedures for assigning values to costs and benefits. 184 Long ago, “economists abandoned the idea that there was something called ‘value’ that underlay or caused ‘price.’” 185 In other words, items have no objective, inherent value to which the analyst can refer—they only have the subjective value that individuals attribute to them in the market. Empirically, however, the subjective value that people attribute to items can depend significantly on how legal

180 Id.
181 Id. at 398.
182 Id. at 398–99.
183 See id. at 401.
184 Kennedy, Law and Economics, supra note 17, at 467.
185 Id.
entitlements are initially allocated.\textsuperscript{186} Often, the amount that an individual will demand to part with an item (the asking price) can greatly exceed the amount that the individual would be willing to pay to purchase the same item (the offer price).\textsuperscript{187} Asking prices and offer prices can diverge considerably.

Nothing within the cost-benefit analysis itself determines whether an analyst should use hypothetical offer price or hypothetical asking price to assign numeric values to the costs and benefits of the activity in question.\textsuperscript{188} On one hand, an analyst can accept the existing allocation of legal entitlements, in which injured third parties have no legal entitlement to stop the activity, and estimate what they would be willing to pay the actor to stop.\textsuperscript{189} Within this approach, the analyst uses offer price to value the activity’s externalities, which minimizes their value and makes it much more likely that the cost-benefit calculation will favor the activity.\textsuperscript{190} Alternatively, the analyst can imagine a “hypothetical reversal of entitlements” in which the injured third parties have the right to prevent the activity, and estimate what they would demand to waive that right.\textsuperscript{191} With this approach, the analyst uses asking price to value the activity’s externalities, which significantly “inflat[es] their value”\textsuperscript{192} and makes it much more likely that the cost-benefit calculation will disfavor the activity. Again, nothing within cost-benefit analysis logically compels the analyst to use one valuation method or the other.\textsuperscript{193} Considerations external to cost-benefit analysis, such as equitable considerations or reliance interests, might weigh in one direction or the other.\textsuperscript{194} However, such “political value judging” arguably should not take place “behind the neutral screen of the efficiency concept.”\textsuperscript{195}

\textsuperscript{186} See Kennedy, Cost-Benefit Analysis, supra note 21, at 401.
\textsuperscript{187} Id.
\textsuperscript{188} See id. at 407 (arguing that “there is no consensus among economists about how to perform the valuation of externalities from the setting of entitlements,” and “it is not true that the correct answer to the question of how to value is implicit in the very concept of efficiency”).
\textsuperscript{189} Id. at 415.
\textsuperscript{190} See id. at 412 (stating that, when offer price is used, “these much smaller sums might not tip the balance in favor of” the injured third parties).
\textsuperscript{191} Id. at 417.
\textsuperscript{192} Id. at 405.
\textsuperscript{193} Id. at 417.
\textsuperscript{194} Id. at 418–19 (arguing that “equitable” interests may weigh in favor of valuing externalities at the victims’ asking price to justify a change to the status quo, whereas “reliance” interests may weigh in favor of valuing externalities at the victims’ offer price to justify maintaining the status quo).
\textsuperscript{195} Id. at 419.
In sum, Kennedy’s argument that cost-benefit analysis is indeterminate has two steps. The first step of the argument is that, in order to perform a cost-benefit calculation, an analyst must take into account all of the costs and benefits associated with the activity in question, including its remote psychological, moral, and aesthetic externalities. If Kennedy’s argument ended here, it would not constitute a complete rejection of cost-benefit analysis. Instead, it would merely constitute a warning that cost-benefit calculations can be extremely complex due to the innumerable costs and benefits associated with any given activity. The argument would leave open the possibility that an extremely skilled, careful analyst could identify all of an activity’s costs and benefits and add them up in a determinate and objective way.

However, the second step of Kennedy’s argument is that, after identifying all of an activity’s costs and benefits, an analyst must assign numeric values to them in order to add them up. At this point, nothing within cost-benefit analysis determines whether the analyst should value the activity’s externalities at the offer price or the asking price of the victims on whom they fall. Instead, the analyst must choose, and the choice dramatically skews the outcome of the cost-benefit calculation either for or against the activity in question. Essentially, the activity’s externalities operate like a large swing vote, and the analyst’s choice to use either offer price or asking price in valuing them determines the direction in which they swing. Taken together, both steps of Kennedy’s argument constitute a complete rejection of cost-benefit analysis. The argument aims to show that cost-benefit analysis yields multiple correct answers to questions like, “Do the benefits of a legal rule outweigh its costs?” In other words, it aims to show that cost-benefit analysis is indeterminate.

VI. APPLICATION OF THE CLS CRITIQUE OF “LAW AND ECONOMICS” TO THE THREE COMMON ARGUMENTS FOR THE BUSINESS JUDGMENT RULE

As discussed in Part III, three of the policy arguments commonly made for the business judgment rule are, at bottom, cost-benefit arguments. In some shape or form, they claim that the business

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196 Id. at 398–99.
197 See id. at 401.
198 Id. at 417.
199 See id. at 401.
judgment rule is justified because increasing directors’ liability risk would impose significant costs on shareholders. As discussed in Part IV, most of the existing critiques of the business judgment rule are also cost-benefit arguments. In some shape or form, they claim that the benefits of increasing directors’ liability risk would be much greater than previously assumed. However, because most of the existing critiques remain within the cost-benefit framework, they fail to definitively disprove the pro-business judgment rule arguments. In this section, I apply the CLS claim that cost-benefit analysis is indeterminate to the three common arguments for the business judgment rule. My goal is to illustrate that the pro-business judgment rule arguments actually fail to justify the rule. Because of the indeterminacy of cost-benefit analysis, one analyst could conclude that the business judgment rule’s benefits exceed its costs, while another analyst could just as readily conclude that its costs exceed its benefits.

A. Identifying and Valuing the Externalities of Director Risk-Taking and Inadequate Director Care

The first step of cost-benefit analysis is to identify all of the costs and benefits associated with the activity in question, including all of its physical, psychic, moral, and aesthetic externalities. It is widely recognized in the corporate law literature that director risk-taking and carelessness can impose externalities on parties outside of the corporate entity.\textsuperscript{200} Today, “[p]ublicly traded corporations are the core of our economy, essential building blocks of our society, and centers of our individual and collective lives.”\textsuperscript{201} Many of the world’s largest economies are corporations, not countries.\textsuperscript{202} Therefore, when a company collapses or a major project fails, shareholders are not the only ones who suffer.\textsuperscript{203} Most immediately, “employees lose their jobs and pensions.”\textsuperscript{204} However, the harms radiate outwards


\textsuperscript{201} Greenwood, Enronitis, supra note 7, at 780.

\textsuperscript{202} See GILLESPIE & ZWEIG, supra note 3, at 18 (“Of the world’s two hundred largest economies, more than half are corporations.”).

\textsuperscript{203} Greenwood, Enronitis, supra note 7, at 781. But see Easterbrook & Fischel, supra note 13, at 1421 (arguing that managers have market incentives to “make the choices investors prefer” and such “choices do not generally impose costs on strangers,” so “what is optimal for the firms and investors is optimal for society”).

\textsuperscript{204} Greenwood, Enronitis, supra note 7, at 781.
from there to “[c]ommunities that have conferred benefits on firms,”205 and “customers and suppliers [who] must struggle to pick up the pieces in disrupted markets.”206 The most recent financial collapse provided countless examples of such costs.207 Widespread director carelessness and excessive director risk-taking were significant factors contributing to “ordinary people losing their retirement savings, their jobs, their homes, or even just the bank or factory or car dealership in their towns,” not to mention “the trillions of taxpayers’ dollars spent to prop up some of the companies,” and “the legacy of debt we’re leaving for the next generation.”208 While some have argued that these groups can take steps to protect themselves by contract,209 many others argue that they cannot due to numerous impediments to bargaining.210 Therefore, the costs externalized to these third parties are probably not reflected in the incentives that directors feel when they decide whether to engage in high-risk behavior or to carefully consider their decisions.211


206 Greenwood, Enronitis, supra note 7, at 781.

207 See GILLESPIE & ZWEIG, supra note 3, at 62 (“It is astonishing how far you can be from the boardrooms of companies that triggered the economic meltdown and still find victims who suffered devastating losses.”).


209 See Jonathan R. Macey, Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes, 1989 DUKE L.J. 173, 191–93. On one hand, Macey acknowledges that externalities exist. Id. at 174. On the other hand, he argues that employees protect themselves by forming unions, and communities, customers, and suppliers can protect themselves by contracting. Id. at 191–93. These two propositions are, at best, in tension. If an externality is a cost associated with directors’ actions, but not reflected in their incentives due to impediments to bargaining, then by definition the parties on whom the externalized cost falls could not have protected themselves by contracting.

210 See, e.g., Barnali Choudhury, Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm, 11 U. PA. J. BUS. L. 631, 650 (2009) (arguing that “both contract and regulation contain gaps, which can expose non-shareholder constituents to significant risks to their welfare,” and which can “actually reduce social welfare” overall); Leung, supra note 205, at 594 (arguing that, due to transaction costs and informational disparities, important stakeholders, such as employees and communities, often “lack the benefit of explicit contracts or collective bargaining” and “need other means to protect their interests”).

211 See Kennedy, Cost-Benefit Analysis, supra note 21, at 398 (defining an externality as a “cost, associated with an activity, which is not reflected in the activity’s price because transaction costs prevent those on whom the loss falls from making a contract with whoever might prevent it”).
On top of these tangible costs, major corporate failures can impose a variety of intangible costs on third parties, which must also be considered in the cost-benefit calculation. First, corporate failures can lead to “investor mistrust.”212 A serious “crisis of confidence among investors” can harm many other companies “as capital is diverted away from American corporate debt and equity markets.”213 Second, they can impose not only financial costs, but also psychological costs on people who lose their jobs or homes, and even on people who see friends or family members lose their jobs or homes.214 The existence of such psychological externalities has been recognized in the government takings and contract law literature.215 In the takings context, Frank Michelman argues that a cost-benefit analysis of takings should consider not only efficiency gains and administrative costs, but “[d]emoralization costs” as well.216 Demoralization costs are the “disutilities which accrue to losers and their sympathizers specifically from the realization that no compensation is offered,” and the “value of lost future production (reflecting either impaired incentives or social unrest) caused by demoralization of uncompensated losers, their sympathizers, and other observers disturbed by the thought that they themselves may be subjected to similar treatment on some other occasion.”217 In other words, uncompensated takings of property impose psychological harm not only on individuals who lose their property, but also on friends and family members who sympathize with the losers, and even on other property owners who realize they might be next.

Similarly, in the contract law context, Leonard Jaffee argues that a cost-benefit analysis of contractual breaches should take demoralization into account.218 Typically, proponents of law and economics argue that expectation damages are the efficient remedy for breach of contract.219 They optimally set incentives because a party will breach only when the benefits of breaching (the profits from the new endeavor) outweigh the costs of breaching (the

212 GILLESPIE & ZWEIG, supra note 3, at 17.
213 Id.
215 Id.
216 Id.
217 Id.
219 Id. at 784.
frustrated expectations of the other party). Jaffee criticizes this argument on the grounds that it ignores externalities—demoralization costs in particular.\footnote{Id.} Expectation damages might compensate the victim for the financial value of “the opportunity she had before the breach,” but they ignore the victim’s feeling that the breacher effected “a wilful, capricious conversion of the opportunity of her enterprise” and that “cash instead of that opportunity ought to be her choice.”\footnote{Id. at 796.} Applying the concept of demoralization costs to the recent financial meltdown, certainly the millions who lost their jobs and their homes suffered significant psychological harms as well as financial harms.\footnote{See Michelman, supra note 214, at 1214 (including the sympathy felt by bystanders and the fear felt by other property owners in the cost-benefit calculation for government takings).} Additionally, those who fortunately did not lose their jobs or homes felt sympathy for those who did, and lost the sense of economic security that predominated before the financial meltdown.\footnote{Id.} These psychological harms should be taken into account in any cost-benefit analysis of the legal rules affecting the degree of risk that directors decide to undertake, or the level of care that directors use in making decisions.

The second step of cost-benefit analysis is assigning numeric values to the various costs and benefits using hypothetical offer prices or asking prices. Again, nothing within cost-benefit analysis logically determines which price the analyst should use.\footnote{See Kennedy, Cost-Benefit Analysis, supra note 21, at 417.} Instead, the choice depends on political considerations external to the cost-benefit analysis.\footnote{See id. at 418–19 (providing reliance interests and equitable considerations as examples of values external to cost-benefit analysis that might weigh in one direction or the other).} Indeed, in some cases, “there might be good reasons for using . . . asking price” rather than offer price to assign values to externalities.\footnote{Id. at 418.} For instance, we might “feel that . . . third parties are entitled not to have to live in a society where wife beating occurs, and so choose to value their outrage at their asking prices when the question is whether the wife should have a cause of action.”\footnote{Id.} Therefore, an analyst could value the externalities associated with director risk-taking at the hypothetical asking price of the third parties on whom those externalities fall. To do so, the

\footnotesize{\begin{itemize}
\item \footnote{Id.}
\item \footnote{Id.}
\item \footnote{Id. at 796.}
\item \footnote{See Michelman, supra note 214, at 1214 (including the sympathy felt by bystanders and the fear felt by other property owners in the cost-benefit calculation for government takings).}
\item \footnote{Id.}
\item \footnote{See Kennedy, Cost-Benefit Analysis, supra note 21, at 417.}
\item \footnote{See id. at 418–19 (providing reliance interests and equitable considerations as examples of values external to cost-benefit analysis that might weigh in one direction or the other).}
\item \footnote{Id. at 418.}
\item \footnote{Id.}
\end{itemize}}

analyst would hypothesize that the millions of people who lost their jobs or their homes were legally entitled to keep them, and then estimate the price that those people would demand to part with this entitlement. Similarly, the analyst would estimate the price that the countless psychologically demoralized bystanders—those who watched as family and friends lost their jobs or their homes—would demand to part with a legal entitlement to not feel demoralized. Due to the analyst’s choice to use asking price, the externalities of director risk-taking would be assigned tremendous value, and the costs of director risk-taking would appear to dwarf the benefits.

Alternatively, an analyst could value the externalities of director risk-taking at the victims’ offer price. To do so, the analyst would accept, as given, the baseline allocation of legal entitlements under which the victims have no right to limit director risk-taking. The analyst would then estimate the price that, for example, demoralized bystanders would be willing to pay to obtain a legal entitlement to not feel demoralized—a vastly lower price than they would demand to give up such an entitlement if they had it to begin with. So, due to the analyst’s choice to use offer price, the value assigned to the demoralization externalities would shrink to little or nothing, and the benefits of director risk-taking would be more likely to exceed the costs as a result. In sum, due to the indeterminacy of cost-benefit analysis, the benefits of deterring director risk-taking can appear to outweigh the costs or vice versa, depending on choices made by the analyst in performing the cost-benefit calculation.


While the problem of externalities is widely recognized in the corporate law literature, there is little agreement regarding its implications. On one hand, some scholars use externalities to defend the business judgment rule or to argue for the expansion of board discretion even further. On the other hand, other scholars use externalities to argue for a variety of radical reforms to the structure of corporate law. A review and assessment of the

228 See Bratton & Wachter, supra note 99, at 659–60.
229 See Choudhury, supra note 210, at 673.
various radical reforms proposed in the literature is beyond the scope of this article. However, my analysis does reveal a problem with using externalities to defend the business judgment rule or to argue for further expanding director discretion. In particular, it shows that, if the externalities associated with director risk-taking and carelessness are assigned tremendous value, then cost-benefit analysis can lead to the conclusion that the business judgment rule is inefficient. In this section, I will first describe the arguments of some of the scholars who use externalities to defend the business judgment rule. I will then explain why the problem of externalities can actually cut against the business judgment rule.

Some of those corporate law scholars who acknowledge the externalities problem use it to defend the business judgment rule or even to argue for further expanding director discretion. For example, William Bratton and Michael Wachter use externalities to provide a general defense of the existing legal regime, including the business judgment rule, against reform efforts aimed at increasing shareholder empowerment.\footnote{Bratton & Wachter, supra note 99, at 658–59.} They argue that shareholder empowerment contributed significantly to the recent financial meltdown because it led directors at major financial institutions to engage in excessive risk-taking.\footnote{Id.} Shareholder empowerment directs corporate managers to “manage to maximize the market price of the stock” of the company.\footnote{Id.} However, for various reasons market price does not always capture the risk to which the enterprise is exposed.\footnote{See id. at 707.} A primary reason is that market price has a “speculative component” which represents the potential that the owner will be able to sell the stock to a “more optimistic investor.”\footnote{Id.} Under the right circumstances,\footnote{Id. (describing such circumstances as “when there is a change in technology, when glamour companies emerge, or when companies running newer businesses with less established track records become an important part of the market”).} the speculative component of market price can “cause[ ] prices to diverge from fundamental value,” resulting in pricing “bubbles.”\footnote{Id.} During such bubbles, if
managers are directed to manage to the market, they will feel pressure to approve transactions that yield “a speculative price enhancement for the company stock,” even if “they perceive little fundamental value and predict an eventual bust.”

In other words, managers will take excessively high risk actions to drive up stock price because the price does not “factor in concomitant increases in risk.” Because shareholder empowerment can lead to risk externalization in this manner, Bratton and Wachter argue in favor of “[t]he prevailing legal structure of the corporation,” which “has always privileged the directors and their appointed managers in business policymaking because they are better informed than the shareholders and thus better positioned to take responsibility for both monitoring and managing the firm and its externalities.”

Similarly, Barnali Choudhury uses externalities to argue that directors should be liberated from the strict profit maximization norm. He observes that “[p]rofit maximization activities, pursued by corporate managers because they are not prohibited by law, can . . . result in the infliction of serious harm to non-shareholder constituents, such that the acts actually reduce social welfare.” Furthermore, “not all affected stakeholders possess sufficient economic power to compel corporations to internalize social costs.” Therefore, we should free directors to “elect to prevent harm to others over goals of profit maximization.” One way to expand directors’ discretion is by “[i]ncorporating the interests of stakeholders and shareholders alike within the best interests of the corporation, and consequently within the purview of the business judgment rule.”

In sum, Choudhury uses externalities to argue for significantly expanding director discretion. Directors should be free to take any act that “responds to market views of corporate responsibility obligations” or “conforms to the basic rules of the society,” such as “ethical custom” or “international norms.”

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238 Id. at 711.
239 Id. at 659.
240 Id.
242 Choudhury, supra note 210, at 650.
243 Id. at 654.
244 Id.
245 Id. at 657.
246 Id. at 666.
247 Id. at 668. See also Greenfield & Nilsson, supra note 147, at 812, 817, 834–35, 848.
The problem with these arguments is they do not go far enough. They see how externalities can be used to argue against shareholder empowerment or the strict profit maximization norm. However, they ignore the role that the business judgment rule plays in promoting shareholders’ interests or profit maximization at the expense of third parties.248

As discussed in Part III, three of the arguments commonly provided for the business judgment rule are that (1) if directors’ liability risk were increased, directors would be overly deterred from taking entrepreneurial risks;249 (2) if directors’ liability risk were increased, current directors and director candidates would be overly deterred from serving as directors;250 and (3) market mechanisms, namely the market for capital and the market for corporate control, already provide sufficient incentives for directors to exercise care.251 Essentially, all of these arguments purport to show that the business judgment rule is efficient because increasing directors’ liability risk would impose significant costs on shareholders. Shareholder wealth would be reduced if directors were sensitive to diversifiable risk and were therefore deterred from undertaking high risk projects that diversified shareholders would find desirable. Forcing shareholders to compensate directors with cash, rather than liability protection, would be expensive for shareholders because shareholders are efficient risk-bearers and therefore would prefer to compensate using liability protection. Interfering with the bargains struck by directors and shareholders in the free market, including the corporate governance provisions of a corporate charter, would reduce the price of shareholders’ stocks.

However, as discussed in Part V(A), director risk-taking also externalizes costs to third parties. When a corporation goes under, or a major project fails, employees, communities, consumers, suppliers, and even taxpayers suffer tangible financial costs. Also,

(rejecting utilitarian reasoning, which focuses solely on wealth maximization, as irrational and contrary to human experience, and approving the business judgment rule on the grounds that it gives directors room to consider values other than wealth maximization, and arguing that director discretion should be expanded even further).

248 See Greenwood, Enronitis, supra note 7, at 840–41 (arguing that, “shifting power from the market to managers or boards they effectively dominate” will simply enable managers and directors to “steal more freely”); Leung, supra note 205, at 622–23 (arguing that, “[i]f the power to consider stakeholder interests is left to the discretion of directors, this discretion may never be used,” because directors “owe their positions to shareholders, not stakeholders, and will therefore act to benefit the former”).

249 See, e.g., Allen, Jacobs & Strine, supra note 11, at 454–55.

250 Id. at 455.

251 See, e.g., Easterbrook & Fischel, supra note 13, at 1420.
third parties may feel a variety of intangible psychological costs, such as the demoralization felt by people who lose their jobs and homes, and the people who sympathize with them. The value assigned to these externalities would be tremendous if the analyst performing the cost-benefit calculation used the asking price of the victims on whom these externalities fall. Therefore, cost-benefit analysis can yield the conclusion that the business judgment rule is inefficient. An analyst could conclude that the externalities associated with a high degree of director risk-taking, or careless decision-making, exceed the benefits to shareholders of shielding directors from liability. So, the business judgment rule reduces costs to shareholders at the expense of imposing substantially greater costs on multitudes of third parties.

If this conclusion were accepted, then the legal regime should be altered so that outcomes “correspond to the one[s] that bargaining would have produced,”\textsuperscript{252} namely an increase in directors’ liability risk for taking excessive risks or failing to carefully consider their decisions. Increasing directors’ liability risk might deter directors from taking risks that diversified shareholders would find desirable. However, it would simultaneously deter directors from taking risks that numerous third parties—everyone from the corporation’s employees to far-flung demoralized bystanders—would find undesirable.\textsuperscript{253} Shareholders might be required to pay additional cash to directors to offset their increased liability risk, but imposing this cost on shareholders amounts to requiring “the corporate governance system” to internalize the costs of its own activities.\textsuperscript{254} The market for capital, and the market for corporate control, might constrain directors’ discretion by driving them to maximize share price. However, as Bratton and Wachter argue, exposing directors to market pressures can drive directors to engage in excessive risk-taking when, due to circumstances, stock prices do not fully reflect the firm’s risk.\textsuperscript{255} More generally, leaving directors exposed to market pressures ensures that directors will fail to take into account the externalities associated with corporate actions. Directors “have only limited ability to unilaterally reject the

\textsuperscript{252} Kennedy, \textit{Cost-Benefit Analysis}, supra note 21, at 397.

\textsuperscript{253} See Leung, \textit{supra} note 205, at 599 (arguing that “shareholder wealth may be an inaccurate proxy for efficiency” due to externalities, and therefore “maximizing shareholder wealth is not necessarily efficient”).

\textsuperscript{254} See Fairfax, \textit{supra} note 7, at 451 (arguing that “we must look towards legal sanctions when the alternatives prove ineffective,” and if “the corporate governance system must rely on legal sanctions” then it “must bear the cost associated with those sanctions”).

demands of the share value centered model before the market, as currently regulated, will oust them.” Finally, increasing directors’ liability risk might amount to interference with the corporate contract into which shareholders and directors have freely entered, which might reduce stock price. However, “[i]n the presence of externalities, the privately agreed upon terms” of the corporate contract “might be socially inefficient as the contracting parties would not take into account the effect on third parties.” Therefore, “mandatory terms”—such as prohibiting shareholders from shielding directors from liability for breaching the duty of care—“might consequently move us closer to social optimality.”

In response, a proponent of the business judgment rule might argue that the rule shields directors from liability in a shareholder derivative suit, and the derivative suit is a mechanism for holding directors accountable to shareholders. Therefore, reducing the protections of the business judgment rule will only serve to increase shareholder empowerment, which will exacerbate the problem of externalities. However, this argument directly conflicts with the conventional wisdom that increasing directors’ liability risk will make directors more risk averse, not less. The likely effect of increasing directors’ liability risk is that directors will be more cautious, and more caution is precisely what the opponents of shareholder empowerment want. Moving from the waste test, which is used to review the substance of directors’ decisions, to a tougher standard of review would cause directors to be substantively more risk averse. Moving from the gross negligence standard of review to the business judgment rule would...

257 Lucian Arye Bebchuk, “The Debate on Contractual Freedom in Corporate Law,” 89 *Columbia L. Rev.* 1395, 1405 (1989); see also Bolodeoku, supra note 200, at 474 (“The characterization of the corporation as a mere nexus of contracts, with its normative sermon that corporate law should comprise the rules agreed to by contracting parties, suppresses many crucial issues relating to the . . . externalities associated with management . . ..”).
258 Bebchuk, supra note 257, at 1405.
259 See Dooley, supra note 27, at 470 (arguing that “the business judgment rule can only be understood as intended to protect the authority of the board,” and “affording shareholders the right to demand frequent judicial review of board decisions has the effect of transferring decision-making authority from the board to the shareholders”).
260 See Bratton & Wachter, supra note 99, at 658–59 (arguing that shareholder empowerment leads managers to manage to maximize market price, resulting in excessive risk-taking under certain circumstances).
261 See Fairfax, supra note 7, at 433 (“[L]egal penalties in the form of financial sanctions or incarceration are a powerful form of deterrence because they make the costs of illegal behavior outweigh the benefits.”).
262 See Bratton & Wachter, supra note 99, at 659 (explaining that excessive risk-taking on the part of management was a major cause of the recent meltdown).
263 See Letsou, supra note 32, at 205 (arguing that increasing directors’ liability risk would...
test, which is used to review directors’ decision-making procedures, to a tougher standard of review would cause directors to invest in more elaborate decision-making procedures.264 This analysis suggests that the mechanisms for achieving director accountability should not be lumped into one category. Instead, it makes more sense to differentiate between them based on their effects. Some mechanisms, such as using stock options to link director compensation to market performance, will increase director risk-taking.265 Other mechanisms, like ex post review of directors’ decisions in a shareholder derivative suit, will have precisely the opposite effect.

VII. CONCLUSION AND POSSIBLE EXTENSIONS

In sum, three of the policy arguments commonly provided for the business judgment rule are cost-benefit arguments. They purport to show that the business judgment rule is efficient because increasing directors’ risk of liability for breaching the duty of care would impose significant costs on shareholders. However, given the magnitude of the recent financial meltdown, one wonders whether the arguments commonly provided for the business judgment rule really show that the rule is efficient. Many of the existing critiques of the business judgment rule attack the rule on cost-benefit grounds. They suggest that the outcome of the cost-benefit analysis is not so clear because the benefits of increasing directors’ liability risk might be much greater than previously thought. While such critiques can serve as counterweights to the arguments for the business judgment rule, they do not definitively show that the pro-business judgment rule arguments fail to justify the rule. To do that, a critique based in cost-benefit analysis would have to identify, quantify, and add up all of the costs and benefits associated with the business judgment rule. Putting aside the problem of the cost-benefit analysis’s indeterminacy for a moment, performing such a calculation is, at the very least, an empirical problem of tremendous difficulty.

deter them from undertaking high risk projects that diversified shareholders would find desirable).

264 See Fraidin, supra note 26, at 72–73 (arguing that judicial review of directors’ decision-making procedures would cause directors to invest in more elaborate procedures, which would be beneficial if courts based their test for good procedures on social science research); Stout, supra note 14, at 678 (arguing that increasing judicial review of directors’ decision-making procedures would cause directors to question management and inform themselves more).

However, to the extent that the pro-business judgment rule arguments use a cost-benefit framework, they are susceptible to critiques that reject cost-benefit analysis altogether. Critical legal scholars have developed a collection of such critiques, including the argument that cost-benefit analysis is indeterminate. In this article, I have attempted to use the argument that cost-benefit analysis is indeterminate to show that cost-benefit analysis can lead to the conclusion that the business judgment rule is inefficient, just as readily as it can lead to the conclusion that it is efficient. In addition to the numerous tangible, financial externalities associated with a high degree of director risk-taking or careless decision-making, one can identify many intangible, psychological externalities. If those externalities are valued using the victims’ asking price, the business judgment rule no longer appears justified on cost-benefit grounds. Therefore, the arguments commonly made for the business judgment rule actually fail to justify the rule.

In the future, this line of critique could be extended to other corporate law doctrines, many of which are also typically defended on cost-benefit grounds. Limited shareholder liability is an obvious potential target. Economic efficiency-based arguments are often made on behalf of limited shareholder liability,266 and yet it is also widely recognized that limited shareholder liability enables corporations to externalize costs to third parties.267 Additionally, other lines of critique developed by critical legal scholars could be applied to arguments in corporate law. For example, Duncan Kennedy also criticized law and economics on the grounds that its conclusions rest “on assumptions about facts in the world, which law-and-economics scholars rarely examine[] in sufficient detail to justify their claims.”268 Kennedy used this argument to rebut the “standard economic critique” of implied warranties of habitability, namely “that they are ineffective in protecting low-income renters against inadequate housing, because landlords will simply raise the rent.”269 In a way, the argument that landlords will simply raise the rent is similar to the pro-business judgment rule argument that directors will simply pass along the costs of increased liability risk

267 Bolodeoku, supra note 200, at 474 (“[L]imited liability externalizes the risk of failure, essentially requiring that persons other than the residual claimants . . . underwrite the risk.”).
269 Id. at 110.
to shareholders. In fact, the ability and willingness of directors to pass costs along to shareholders might vary significantly from firm to firm, and an empirical investigation has not yet been conducted.\textsuperscript{270}

Not too long ago, Douglas Branson observed that “realism and indeterminacy have yet to touch corporate law.”\textsuperscript{271} Today, the field of corporate law still seems to be full of possibilities for anyone interested in making the critical arguments.

\textsuperscript{270} See Fairfax, \textit{supra} note 7, at 452.

\textsuperscript{271} Branson, \textit{supra} note 25, at 87.