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at the Century's Turn**

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BERLE AND MEANS RECONSIDERED AT THE CENTURY'S TURN

William W. Bratton*

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INTRODUCTION

Adolf Berle and Gardiner Means' *The Modern Corporation and Private Property*¹ still speaks in an active voice. Since it first appeared in 1932, corporate law has been reckoning with its description of a problem of management responsibility stemming from a separation of ownership and control. This history has two phases. During the first phase, which lasted for 50 years, the book, and particularly its recommendation of stepped up fiduciary constraints, became the basis of a paradigm that dominated the field. The second phase began in the early 1980s, when the book lost its paradigmatic position along with the general collapse of confidence in regulatory solutions to economic problems. A body of hostile criticism also had an effect.² Some claimed that events had superseded the book's salience.³ Others asserted it to be wrong on the facts.⁴ Yet today, despite diminished status and generations of criticism, *The Modern Corporation and Private Property* has not gone away. At the end of the second phase's second decade, Berle and Means retain an enviable place at the forefront of policy discussion in a field where even a highly successful academic contribution rarely has a shelf life exceeding ten years.

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¹ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (rev. ed. 1991).

²It was memorialized by a 261 page obituary published in *The Journal of Law and Economics* in the guise of a fiftieth anniversary symposium. See *Corporations and Private Property: A Conference Sponsored by The Hoover Institution*, 26 J. L. & ECON. 235-496 (1983).

³Walter Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L.REV. 388 (1977).

⁴See Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983). See also George J. Stigler and Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J. L. & ECON. 237 (1983)(describing the economics' professions' reception of the book as uncritical and noting that the thesis was not original); Henry G. Manne, *The "Higher" Criticism of the Modern Corporation*, 62 COLUM. L. REV.399, 399-407 (1962)(thirtieth anniversary commentary purporting to falsify central assertions).

The database confirms their continued presence.⁵ Westlaw's "JLR" index shows citations of *The Modern Corporation and Private Property* in 631 articles through the end of 1999, 42 of those articles published in 1999 itself.⁶ The 1999 figure compares instructively with those of the two leading corporate law volumes published in the 1990s, Frank Easterbrook and Daniel Fischel's *The Economic Structure of Corporate Law*⁷ and Mark Roe's *Strong Managers, Weak Owners*.⁸ Berle and Means firmly hold their ground against the newcomers: Easterbrook and Fischel's book was cited in 62 articles in 1999; Roe's in 21.

They do better still against their contemporaries. During the 1920s and 1930s, John Dewey and William O. Douglas also joined in reconstructing corporate legal theory. Dewey came first with an essay, *The Historic Background of Corporate Legal Personality*,⁹ offering a definitive critique of a set inherited concepts about the firm. Douglas and Berle followed, taking similar paths. Douglas' academic work on bankruptcy at the Columbia and Yale Law Schools led to Washington appointments and the rare chance to turn an academic policy construct into real world law reform. *The Modern Corporation and Private Property* likewise influenced New Deal legislation.¹⁰ Berle, moreover, was a member of the "Brain Trust" that advised Roosevelt during the 1932 presidential campaign and an occasional advisor in Washington thereafter.¹¹ But the two career paths diverged over time, with Douglas becoming a Supreme Court justice and Berle remaining a professor. Yet, at least in the area of business law, Berle's voice remains stronger today. Douglas and Dewey tend to speak to us in the context of historical inquiry, where Berle and Means

⁵Albeit crudely. For discussion of the inherent shortcomings of bald comparative citation counts such as those in the text, see Ian Ayres & Frederick E. Vars, *Determinants of Citations to Articles in Elite Law Reviews*, Yale Law School Program in Studies in Law, Economics, and Public Policy, Working Paper #234 (1999).

⁶The search request is "Berle w/10 'Modern Corporation and Private.'"

⁷FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

⁸MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994)

⁹John Dewey, *The Historic Background of Corporate Legal Personality*, 35 *YALE L.J.* 655 (1926).

¹⁰*The Modern Corporation and Private Property* is credited with having laid the foundation for the federal securities laws. JORDAN A. SCHWARZ, *LIBERAL: ADOLF A. BERLE AND THE VISION OF AN AMERICAN ERA* 61 (1987).

¹¹But he nonetheless remained in residence at Columbia Law School during the New Deal. When he finally took a Washington job in 1938 it was at the State Department. *Id.* at 114-121.

show up in discussions of present problems. The citation numbers again provide confirmation. Where *The Modern Corporation and Private Property* shows up in 631 articles, Dewey's essay has been cited in a much smaller (but respectable) total of 52 articles.¹² Douglas runs a poor third. His collaboration with Jerome Frank on the absolute priority rule shows up in only three articles in the Westlaw database;¹³ his empirical work on small bankruptcies¹⁴ is mentioned in seven.¹⁵ He is better remembered for making new bankruptcy law some years later as a Supreme Court Justice. His *Case v. Los Angeles Lumber*¹⁶ shows up in 324 articles¹⁷--foundational no doubt, but not so much so as *The Modern Corporation and Private Property*, which of course never had the benefit of the status of positive law.

The Modern Corporation and Private Property's endurance is a singular event in the last century of academic corporate law. This essay seeks to explain this longevity. In so doing it first looks at the book in the context of its time, comparing the contemporary contributions of Dewey and Douglas. It goes on to reconsider the book in the context of contemporary corporate legal theory. Both exercises break with the tradition of cataloging the things the book got wrong. After the turn of the century, the interesting question is what Berle and Means got *right*.

The answer to the question respecting the book's longevity reverses usual expectations concerning elements of scholarly success. We tend to look for real world consequences, equating success with changes in positive law. But *The Modern Corporation and Private Property*'s academic survival does not result from its influence on New Deal legislation. Indeed, the book's prescription for remedying the

¹²The search request is "Dewey w/8 'Corporate Legal.'" Notably, only two of those citations occurred before 1985, the year in which Dewey's essay received renewed attention in Morton Horowitz's famous discussion early twentieth century corporate legal theory. See Morton J. Horowitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W.VA.L.REV. 173, 176, 224 (1985). Berle and Means, in contrast, show up in 103 pieces dated 1985 and earlier.

¹³William O. Douglas & Jerome Frank, *Landlord's Claims in Reorganizations*, 42 YALE L.J. 1003 (1933).

¹⁴William O. Douglas & Dorothy S. Thomas, *The Business Failures Project--II: An Analysis of Methods of Investigation*, 40 YALE L.J. 1034 (1931); William Clark, William O. Douglas & Dorothy S. Thomas, *The Business Failures Project--A Problem in Methodology*, 39 YALE L.J. 1013 (1930).

¹⁵The search request is "Douglas w/10 'Business Failure.'" But only one of the seven is in an article on bankruptcy; the others are in jurisprudential and historical essays.

¹⁶308 U.S. 106 (1939).

¹⁷The search request is "Case w/8 'Los Angeles Lumber.'"

problem of separation of ownership and control--a step up in the intensity and scope of fiduciary duties--must be characterized as a policy relic.¹⁸ Berle and Means survive, *despite* their prescription, because they correctly diagnosed a persistent condition. Their book's continued vitality results from its identification and discussion of problems left untreated then and later. Leading corporate governance discussions still implicate the separation of ownership and control because, as Berle and Means asserted, the separation implies shortfalls of competence and responsibility. Their association with these problems seems permanent and the problems themselves never seem to go away. It follows that we can predict a continuing presence for *The Modern Corporation and Private Property*, both normative and descriptive, in the twenty-first century.

Part I places Berle and Means in the context of the legal theory of its day by comparing work of Dewey on the theory of the firm and Douglas on corporate reorganization. This discussion highlights two progressive assumptions Berle and Means shared with these business law contemporaries--a confidence in the efficacy of judicial intervention to vindicate distributive policies and a distrust of the institution of contract. These assumptions would in the long run cause the book's prescription to land wide of the mark. After 1980, Berle and Means lost their paradigmatic status due to a combination of scepticism respecting judicial competence (and a concomitant retreat to process scrutiny) and renewed faith in the institution of contract. Significantly, by 1980 the same emerging perspectives already had played a role in the Congress' abandonment of Douglas' corporate reorganization scheme.

Part II reconsiders *The Modern Corporation and Private Property* in the context of contemporary corporate legal theory. It begins, in Section A, with a look at the book as an early example of corporate law and economics. The book's pro-regulatory posture reverses contemporary expectations about interdisciplinary influence, under which economics means deregulation. The alignment of methodology and policy prevailing in the 1930s was very different from that today and the book reflected that alignment. Section B takes up the separation of ownership and control, showing that the book's description of the problem synchronizes neatly with contemporary views on corporate governance. It turns out that even the latest microeconomic theory of the firm coexists in consonance with Berle and Means. Section C turns to the solution the book recommends for the problem of separated ownership and control, a judicially-enforced norm of trust. Here Berle and Means have become history, eclipsed in business law

¹⁸Strong fiduciary controls still have proponents, but this it is now distinctly a minority point of view. Its present manifestations do not necessarily retain close ties to Berle and Means. Fiduciary constraint may be commended for ethical reasons, see Lawrence E. Mitchell, *Contract. Trust. Process.*, in PROGRESSIVE CORPORATE LAW 185 (Lawrence E. Mitchell, ed., 1995). It may be commended for efficiency reasons. See Eric Talley, *Turning Servile Opportunities into Gold: A Strategic Analysis of Corporate Opportunities Doctrine*, 108 YALE L.J. 277 (1998); William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty*, in PROGRESSIVE CORPORATE LAW, *passim* 139, 144-46. But no one commends it as the means to end of bridging the separation of ownership and control.

along with many other progressive policy positions. But the book hedges its presentation carefully enough to retain a measure of plausibility in a contemporary reader's eyes. Nor should Berle and Means have foreseen a critical subsequent change in the context of corporate lawmaking. The Delaware courts have been the primary agents of the book's prescriptive failure. They did not assume an obstructive position until *Erie Railroad Co. v. Tompkins*¹⁹ took the federal courts out of corporate fiduciary lawmaking a few years after the book was published.

This essay's reconsideration of Berle and Means together with Dewey and Douglas invites characterization as an evaluation of the business law legacy of the legal realist movement of the 1920s and 1930s. But this invitation can be accepted, if at all, with utmost caution. These writers' contributions do not constitute a core "realist legacy" in corporate law to which reference meaningfully may be made. Of the three, only Douglas defined himself as a legal realist and self-consciously pursued the realist scholarly program.²⁰ Certain identifiably "realist" assumptions and methodologies do play a role in the history of his bankruptcy reform. But the history supports no general pronouncements about realist success or failure, realist influence or marginalization. Douglas' construct went down in the 1970s more because it manifested early-twentieth century progressive thinking than because academic realism figured in its creation. Meanwhile, the realist status of Berle and Means has been a point of contention among legal historians. Some casually include them with the realists; others demur.²¹ *The Modern Corporation and Private Property* anticipates this confusion. Even as it shows realist influence, it reflects the legal formalism of the Harvard Law School Berle attended. Its prescriptions, like those of Douglas, are best described as products of the progressive mindset.

Even as caution prevails respecting "realist" characterizations, one manifestly realist theme does emerge in this account of the survival of *The Modern Corporation and Private Property*. The comparison to Dewey helps us isolate it. Dewey was not a lawyer and so cannot plausibly be called a legal realist. Yet, *The Historic Background of Corporate Legal Personality*, his one corporate law intervention, established a realist point in the field—that what counts in the articulation of corporate law

¹⁹304 U.S. 64 (1938).

²⁰Douglas was a member of the small group of law professors who pursued "scientific" study of law in action. Berle joined the Columbia faculty just as those scientists were leaving Columbia for other appointments. Dewey, of course, was not a law teacher at all. See WILLIAM TWINING, KARL LLEWELLYN AND THE REALIST MOVEMENT 8, 56-67 (1973)

²¹Under the narrower usage, Berle is not termed be termed a realist because he was not associated with a core group of contemporary legal academics whose scholarship centered on empirical studies (and which included Douglas). See JOHN HENRY SCHLEGEL, AMERICAN LEGAL REALISM AND EMPIRICAL SOCIAL SCIENCE 6-12 (1995). For a broader usage that easily encompass Berle, see, e.g., RONEN SHAMIR, MANAGING LEGAL UNCERTAINTY: ELITE LAWYERS AND THE NEW DEAL 134-37 (1995).

policy is the firm's economic and social reality rather than the formal integrity of an academic theory of the firm, whether legal or economic. That point has stuck. Academic corporate law's continuing fidelity to it supports a claim of continued realist influence. Berle and Means' fidelity to it has meant a long shelf life for their book.

I. DEWEY AND DOUGLAS: SUCCESS IN THEORY, FAILURE IN PRACTICE

Business law was not the primary career path for either John Dewey or William O. Douglas. Even so, both are remembered with Berle for contributions to the field: Dewey to the theory of associations, Douglas to corporate reorganization, and Berle to corporate governance. The business law writings of each show what we take today to be the traits of realist scholarship, variously attacking the conceptualism of formalist legal reasoning, pursuing greater fact sensitivity, and encouraging (and paying) attention to social circumstances.²² The work of Douglas and Berle also advances the common cause of investor protection through regulation. But where *The Modern Corporation and Private Property* retains policy import, the work of Dewey and Douglas now resides in history books.

A. John Dewey and the Theory of the Firm

No negative inferences should be drawn from the consignment of John Dewey's *The Historic Background of Corporate Legal Personality* to historical status. Dewey's essay is history because it made history, accomplishing everything it set out to do. It claimed no direct policy import, addressing only the metatheory of associations. But it made its metatheoretical point so clearly and irrefutably that it permanently affected the way lawyers think about firms. Few since have dared to reassert the theories it rejected and criticized.²³ One strains to think of a contemporary theoretical intervention that will enter the history of American jurisprudence similarly situated.

Since Dewey was neither a lawyer nor a legal academic, he technically was not a "legal realist." Even so, along with other philosophical pragmatists of his day he contributed to the antiformalist milieu in American social thought on which legal realism drew heavily.²⁴ In this one essay in the *Yale Law Journal* Dewey went a step farther, crossing the disciplinary line to make a legal contribution in the realist mode. He addressed a series of philosophical and legal debates, descended directly from ancient and medieval texts, on the question whether associations are in essence "artificial" or "natural." He claimed a

²²See Brian Bix, *Positively Postivism*, 85 VA. L.REV. 889, 894 (1999)(reviewing ANTHONY A. SEBOK, *LEGAL POSTIVISM IN AMERICAN JURISPRUDENCE* (1998)).

²³The names of this naive and undereducated few are better left undisclosed.

²⁴For a discussion that illustrate the distinction between realism and antiformalism, see LAURA KALMAN, *LEGAL REALISM AT YALE, 1927-1960*, 49-54 (1986)(reviewing antiformalism at the Harvard Law School, personified in academics like Frankfurter, Landis, and Powell).

consequentialist justification for his intervention. The whole line of inquiry, he said, was causing perverse effects in legal practice. Philosophical ideas and dogma had found their way into law with obstructive results.²⁵ Dewey administered a strong dose of realist critique. The discussants, he said, wrongheadedly tried to “induce unity into a conception where the facts show utmost divergence.”²⁶ They deployed theories that, first, yielded no determinate results (each theory “has been used to serve the same ends, and each has been used to serve opposing ends”²⁷), and, secondly, figured into policy debates largely as *ex post* rationalizations for the discussants’ positions.²⁸ At a descriptive level the debate was not even particularly interesting: Corporations and other associations had an obvious social reality.²⁹ That point being established, the thing to do was analyze the facts respecting given specimens of the breed, identifying “whatever specific consequences flow from the right-and-duty bearing units.”³⁰

Dewey reminded his readers that policy problems related to corporate entities were a constant in Western history:

In its various forms of ecclesiastical bodies and foundations, guilds, municipalities, trading companies, or business organizations, the corporation has always presented the same problem of how to check the tendency of group action to undermine the liberty of the individual or to rival the political power of the state.³¹

Yet Dewey’s history did not lack contemporary implications: This historical observation anticipates Berle and Means’ later description of contemporary practice. At the same time, Dewey’s analysis implied a devastating critique of a theory of the firm much in circulation at the time. That theory, “corporate realism” (not to be confused with the realism Dewey brought to bear in criticizing it), drew on European ideas³² about the spiritual reality of group life to assert that the corporate entity was real and group dynamics were more significant in practice than individual contributions. Important implications followed for the large, mass-producing corporations that had suddenly appeared in the American economy around the turn of the

²⁵Dewey, *supra* note ___, at 655-56, 657.

²⁶*Id.* at 671.

²⁷*Id.* at 669.

²⁸*Id.* at 663.

²⁹*Id.* at 673.

³⁰*Id.* at 661.

³¹*Id.* at 667.

³²See OTTO GIERKE, *POLITICAL THEORY OF THE MIDDLE AGE* i-xliv (F.W. Maitland trans. 1900). In the United States, the theory’s most prominent advocate was Ernst Freund. ERNST FREUND, *THE LEGAL NATURE OF CORPORATIONS* (1884).

century. If the essence lay in the group dynamic, then the entrepreneurial function could not be split and there could be no meaningful separation of ownership and control. The new management-dominated corporations instead reconstituted the profit-maximizing individual of classical economic theory in a collective form. Furthermore, the new collectivities did not need to be contained by regulation. Since individuals and not the state supplied the creative force that brought corporate groups into existence, respect for individuals counseled against regulation. A theory of group production without state control, corporate realism provided an important source of intellectual justification for the mass production firm.³³

Yet corporate realism disappeared without a trace after the publication of Dewey's essay.³⁴ Henceforth, with Dewey, legal theory would treat corporations as reifications and address itself to their economic and social consequences. The basic realist point had been made. In addition, the conceptual underbrush was cleared away for the Berle and Means account.

B. William O. Douglas and Corporate Reorganization

William O. Douglas joined the Columbia law faculty in 1926, the same year that the *Yale Law Journal* published Dewey's essay. Douglas stayed for only two years, but later remembered Dewey, a member of the university's philosophy department, as one of the friends he made during that short term.³⁵

Those two years at Columbia were among the most famously intense and troubled in the history of American law faculties. Columbia's faculty was engaged in a collective study and discussion of curriculum reform. It reached broad agreement over the importance of a social scientific approach only to split over the recommended course of action. The "scientists"--Herman Oliphant, Underhill Moore, Hessel Yntema, Karl Llewellyn, Leon Marshall (an economist visiting from the University of Chicago) and Douglas--wanted the law school to be devoted solely to social inquiry. More conventionally-minded colleagues, although ready to reform the curriculum, wanted to stay in the business of training legal practitioners. When the school's dean resigned for health reasons in 1928, the faculty could not agree on a replacement.³⁶ The university president, Nicholas Murray Butler, broke the deadlock, appointing one of

³³See Horowitz, *supra* note __, at 176, 224.

³⁴Other critics are noted: Max Radin, *The Endless Problem of Corporate Personality*, 32 COLUM. L. REV. 643 (1932); Paul Vinogradoff, *Juridical Persons*, 24 COLUM. L. REV. 594 (1924).

³⁵WILLIAM O. DOUGLAS, *GO EAST, YOUNG MAN: THE EARLY YEARS* 159 (1974)

³⁶TWINING, *supra* note __, at 45-55.

the conventional faction, Young B. Smith, without consulting the faculty. Fury ensued.³⁷ Douglas resigned in protest. He was followed by Oliphant, Yntema and Marshall,³⁸ each of whom took new appointments at a new legal studies institute at Johns Hopkins. Douglas went to Yale's law school, whose dean, Robert M. Hutchins, had been hiring social scientists and aggressively recruited from among Columbia's disaffected.³⁹ At Yale, Douglas joined Charles Clark, Thurman Arnold, and other similarly-minded academics,⁴⁰ including Underhill Moore who after a year also removed to Yale.⁴¹

1. Douglas and the Rise of Chapter X.

Once in New Haven, Douglas worked on an empirical study of practice in individual and small firm bankruptcies.⁴² This led to consulting work on bankruptcy problems with the Commerce Department during the Hoover administration.⁴³ Full time work in Washington came with the New Deal. Douglas was recruited by Joseph Kennedy, the first chairman of the Securities and Exchange Commission. Once again bankruptcy was the topic. He conducted a study of big corporation reorganization procedure that laid the groundwork for an extensive revision of federal bankruptcy law.⁴⁴ Douglas turned in an eight-volume report⁴⁵ and went on to become a member of the SEC. In that position he codrafted the reform legislation

³⁷JULIUS GOEBEL, JR., A HISTORY OF THE SCHOOL OF LAW COLUMBIA UNIVERSITY 305 (1955). The succession choice, which lay between Smith and Oliphant, had been on the table for some years; Oliphant actively had courted Butler. KALMAN, *supra* note __, at 68-74.

³⁸DOUGLAS, *supra* note __, at 160-61.

³⁹KALMAN, *supra* note __, at 107-115.

⁴⁰ DOUGLAS, *supra* note __, at 164-67.

⁴¹Llewellyn stayed at Columbia along with Noel Dowling, Julius Goebel, and others. TWINING, *supra* note __, at 56.

⁴²For accounts of the project, see SCHLEGEL, *supra* note __, at 98-105; David A. Skeel Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1084-1088 (2000).

⁴³*Id.* at 174-75.

⁴⁴*Id.* at 258-59.

⁴⁵1-8 SECURITIES AND EXCHANGE COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937-1940). For contemporary criticism, see Robert T. Swaine, "Democratization of Corporate Reorganizations," 38 COLUM. L. REV. 256 (1938).

that became Chapter X of the Bankruptcy Act of 1938 (the “Bankruptcy Act”).⁴⁶

Chapter X effected a root-and-branch reform of the “equity receivership,” a federal corporate reorganization practice that had reached mature form in connection with late-nineteenth and early-twentieth century railroad bankruptcies.⁴⁷ Equity receivership entailed the creation of a new capital structure for the bankrupt firm and the distribution of its securities to the firm’s securityholder claimants. These reorganization deals were cut in the back room, stage managed by Wall Street lawyers and investment bankers. *Ex post* judicial scrutiny was minimal. Under the fairness standard of the dominant line of cases, termed “relative priority,” a public bondholder had no basis for complaint so long as the plan provided it a security with status senior to that being received by junior holders under the plan. The result was that the bankrupt firm’s obligations could be scaled down at the expense of its debt and senior equity securityholders, who tended to be small investors hobbled by collective action problems. At the same time, the management group that hired the lawyers and investment bankers stayed in place and, despite status as a holder of junior equity, was accorded a controlling participation in the equity of the reorganized firm. Reorganization plans under equity receivership tended to leave outsider investors to take back new securities of lower face value, diminished security, or reduced priority, even though their contracts nominally bestowed claimant status senior to that of the insiders who walked off with significant value.⁴⁸

With Chapter X, Douglas put the equity receivership out of business with a series of process and substantive requirements. Chapter X was designed for large reorganizing firms with outstanding classes of publicly-held securities. It proceeded on the assumption that control and ownership were likely to be separate in such firms, and so displaced their top managers with a judicially-appointed trustee. The trustee took charge of the management of the business and had sole responsibility for formulating a new capital structure. The new capital structure, or “reorganization plan,” had to be approved by a federal judge before being submitted to the holders of the firm’s securities for a confirming vote. And that federal judge had to have the benefit of a report of the SEC on the question whether the reorganization plan adhered to

⁴⁶Chandler Act, ch. 575, 52 Stat. 883 (1938). The other drafters were Douglas’ assistant, Abe Fortas, and Congressman Walter Chandler. DOUGLAS, *supra* note __, at 264. David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy*, University of Pennsylvania, Institute for Law and Economics, Working Paper No. 267 (November 1999), provides useful history this legislation.

⁴⁷Douglas’ academic work on bankruptcy included a study of equity receiverships filed in the federal district court of Connecticut. William O. Douglas & John H. Weir, *Equity Receiverships in the United States District Court for Connecticut: 1920-29*, 4 CONN. BAR J. 1 (1930).

⁴⁸For accounts of the evolution of the equity receivership, see Douglas G. Baird and Robert K. Rasmussen, *Boyd’s Legacy and Blackstone’s Ghost*, 1999 SUP. CT. REV. 393, 401-412; David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1355-61 (1998).

substantive standards.⁴⁹ The text of Chapter X did not specifically articulate what those substantive standards were, requiring only that the plan be “fair and equitable.” But Douglas quickly filled in the missing content once in his next job as a justice of the Supreme Court. Under his opinion in *Case v. Los Angeles Lumber*,⁵⁰ “fair and equitable” meant absolute, as opposed to relative, priority. Under absolute priority, no holder in a junior position can receive any value under a reorganization plan if any objecting holder in a senior position receives less than full value in respect of his claim.⁵¹ In other words, absolute priority wipes out insiders holding common stock if any senior bond or preferred holder receives less than 100 cents on the dollar.

In order to know where to locate absolute priority’s cut-off line between seniors entitled to receive securities in the new capital structure and juniors to be wiped out, one has to know how much a bankrupt firm is worth. Thus does absolute priority, instituted as a rule for judicial application, necessitate a judicial valuation of the going concern in reorganization. In the Chapter X scheme of things, the valuation is submitted to the judge by the trustee as a part of the reorganization plan. The mandatory SEC report then provides disinterested expert advice, exposing to the reviewing judge any finagling designed to create room for distributions of value to junior holders who should be wiped out.

Chapter X, thus outlined, was progressive legislation that disempowered corporate managers and Wall Street intermediaries. It also manifested a legal realist imprint. To see this, it is useful to distinguish between two strands of realism, one connected to private law and the other to public law and economic regulation. Both strands join the realist attack on formalism, insisting on a high level of generality in statements of law and advocating narrow and pluralistic legal formulations in particular cases.⁵² But they differ on the role of the common law judge. The private law strain, most famously manifested in the commercial law realism of Karl Llewellyn, accorded the judge a crucial institutional role.⁵³ The judge

⁴⁹Skeel, *supra* note ___, at 1371, notes that the statute accorded the SEC a less powerful advisory role than that accorded to the Interstate Commerce Commission in railroad reorganizations. Skeel suggests that this may have been a concession to the National Bankruptcy Conference.

⁵⁰308 U.S. 106 (1939).

⁵¹VICTOR BRUDNEY & WILLIAM W. BRATTON, *BRUDNEY AND CHIRELSTEIN’S CASES AND MATERIALS ON CORPORATE FINANCE* 272-73 (1993).

⁵²*See, e.g.*, WALTER WHEELER COOK, *THE LOGICAL AND LEGAL BASES OF CONFLICT OF LAWS* 196-197 (1942)(arguing for a particularistic application of the conflict of laws concept of domicile); Morris R. Cohen, *On Absolutisms in Legal Thought*, 84 U. PA. L. REV. 681 (1936).

⁵³For a discussion of the contemporary relevance of Llewellyn’s realism in commercial law, *see* Gregory E. Maggs, *Karl Llewellyn’s Fading Imprint on the Jurisprudence of the Uniform Commercial Code*, 71 U. COLO. L. REV. 541 (2000).

would operate at the frontier between positive law and business practice. There, applying loose standards, the judge would actualize the realist program by confronting real-world facts and bringing them to bear in regulating business relationships.

Douglas' legislation manifests no such confidence in common law adjudication.⁵⁴ Indeed, Douglas deemed the federal judiciary's performance in equity receiverships to be a problem for solution in Chapter X. Chapter X accordingly constrained the judge with a rule even as it left bankruptcy reorganization under judicial administration. Having taken that step, Chapter X still did not trust the judge applying the rule accurately to evaluate real-world business evidence. Technical advice from an agency expert would be required. Thus structured, Chapter X reflected legal realism's public law strain, which in turn reflected progressive hostility to the rulings of courts of the *Lochner* era. Under this line of thinking, common law courts were both ideologically and administratively incapable of solving regulatory problems in an industrial economy.⁵⁵ Practical reasoning and particularistic decisionmaking still would be required, but should come from an expert operating in an agency framework.⁵⁶ Judicial valuations had come in for particularly sharp criticism, due to their importance in public utility regulation.⁵⁷

2. Douglas and the Fall of Chapter X.

Chapter X did succeed in displacing Wall Street lawyers and investment bankers from the reorganization process.⁵⁸ But, even as Douglas displaced, so was his reorganization law package itself displaced. Chapter X did not work well and was replaced forty years later by Chapter 11 of the Bankruptcy Act of 1978, the present Bankruptcy Code (the "Code"). The Code dispenses with trustee administration, leaving the bankrupt firm's managers in charge.⁵⁹ It then returns the locus of deal-making

⁵⁴It should be noted that at other times and on other bankruptcy topics, Douglas took the opposite tack and advocated reliance on the trial judge's powers of discrimination. *See infra* text accompanying note __; Skeel, *supra* note __, at 1085-1086 (discussing Douglas' advocacy of expanded judicial discretion in the granting of discharges to individual debtors).

⁵⁵MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 221 (1992).

⁵⁶JAMES M. LANDIS, *THE ADMINISTRATIVE PROCESS* 23-23, 33 (1938).

⁵⁷Robert Hale of Columbia was leading exponent of this critique. See BARBARA H. FRIED, *THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE: ROBERT HALE AND THE FIRST LAW AND ECONOMICS MOVEMENT* 193-204 (1998).

⁵⁸Skeel, *supra* note __, at 1090-1093, 1112-1113.

⁵⁹The firm becomes a "debtor in possession." 11 U.S.C. § 1101(1).

authority to the back room, removing judicially-enforced absolute priority from the center of the reorganization system. Absolute priority is demoted to second-tier status, contingently available for reorganizations where back room wheeling and dealing fails to produce agreement among the various classes of claimant.⁶⁰ Interestingly, the contingency has yet to occur in a Chapter 11 involving a debtor with classes of publicly-held debt.

The impetus for the move away from Chapter X stemmed in part from dissatisfaction with its administrative requirements. Practitioners disliked the troika of trustee administration, judicial fairness review, and SEC input. They found they could avoid it in practice by filing public company reorganizations under the 1938 Bankruptcy Act's Chapter XI, which had been designed for small business bankruptcies. A Chapter XI proceeding neither required a trustee, imposed an absolute priority standard of fairness, nor looked to the SEC for input. It was, of course, manifestly to disregard the statutory scheme to administer the reorganization of a large firm with publicly-held debt under Chapter XI. Yet such proceedings were common by the 1960s and 1970s, facilitated by a loophole opened by Douglas himself. His opinion in *General Stores v. Shlensky*⁶¹ made it possible for debtors with classes of publicly-held securities outstanding to file under Chapter XI. The case rejected the option of a *per se* rule on the choice-of-chapter question.⁶² Instead it remitted the matter to determination under an open-ended standard, holding that the question whether a bankrupt firm with publicly-held securities belonged in Chapter X or Chapter XI depended on "needs to be served." The idea was that some widely-dispersed classes of claimants, such as common stockholders⁶³ and trade creditors,⁶⁴ were not included in the classes Chapter X was intended to protect. The courts were to take up the matter case by case.

The Douglas of *Shlensky*, by then long a judge himself, no longer seemed to harbor the fear of judicial subterfuge or incompetence that shaped the original legislation. He accordingly reverted to the general realist preference for standards over rules and, joining realism's private law strain, relied on the judicial capacity to discriminate in the administration of Chapter X. Yet Chapter X's earlier rejection of an open-ended fairness standard had reflected a different policy judgment: Any allowance of maneuvering room would come at the expense of the securityholders the statute sought to protect. Had Douglas held to that judgment, the *Shlensky* court might have articulated a *per se* rule respecting the choice of chapter.

⁶⁰See 11 U.S.C. § 1129(b)(absolute priority applies only when a class of creditors or claimants dissents).

⁶¹350 U.S. 462 (1956).

⁶²He ignored a narrow reading permitted by the United States Realty and Investment Co., 310 U.S. 434 (1940)(refusing a corporation with public debt access to Chapter XI).

⁶³*Schlensky* concerned a firm with public common stock outstanding but no public debt.

⁶⁴Securities and Exchange Commission v. American Trailer Rentals Co., 379 U.S. 594 (1965).

As it turned out, Douglas' latter day trust in judicial administration proved misplaced. Under *Shlensky*, it always made sense for an insolvent firm's counsel to file under Chapter XI. Since the appointment of a Chapter X trustee meant that the chief executive officer of the client firm got fired and the worst result of a wrongful XI filing was removal to X, there was every reason to give XI a shot. The courts came to look the other way on these filings, ignoring the manifest intent of Douglas' creditor-protective statutory scheme. Perhaps Chapter X's mandated rigors had become a medicine as distasteful to federal judges as it had been to corporate managers and the bankruptcy bar. Meanwhile, the edge gradually had worn off the Depression-era sense of the bondholder interest as a paramount "need to be served." Avoidance of Chapter X became the practice norm.⁶⁵ With that, Douglas' bifurcated scheme started to look dispensable, a look that increased its vulnerability to substantive criticism. He was hoisted on his own realist petard: A hard but crude choice-of-chapter rule better might have served Chapter X's creditor protective purpose, giving it a clearer chance at proving its value in practice.

Judicial gatekeeping was not the only problem, however.⁶⁶ Changes in security-holding patterns—the tendency for more small investors to hold common stock that created the governance problem addressed in *The Modern Corporation and Private Property*--also prompted dissatisfaction with Chapter X. Prior to the 1920s, the general public had tended to hold debt while insiders often held control blocks of stock. Widespread stock ownership dates from the 1920s. During the Depression both patterns of capital structure coexisted. By the 1960s, the small bondholder had started to disappear as bondholding became the territory of investment institutions. At the same time, the profile of the small, public stockholder loomed ever larger. Those responsible for the shift away from absolute priority pointed to the shift in holding patterns as an investor-protective justification.⁶⁷

The Bankruptcy Code of 1978 also reflects institutional dissatisfaction with judicial fairness review in the absolute priority framework. On the one hand, absolute priority review was criticized for being rule-based and rigid. On the other hand, it was criticized for being unreliable and open-ended, dependent as it was on the vagaries of the inexact and manipulable exercises of valuation. The financial science on which Chapter X depended proved as indeterminate in practice as any fractured body of Victorian formalist legal doctrine.⁶⁸ The statute's interpolation of an expert advisory opinion had not ameliorated the problem. Nor was the judiciary thought to have done a particularly successful job of mediating between the indeterminacy of the financial evidence and the application of the statute's fairness rule. The upshot was that "rules versus standards" ceased to be the issue by the late 1970s. Instead the necessity of judicial fairness review itself came to be questioned. But, unlike Depression-era observers, who substituted agency oversight for

⁶⁵Skeel, *supra* note __, at 1374-75.

⁶⁶For a structural account, *see id.* at 1372.

⁶⁷House Report No. 95-595, 95th Cong., 1st Sess., 1977, at 221-24.

⁶⁸*Id.*

judicial review, observers in the late-1970s looked toward contractual solutions. They had come to the view that process rules and process review adequately could protect dispersed investors. The 1978 Code manifested this thinking when it took the formation of the reorganization plan out of the hands of a fiduciary to return it to back room bargaining constrained by process and structure rules. These centered on disclosure: Securityholders asked to vote in favor of reorganization plans were required to receive judicially-endorsed disclosure documents respecting both the plan and financial condition of the firm.⁶⁹ Collective action problems would be dealt with through organization of similarly-situated claimants into formal “classes” which would be represented by a new generation of bankruptcy lawyers.⁷⁰

The bankruptcy community, in sum, had lost confidence in both agency input and judicial competence. As a result, mandatory fairness review gave way to a less demanding system of process controls. This in turn implied an additional shift in presuppositions. For Douglas, public senior securityholders needed absolute priority protection because they had a collective action problem. Their inability to organize rendered them incapable of taking advantage of the institution of free contract so as to bargain their way to participation in a new capital structure that could make them better off even as it called for give ups. The 1978 Code readmits bargaining (and give ups by seniors) to an acknowledged place in the formulation of reorganization plans, albeit a place subject to backstop substantive controls.

If we shift sights from the late 1970s bankruptcy community to the late 1970s corporate law community, we see a different conceptual picture. There Berle and Means’ paradigm, and its reliance on judicial application of fairness principles, still held primacy of place in legal theory, if not in courtrooms. But the theoretical shifts that brought down Douglas’ reorganization regime—scepticism respecting judicial competence and a concomitant retreat to process scrutiny, along with renewed faith in the institution of contract—were about to bring down the Berle and Means’ paradigm.

II. A NEW LOOK AT BERLE AND MEANS

Adolf Berle took up residence at Columbia Law School on a soft money basis in 1927. Support came from a Rockefeller Foundation grant for a research project that eventually became *The Modern Corporation and Private Property*. Berle got an office and an adjunct teaching assignment at the business school while he waited for a permanent faculty line to become available at the law school. The line came forth when the faculty ruptured in 1928: Douglas’ resignation became effective on June 30, 1928; Berle’s appointment became effective the next day.⁷¹ Soon thereafter each edited a casebook on

⁶⁹11 U.S.C. § 1125.

⁷⁰11 U.S.C. § 1103(c).

⁷¹GOEBEL, *surpa* note ___, at 310-311. The departure of the members of the losing faction opened up quite a few slots. But Berle did not “replace” Douglas as Columbia’s corporate law teacher. The aged George Folger Canfield was still teaching the Corporations course, not very

corporate finance. The two books reflect their differing interests. Douglas concentrated on the rights of bondholders where Berle emphasized the governance and control problems taken up in *The Modern Corporation and Private Property*.⁷²

This Part's reconsideration of the book proceeds in three segments. Section A looks at Berle's collaboration with Means as an early exemplar of law and economics inquiry. The collaboration reverses contemporary expectations. Berle went into it as a proponent of corporate self regulation, only to have Means, the economist, persuade him of the a need for government intervention. There resulted a book reflecting the theoretical posture of the law and economics of the day. Section B reconsiders the book's presentation of the separation of ownership and control. Here we find the key to its continuing place in corporate legal theory: The separation of ownership and control remains corporate law's principal source of unsolved problems. The book's characterization of the problem turns out to be better aligned with today's views on corporate governance than historical memory has tended to admit. Section C turns to a line of analysis now thought to be wrongheaded--the book's recommendation that corporate governance be reconstructed around a judicially-enforced norm of trust. No attempt is made to reverse the judgment of error. But historical memory turns out to be inaccurate once again. Berle and Means made their policy recommendations with scrupulous recognition of problems and weak points, anticipating contemporary objections. Even here, at its point of failure, *The Modern Corporation and Private Property* retains a pragmatic modesty that imports plausibility.

A. Law and Economics Before Law and Economics

Berle's Rockefeller grant stipulated an "interdisciplinary" study of corporations to be conducted with an economist. Berle chose Gardiner Means, a friend from youth who had become an economics

successfully, until 1930. *Id.* at 322. His much-delayed retirement blocked Berle's appointment. Subterfuge was resorted to: In 1927, Berle taught an advanced corporations course in the Business School on an adjunct basis. SCHWARZ, *supra* note __, at 51. Canfield's retirement had been announced a few years earlier, while Douglas was an upperclass student at the law school. Douglas joined some other students and held a party for the retiring Canfield after his last class, presenting him with a gift of pipes from Dunhill's. Canfield was so moved that he decided to stay on, to the great annoyance of the dean. DOUGLAS, *supra* note __, at 147.

⁷²Compare WILLIAM O. DOUGLAS & CARROL M. SHANKS, CASES AND MATERIALS ON THE LAW OF FINANCING OF BUSINESS UNITS (1931), with ADOLF A. BERLE, JR., CASES AND MATERIALS IN THE LAW OF CORPORATION FINANCE (1930). Douglas starts with bonds on page 1 and does not get to common stock until page 465 of his 1155 pages; Berle starts with the charter and the power structure and devotes 168 of his 903 pages to bonds and preferred. For discussion of Douglas' pedagogy, see KALMAN, *supra* note __, at 85-86.

graduate student, first at Columbia and later at Harvard.⁷³ Means first joined the project as a “statistical and economics research assistant,”⁷⁴ and contributed the book’s empirical studies of corporate concentration and dispersed share ownership. Berle eventually conceded coauthorship and one-third of the royalties.⁷⁵

When work began in 1927, Berle already was well known for a series of law review commentaries on corporate law.⁷⁶ Management power and the shareholders’ inability to control it appear as central concerns even in this early work.⁷⁷ But the Berle of the 1920s remained highly skeptical respecting prospects for constructive judicial intervention:

[C]ourts cannot be expected to work out rules of conduct for the business community except with the guidance and assistance of business men themselves, and for this purpose business standards must be made apparent.⁷⁸

For Berle, the problem was that the sources of corporate regulation, corporate charters and statutes, were not helping to make “business standards” apparent. Then, as now, the practice standard favored broad drafting toward the end of giving management complete discretion. Berle saw a resulting need for constraints on management discretion. But he looked to self regulation instead of judicially-administered fiduciary principles.⁷⁹ More specifically, he suggested (1) that investment bankers organize themselves into an enforcement body to facilitate scrutiny (and screening) of firms making public securities offerings; (2) that the stock exchanges withhold listing from firms whose managers abused their power and demand disclosure of corporate information; and (3) that large institutional shareholders like insurance companies might be positioned to obtain accurate information about issuers and to protect shareholder rights.⁸⁰ With respect to institutional holders he had a more specific suggestion:

⁷³SCHWARZ, *supra* note __, at 51.

⁷⁴ADOLF A. BERLE, JR., NAVIGATING THE RAPIDS, 1918-1971, at 21 (Beatrice Bishop Berle and Travis Beal Jacobs, eds. 1973)

⁷⁵*Id.* 58-59.

⁷⁶ He summarized this work in a 1928 book, ADOLF A. BERLE, JR., STUDIES IN THE LAW OF CORPORATE FINANCE (1928).

⁷⁷*Id.* at v-vi, 26-34, 37.

⁷⁸*Id.* at 36.

⁷⁹For a contemporary articulation of this position well-rooted in the economic theory of the firm, see Edward Rock and Michael Wachter, *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, __ U. PA. L. REV. __ (2001).

⁸⁰*Id.* at 37-39.

Suppose . . . trust companies were in the habit of accepting, on “custodian account,” deposits of stocks from small shareholders, thereby gathering many small holdings into an institution commanding a block so large that protection was worth while, and that they also provided themselves with power to represent the depositors of stock. Such institutions could easily keep themselves informed as to the affairs of the corporation . . . and, as representing their clients, could take the action necessary to prevent or rectify violations of property rights. . . .⁸¹

Ironically, each of the items on Berle’s list shows up prominently in contemporary governance debates.⁸²

Berle’s attitude toward regulation changed even before the stock market crashed.⁸³ The catalyst was Means, whose empirical results showed that one-third of the national wealth lay in the hands of 200 large corporations. Means projected that given continuation of the present rate of growth of that relative share, seventy percent of economic activity would be carried on by 200 corporations by 1950 even as share ownership became more and more dispersed.⁸⁴ The upshot was that economic power was becoming concentrated in the hands of a cluster of corporate managers, the same group whose level of responsibility already had come to concern Berle. What Berle formerly had seen as a problem of finance he now came to see as a problem of government.⁸⁵ The corporate system, as he would write in *The Modern Corporation and Private Property*, had attracted to itself certain significant attributes and powers, and now amounted to a major social institution.⁸⁶ Individual property had gone into a “collective hopper” which had brought forth huge industrial oligarchies.⁸⁷ The oligarchs exercised unified control over the wealth under their charge, and the law had played a role in investing this power.⁸⁸ This called for intervention. With the crash and depression, Berle later recalled, many others who had been hostile to regulation in the

⁸¹*Id.* at 39.

⁸²*See, e.g.,* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L. J.* 2359 (1998); Paul G. Mahoney, *The Exchange As Regulator*, 83 *VA. L. REV.* 1453 (1997); Bernard Black & Reinier Kraakman, *A Self Enforcing Model of Corporate Law*, 109 *HARV. L. REV.* 1910 (1996).

⁸³The change occurred by the spring of 1929. SCHWARZ, *supra* note ___, at 55.

⁸⁴BERLE & MEANS, *supra* note ___, at 9, 37, 47.

⁸⁵*Id.* at 56.

⁸⁶*Id.* at 3.

⁸⁷*Id.* at li.

⁸⁸*Id.* at 4, 131.

1920s became receptive to this criticism of the corporate governance regime.⁸⁹

Thus did corporate law meet economics law seventy years ago with results different from those usually attending such encounters today. In the Berle-Means collaboration the economics prompted the lawyer to abandon a self-regulatory approach in favor of government control of corporate activity. Today economics tends to encourage lawyers to take deregulatory positions. The shift in the pattern of influence doubtless reflects shifts in political currents. But other, more narrowly academic factors also operate. Means' institutional economics, which today might be characterized as socio-economics, fit much more neatly into the law and society project of the legal realists of the 1920s than it would fit into the microeconomic project of contemporary corporate legal theory. The institutional economists of Means' era disliked the deductive methodology of classical economics and sought a more capacious framework for describing economic behavior. They worked together with the legal realists in describing the economy's legal underpinnings and shared their reformist leanings.⁹⁰

An interventionist profile also made sense given the prevailing posture of the theory of the firm. Economics had no theory of the firm on which Berle and Means could draw in discussing the problem of *The Modern Corporation and Private Property*. The microeconomics of corporate governance dates only from the 1970s.⁹¹ In Berle and Means' day, microeconomics was thought to be a theory about markets. It modeled only the price system's coordination and use of resources and distribution of income. The firm was accorded black box status. That perception accorded exactly with that of *The Modern Corporation and Private Property*: Results within firms were seen as engineered in a hierarchical context and therefore unsuited to description under a paradigm designed for the study of markets.⁹² Microeconomics accordingly dealt with the firm at the level of assumption: It was deemed a production function that followed profit considerations and behaved as an entity in rational patterns no different from those of human actors.⁹³ *The Modern Corporation and Private Property* became famous because it

⁸⁹BERLE, *supra* note __, at 22.

⁹⁰FRIED, *supra* note __, at 11-12.

⁹¹Ronald Coase made the earliest suggestion in the field that internal firm operations could be described contractually. See Ronald Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). But his model had no influence until after 1970.

⁹²Harold Demsetz, *The Theory of the Firm Revisited*, 4 *J.L.ECON. & ORG.* 141, 142 (1988); Michael Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J FIN. ECON.* 305, 306-07 (1976).

⁹³See Chueng, *The Contractual Nature of the Firm*, 26 *J.L.& ECON.*1 (1983); Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 *J.L.& ECON.* 375, 377-78 (1983).

successfully challenged that assumption's plausibility.⁹⁴

B. The Enduring Separation of Ownership and Control

Dewey's *The Historic Background of Corporate Legal Personality* opened a gap when it signaled that corporate legal theory would have to be rethought for the new context of the twentieth century. *The Modern Corporation and Private Property* filled the gap by with the separation of ownership and control, which has remained at the forefront of policy analysis of corporate governance ever since. The book's claim of concomitant economic and social dislocation also remains on the table, never successfully refuted by generations of apologists for corporate institutions. Thus situated, the book's ideas continue to move discussions.

Bringing corporate legal theory into the twentieth century meant the severance of some ties to classical economics, with which nineteenth century corporate law had shared certain basic assumptions. Under that earlier, shared vision, the usual case of production and trade was conducted by self-employed individuals. Corporate production was an exception limited to special situations. Limitations on corporate authority were thought inevitably to accompany that special status and corporate law was thought the appropriate means of limitation. But as corporate law evolved during the nineteenth century, it stopped placing limits on corporate operations. It instead facilitated the appearance and success of the large, mass-producing, management-controlled corporation. This was a reactive rather than a purposive development. As Berle and Means noted, the change recognized underlying economic facts.⁹⁵ But, for them, the transition from the classical economy had caused the law to become implicated in the creation and perpetuation of an unsatisfactory situation.

In the classical model, profit-maximizing individual entrepreneurs both own the means of production and make all decisions respecting production and consumption. Power relations are bilateral: One actor can affect another's behavior only indirectly, by refusing to contract. The result is market competition that effectively controls the producers, constraining both the incompetent and the greedy and legitimating private economic power. But corporate mass production on a large capital base does not fit within the classical model's legitimating parameters. As Berle and Means pointed out, the big corporations of the twentieth century had split the classical entrepreneurial function between salaried executives, who sit atop hierarchical organizations, and anonymous equity participants, who hold small stakes and prize market liquidity over participation. Berle and Means showed that this combination of capitalization through liquid securities markets and management by salaried professionals fit awkwardly in the wider socio-economic scheme. It presented problems of competence and responsibility absent in an ideal capitalist world inhabited by self-

⁹⁴In so doing it performed a core institutional function. Thorsten Veblen had attacked neoclassical methodology in which capitalist institutions were "taken for granted, denied, or explained away." THORSTEN VEBLÉN, *THE PLACE OF SCIENCE IN MODERN CIVILIZATION AND OTHER ESSAYS*, 233 (1919).

⁹⁵BERLE & MEANS, *supra* note __, at 131.

employed individual producers.⁹⁶ The fit remains awkward to this day.

Some of the rhetoric with which Berle and Means describe the situation sounds outdated.⁹⁷ Nor did Means' prediction of ever-increasing concentration and dispersion of ownership prove accurate. But Berle and Means hit the issue. The split in the classical entrepreneurial function came to be seen as a problem by observers on all points of twentieth century America's ideological spectrum, even as few denied the large corporation's success as a producer.⁹⁸ The problem has never been solved. We instead have seen a process of accommodation and adjustment between the mass-producing, management-controlled corporation and the wider economy and society. The process, which began before the turn of the twentieth century, continues into the twenty first.

Berle and Means play an enduring and exceptional role in the accommodation process. To get a sense of that places' uniqueness, let us compare the history of their theory's paradigmatic replacement, the contractarian theory of the firm that became ascendant in the 1980s. The contractarians scored many points. But they failed to displace the separation of ownership and control with a free market success story.

Contractarianism drew on a line of contemporary microeconomic theory that succeeded where classical microeconomics stopped short, modeling the governance of large firms with separate ownership and control as incidents of contracting among the rational economic actors. Under the model there is no meaningful separation of ownership and control. Since the firm represents a series of contracts joining inputs to outputs, ownership becomes an irrelevant concept. Equity capital, the focus of the Berle and Means analysis, is simply one of the inputs and corporate law a part of that input's governing contract.⁹⁹ Nor do the terms of the equity contract present problems calling for regulatory solution. The imperfections subsumed under Berle and Means' "separation" rubric reemerge under the more neutral denomination "agency costs." In the model's pure version, free market competition solves the problem of the separation of ownership and control by forcing firms to minimize agency costs. Managers are not the powerful actors described by Berle and Means. When they fail, they get removed—either a hostile offeror takes over the company and throws them out, the firm with a high agency cost base fails to survive in the product market, or the managers fail to survive in the management labor market in the first place. Their incentives

⁹⁶*Id.* at 3-10.

⁹⁷*See, e.g., id.* at 4 (referring to "princes of industry").

⁹⁸The collective aspect of corporatization that Berle identified, *id.* at li, implied that standard individualist defenses against government intervention did not apply to large corporations.

⁹⁹*Id.* at 420.

accordingly are focused on long run productive success for the firm.¹⁰⁰ The regulatory agenda becomes blank, and cost- reductive deregulation is counseled.

This contractarian attempt to consign Berle and Means to the scrapheap failed in short order, however. It depended on the plausibility of the assertion that free market forces by themselves minimize agency costs. The corporate law community gave that assertion due consideration and emerged unpersuaded. The asserted labor and product market correctives turned out on inspection to be more theoretical than real. The takeover corrective started out the 1980s with vigor, importing plausibility to the model,¹⁰¹ but ran into some unanticipated public choice problems. The model emerged in the 1990s severely compromised. Discussion still proceeded under the rubric of contract, but it was not at all clear that optimal management-shareholder contracts and governance arrangements were attainable within the large corporation's institutional framework. Collective action problems substantially impaired contractual self protection by the dispersed equity interest. Agency costs remained suboptimally high.¹⁰² In other words, the corporation's agency cost posture remained suboptimal because of the separation of ownership from control. Berle and Means thus returned to the top of corporate law's policy agenda in the 1990s.¹⁰³

But they returned to a framework of discussion that had changed radically under contractarian influence. Where Berle and Means suggested amelioration through regulation, contemporary corporate law writers return to the self-regulatory strategies that Berle considered and abandoned in the 1920s.¹⁰⁴ That return follows from a number of influences. Politics is one—confidence in regulatory solutions to economic problems remains low. Academic methodology is another—contractarianism's microeconomic

¹⁰⁰William W. Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 417-18 (1989).

¹⁰¹See William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1517-19 (1989)

¹⁰²John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay in the Judicial Role*, 89 COLUM. L. REV. 1618, 1675-76 & n. 234 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1577 (1989).

¹⁰³A further substantive comparison of the two leading corporate law volumes published in the 1990s, EASTERBROOK & FISCHER, *supra* note __, and ROE, *supra* note __, confirms this assertion. Easterbrook and Fischer's book, which summarizes a series of articles written in the 1980s, for the most part avoids any mention of Berle and Means. See EASTERBROOK & FISCHER, *passim*, at 81-82, 127 & fn. 9, 295 & fn. 14. With Roe, the problem of the separation of ownership and control and the "Berle and Means corporation" are principal subject matter. ROE, *passim*, at 6-17.

¹⁰⁴See *supra* note __

assumptions have persisted even though its assertion of thorough-going market success proved unpersuasive. Changes of corporate circumstances come third, and probably first in causal importance. By 1990, the proportion of equities held by institutional investors had increased so much as to make it plausible to project that the shareholder collective action problem at the core of the separation of ownership and control might be overcome in practice.¹⁰⁵ This has not happened in a formal, institutional sense--institutional shareholders have not organized themselves into oversight committees or invested in election campaigns to gain a place on boards of directors. But profound changes have occurred at a normative level.¹⁰⁶ Shareholder value now sits atop management agendas. Managers who create it build reputations and careers. Managers who do not are deemed failures. Managerialism, the contra-norm against which Berle and Means wrote and which guided corporate behavior through the 1980s, has not disappeared. But it no longer is respectable if untempered by reference to the shareholder interest. Outcomes change in the shareholders' favor as a result. Self regulatory strategies become more plausible. When considered in comparison to the costs and perverse effects of regulation, they even start to look attractive.

Meanwhile, the microeconomics of the firm has been restated in a second best framework. The restatement realigns it with Berle and Means. Under the now-prevailing incomplete contracts approach,¹⁰⁷ transacting actors are deemed able to create producing institutions that assuredly evolve to first-best status only to the extent that they deal with "contractible" subject matter. Contractibility is not a safe assumption,¹⁰⁸ particularly with respect to corporate governance. The contracts that create and govern

¹⁰⁵See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

¹⁰⁶Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278-87 (1999).

¹⁰⁷For overviews of the literature, see BERNARD SALANIE, *THE ECONOMICS OF CONTRACTS: A PRIMER* 175-188 (1998); Bengt Holmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73, 75-79 (1998). For precedent treatments in the legal literature, see, e.g., Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249, 1278-79 (1996); William W. Bratton, *Dividends and Noncontractibility*, 19 CARDOZO L.REV. 409 (1997); Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO L. REV. 299 (1993); Phillippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J. L. ECON. & ORG. 381 (1990).

¹⁰⁸To have contract terms that govern future states, those contingent states must be specified and the future outcomes must be computable. Since many future states of nature clearly are not computable, transacting parties as a result lack the technology necessary to enable the negotiation and composition of a contract term *ex ante*. See Luca Anderlini & Leonardo Felli, *Incomplete Written Contracts: Undescribable States of Nature*, 109 Q. J. ECON. 1085 (1994). Alternatively, even where an *ex ante* contract term can be devised in theory, *ex ante* agreement on that contract term will

corporate capital structures are seen as archetypical examples of second-best solutions to noncontractible governance problems. They are empty at the core, omitting important future variables due the difficulty or impossibility of *ex ante* description or *ex post* observation and verification. Shareholders, for example, contribute capital in the absence of terms governing such fundamental matters as investment policy, dividend payout rate, and management remuneration and tenure.

Power, expunged from the economic description of the firm by contractarianism, returns to the center of the picture under this theory. To the extent that advance contractual specification is not feasible, power allocations play a larger governance role and bear importantly on the firm's productivity.¹⁰⁹ More particularly, the contracts governing the rights of the firm's securityholders deal with critical noncontractible future contingencies by providing open-ended processes that facilitate control's allocation and reallocation.¹¹⁰ Reallocations follow from the exercise of contingent powers to control the firm's assets,¹¹¹ powers in some cases vested by the basic terms of corporate law and in other cases vested by contract. The control transfer mechanisms are particularly important when the firm performs badly. They determine whether the shareholders vote out the managers; whether a blockholder emerges to put the managers under effective control; whether a tender offer occurs so as to effect needed change; and whether the bondholders take control of the assets in distress situations.¹¹² The theory proceeds on the assumption that some power allocation mechanisms work better than others and tries to identify the properties of the better arrangements. Toward this end, it models the impact of particular provisions for control transfer on *ex ante* incentives to make firm-specific investments of human and financial capital.

Notably, the "owner" of a particular asset is defined in this context as the party who has the right

not be feasible if in practice a party's future performance of the term will be either unobservable by the counterparty or unverifiable by the enforcing authority. For contributions to the literature making this point, see Sanford Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Bengt Holmstrom & Paul R. Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J. L. ECON. & ORG. 24 (1992)(special issue).

¹⁰⁹Raughuram U. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q. J. ECON. 387 (1998).

¹¹⁰See Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUDIES 473, 479 (1992).

¹¹¹*Id.* at 387.

¹¹²There is disagreement within the incomplete contracts literature respecting the efficient location of control rights, in particular with respect to the debt/equity trade off. See Rajan & Zingales, *supra* note __.

to control all aspects of the asset to the extent not specified in a contract *ex ante*. Ownership is control under this definition and the two cannot be separated. On the surface this looks like a fundamental repudiation of Berle and Means. But the appearance deceives. The concept admits the possibility that ownership can be shared among different claimants.¹¹³ Exercises in the theory that articulate the characteristics of “shared” ownership show that the new model accommodates the management-controlled firm of the Berle and Means characterization. Managers are seen to share control with the equity, retaining “effective” control in most states subject to displacement by the shareholders in exceptional situations.¹¹⁴ As thus extended, incomplete contracts theory comes to bear on production-specific aspects of firm governance—for example, a manufacturer’s decision to make or buy a component part¹¹⁵—in addition to control transfer events like takeovers, proxy contests, and insolvency receiverships. The subject matter for examination in these extensions is not “ownership” of assets *per se* but the grant of access to assets owned by others. Here again the emphasis is on the identification of governance arrangements that encourage firm specific-investment and thereby enhance value.¹¹⁶ To the extent that inherited institutions of control-sharing between managers and shareholder permit managers to invest suboptimally, what Berle and Means called the “separation” of ownership and control remains a significant problem in economic theory.¹¹⁷

The perspective of incomplete contracts theory, thus contextualized, overlaps that of *The Modern Corporation and Private Property*. As noted above, incomplete contracts theory focuses on incentive compatibility, distinguishing features of firm governance structures that encourage optimal output from those that do not. Viewed through the lens of this theory, Berle and Means appear as the original expositors of corporate law’s leading incentive compatibility problem. A perfect incentive system, said Berle and Means, would replicate the motivations of the sole proprietor of classical economics.¹¹⁸ The incentives of actual corporate managers were considerably lower powered. This second-best governance structure could

¹¹³Grossman & Hart, *supra* note __, at 695.

¹¹⁴Mike Burkhart, *et al.*, *Large Shareholders, Monitoring, and the Value of the Firm*, 112 Q. J. ECON. 693, 696, 712 (1997).

¹¹⁵Rajan & Zingales, *supra* note __, at 419-20.

¹¹⁶*Id.* at 387-90.

¹¹⁷OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* (1995), offers a formal expression of this point. The insight is that given managers who derive no private benefits from control of assets, first-best results easily can be achieved (in a taxless world) with an all equity capital structure and a simple incentive compensation system. In a second best-world, however, the compensation required align management incentives with those of the outside security holders is unfeasibly large.

¹¹⁸BERLE & MEANS, *supra* note __, at 9, 308.

persist despite market pressures so long as managers performed well enough to provide investors a satisfactory rate of return.¹¹⁹ They argued that a different scenario would be hard to sustain: If all profits were devoted to the enhancement of shareholder value, managers would have no incentive to do a more efficient job.¹²⁰ At bottom, then, the incentive question concerned the composition of the management compensation pay package.¹²¹ Pending some contractual solution to the incentive problem, there remained an envelope within which managers seeking enhanced power had an incentive to reinvest earnings in projects suboptimal from the shareholder point of view.¹²² Other sorts of management empire building also could detract from shareholder value. For instance, investments in labor standards higher than those prevailing among competing firms also came out of the shareholders pockets even though motivated by concern for employee welfare.¹²³

With this analysis Berle and Means anticipated the leading policy concerns of contemporary corporate legal theory. First, as they suggested, high salaries alone do not provide optimal motivation in the absence of stock ownership. Today's discussion turns to stock option compensation as an amelioration. But an optimal incentive package has yet to appear. Secondly, as they suggested, empire building is highly likely to show up in the system. This is now thought to be less of a problem than formerly, but it took the 1980s' bust up takeover and the 1990s' practice of voluntary corporate unbundling to work generations of imperial accretions out of American corporate structures. Thirdly, as they suggested, management and internally-influential nonshareholder constituents often have common interests contrary to those of the shareholders. The implications of this conflict are worked through in contemporary debates over constituency rights.¹²⁴ Finally, it is noted that Berle and Means did not model the separation of ownership and control as a monolithic phenomenon. They described it as a matter of degree, with the nature and extent of the incentive problem varying from firm to firm. Their five-part typology of control

¹¹⁹*Id.* at 62-65.

¹²⁰*Id.*, at 301-302, 306-7.

¹²¹*Id.* at 302.

¹²²*Id.* at 115-16.

¹²³*Id.*

¹²⁴The best exposition of the constituency rights position is David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in MITCHELL, *supra* note __, at 1-33 (1995).

arrangements¹²⁵ tracks current cutting-edge work in financial economics.¹²⁶

C. The Separation of Ownership Control and Fiduciary Duty

The foregoing discussion shows that Berle and Means endure in corporate law because they accurately described an enduring problem. At a prescriptive level, in contrast, we now know them as the authors of a past paradigm. Their recommendation of equitable judicial intervention makes them famous names who got it wrong, well on the way to joining Douglas and the other legal realists in the back room of history.

This Section reconsiders the book's prescriptive assertions. It makes no attempt to disturb the conventional view that their recommendations landed wide of the mark. But it argues that the distance from the target is shorter than we have come to remember. For one thing, the book makes its suggestions with a modesty markedly in contrast with the aggressive advocacy prevalent in scholarship today.¹²⁷ More importantly, the miss follows less from the book's analysis of corporate problems than from now-discarded progressive assumptions about regulation: Berle and Means lost paradigmatic status for roughly the same reasons that led the Congress to dispense with Chapter X. Finally, the book's failure accurately to predict the future course of corporate fiduciary law stems in part from a development Berle could not reasonably have been expected to anticipate--the rise of the Delaware courts to a dominant place in the making of corporate case law due to the ancillary disappearance of federal common law after *Erie Railroad Co. v. Tompkins*.¹²⁸

Berle and Means' grounded their prescriptive analysis in a normative inference drawn from the separation of ownership and control. Corporate property, they said, should no longer be deemed private property.¹²⁹ That assertion in turn supported a presumption favoring regulation of corporate governance. Yet the book recommended no pervasive system of government oversight. Instead it focused on the

¹²⁵BERLE & MEANS, *supra* note __, at 66-111.

¹²⁶See the typology in Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 476-80 (1999).

¹²⁷Discretion counsels against a statement of particular examples.

¹²⁸304 U.S. 64 (1938).

¹²⁹BERLE & MEANS, *supra* note __, at 219. Here they reflect the thinking of their Columbia colleague, Robert Hale, thought all private property amounted to a delegation of public authority to exclude others from its use. ROBERT HALE, *LEGAL FOUNDATIONS OF CAPITALISM* 327 (). The public aspects of private property were, more generally, discussed in a variety of regulatory and theoretical contexts at the time. For discussion, see FRIED, *supra* note __, at 6-107, 169-75.

problem of management self dealing, reasoning as follows. Management, in the absence of a controlling owner, had *de facto* power to confiscate part of the corporation's wealth.¹³⁰ Corporate law was not presently able to constrain the power of confiscation. It would do a better job if it were rewritten to follow basic principles of trust law. More particularly, there should be a pervasive equitable limitation on powers granted to corporate management (or any other group within the corporation): Power should be exercisable only for the ratable benefit of all the shareholders.¹³¹ The enforcement of the equitable limitation safely could be remitted to the judiciary, the common law of fiduciary duties being the only area of corporate law that had not undergone a steady weakening process due to charter competition. Not a single decided case denied the ultimate trusteeship of managers and controlling groups. "Flexible and realistic" judges, "if untrammelled by statute," could be expected to find solutions to problems that demanded a remedy.¹³²

A point by point review of this program follows in the rest of this Section. The "public" characterization of corporate property comes first. The trust model is considered next. Finally comes Berle and Means' reliance on judicial enforcement of an open-ended standard.

1. Corporate Property as Public Property.

Berle and Means' assertion that corporate property should be placed on the public side of the line between public and private lives on in the appellation "public corporation."¹³³ But it otherwise no longer has any apparent adherents because it asks for a more collectivized society than anyone in the corporate law community will concede in these anti-socialist times. Eradication of Berle and Means' public characterization has been one of contractarianism's points of paradigmatic success. Corporate property once more is private and the presumption now lies against government intervention.¹³⁴ Even a limited, background characterization—corporations as private property with public implications—can be hard to sustain today.

The separation of ownership and control nevertheless survives the contractarian rebuttal, reemerging as the primary source of agency costs. This in turn implies that Berle and Means' fiduciary

¹³⁰*Id.* at 219.

¹³¹*Id.* at 220. A further articulation applied the principle to the powers to issue new stock, to declare dividends (majority to minority freezeout fact patterns), to repurchase stock, and to amend the charter. *Id.* at 221.

¹³²*Id.* at 197, 295.

¹³³Berle and Means used the more accurate term "quasi public." *Id.* at 6.

¹³⁴William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 *Nw. U. L. Rev.* 180, 186-90 (1992).

project never needed to characterize corporate property as public in the first place. It could have proceeded on today's assumption that the separation of ownership and control gives management opportunities to impair shareholder value and that correction can be welfare enhancing. There is an additional implication: While the public characterization does invite the imposition of trust duties, there is no particular reason to expect that performance of a trust for the benefit of a particular group of claimants, such as the shareholders, will satisfy the "public" interest in a world of multiple claims. If unconstrained corporate power creates urgent social problems, then stepped-up enforcement of traditional fiduciary duties holds out no serious prospect of a remedy. Indeed, a "public" coloration does not inevitably follow from the description of a separation of ownership and control. Whatever the incentive and conflict of interest problems resulting from the separation, management and shareholders retain an overwhelming commonality of "private" interest so far as concerns the competing interests of the rest of the world. Berle and Means elide this point, focusing exclusively the modern corporation's failure to replicate the single responsible individual of the classical model.

Berle and Means easily can be forgiven their failure to confront this limitation on their remedial program. Since 1932, problems of corporate social responsibility consistently have proven as hard to remedy as they are easy to diagnose. To go beyond a fiduciary palliative and directly confront corporate social deficiencies is to reconsider the mechanisms of corporate governance from the ground up. Berle appears to have been of two minds on the matter. He is best remembered for the position he took in a back-and-forth with E. Merrick Dodd published in 1932, the same year as the book.¹³⁵ There he stated what remains the majority view: Anything other than unilateral management responsibility to the shareholder interest accords management excessive power and invites incoherent instructions.¹³⁶ In *The Modern Corporation and Private Property*, he struck off in the opposite direction, perhaps influenced by Means' projections of ever-increasing industrial concentration. The book's position anticipates that of today's constituency rights advocates: Since the shareholders had given up responsibility for corporate property, other constituents should join them as corporate beneficiaries. Corporations could be asked to serve the public, with fair wages, job security, and good service to their customers; management must develop into a "purely neutral technocracy."¹³⁷

Berle also can be forgiven this inconsistency. His indecision reflects ambivalence displayed in

¹³⁵A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L.REV. 1365 (1932), E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L.REV. 1145 (1932).

¹³⁶Berle, *supra* note __, at 1367-68.

¹³⁷BERLE & MEANS, *supra* note __, at 7-8, 310-12.

corporate law commentary ever since.¹³⁸ The public-regarding approach persists as a minority view. Each generation raises anew the same questions about corporate accountability because corporations continue to bear importantly on our social and political lives and external regulation can never bring corporate results and perceived social goals into congruence.¹³⁹ At the same time, no advocate of enhanced responsibility has ever successfully confronted and disposed of the counterargument Berle made in the debate with Dodd. The Berle of Berle-Dodd made no attempt to deny the gravity of the social responsibility problem. He merely argued that the managerialist solution on the table would make things worse.

2. The Trust Model.

The Modern Corporation and Private Property presents a trust model of corporate fiduciary duty as a conclusion drawn from a case law synthesis. One nevertheless suspects that Berle knew perfectly well that corporate fiduciary law tends to eschew trust law precedent to follow the more relaxed fiduciary pattern of agency law.¹⁴⁰ The proposal of a stricter regime grounded in trust law, although not without resonances in case law, was less a doctrinal result than a policy construct designed to narrow (if not close) the governance breach opened by the separation of ownership and control.

Trust-based duties had two special jobs to perform in the book. First (and famously), Berle and Means wanted a strict duty of self abnegation to follow at the shareholder level upon acquisition of a control block of stock. Gain from transactions in control should be shared with the entire group of equityholders.¹⁴¹ Second, they wanted trust duties to effect anticontractarian results. The corporate law of a century before had included mandatory restraints on corporate power. The corporate law of 1932 permitted corporate insiders to write their own contracts. Management powers multiplied as a result. Immunity clauses and waivers of shareholder rights went on to make the powers absolute. It followed that much diversion of corporate profit to managers' pockets could be justified in contractual terms.¹⁴² It would take a trust regime to check the trend. Berle and Means had an absolute rule in mind: No language in a corporate charter could deny or defeat the fundamental equitable control of the court. The principle was, they said,

¹³⁸He looked to evolution to make the positions consistent: At present management needed to be reined in; later it might prove up to the task of neutral interest balancing. Berle, *supra* note __, at 1369-70.

¹³⁹For an example from the newest generation, see Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

¹⁴⁰For an overview, see Bratton, *supra* note __, at 144-46.

¹⁴¹He admitted that the result had only tentative support in the case law. BERLE & MEANS, *supra* note __, at 209-218.

¹⁴²*Id.* at 128, 220, 312.

part and parcel of the “object and nature of the corporation itself.”¹⁴³

Berle and Means here anticipated the issue debated by contractarians and anticontractarians a half century later—whether corporate actors can opt out of fiduciary duties by means of a charter provision. The anticontractarians got the better of that discussion, but, significantly, they did not in so doing reassert Berle and Means’ trust model. Instead, they validated mandatory corporate law on process grounds: Open-ended opting out of fiduciary duties should not be permitted because collective action problems disabled effective bargaining on the shareholder side.¹⁴⁴ Thus did the separation of ownership and control remain at the fore of the case for shareholder protection in law even in the absence of a trust model.

The trust model, in fact, never really took an absolute hold on antimanagerialist academic writing in the decades after 1932. Many who followed Berle and Means in arguing for a strong fiduciary posture for corporate law drew on the concept of “shareholder expectations” rather than on trust. This also originated in *The Modern Corporation and Private Property*. It shows up when Berle and Means express doubts about a trust model:

The difficulty is less with theory than with application. It would require an expert and courageous court to apply this theory to most of the corporate problems reaching litigation. For this reason, it cannot be reckoned on as a solution of the major difficulties in the problem. It does indicate, however, that the common law has at its command tools adequate to meet the situation in sufficiently competent hands. The indefiniteness of its application, and the extreme expense and difficulty of litigation, still leave the stockholder virtually helpless. In fact, if not in law, at the moment we are thrown back on the obvious conclusion that a stockholder’s right lies in the expectation of fair dealing rather than in the ability to enforce a series of supposed legal claims.¹⁴⁵

Although the passage is not a model of clarity, the point seems to have been that the trust model probably would not lead to a reliable real world enforcement program, leaving the shareholders with something less, mere “expectations” of fair dealing. That lesser concept went to serve for decades as a primary justification for fiduciary duties in corporate legal theory.

Under expectations theory, as articulated by the successor commentators, the rule against management self-dealing reflects the “expectations” of shareholder beneficiaries.¹⁴⁶ Trust is not absent: The shareholders expect management solicitude as an aspect of their trusting investments. But, ironically, the

¹⁴³*Id.* at 242.

¹⁴⁴Bratton, *supra* note __, at 193-95.

¹⁴⁵BERLE & MEANS, *supra* note __, at 242-43.

¹⁴⁶Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J.CORP.L. 997, 998-99 (1988); David M. Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 RUTGERS. L. REV. 184, 219-20 (1979).

fiduciary mandate becomes attached to the expectation rather than the trust because of the separation of ownership and control. With the public corporation, shareholders and managers do not collaborate directly in the manner of traditional trustees and beneficiaries. The shareholders moreover have the self-protective device of exit through market sale. This attenuates the fiduciary law's behavioral framework of loyalty, weighing against a trust model. Given public trading, "expectations" resonate better. But the Berle and Means paradigm still bears critically. It fills in the background picture of operative expectations: Management's position as essential catalyst of mass production empowers it as against the shareholders, who in turn rely on management capability, probity, and commitment to the interests of the enterprise.¹⁴⁷

Even as expectations theory relied on Berle and Means for content, it held out a possibility of rejection of their prescriptive program. It admitted a retelling of the story of management power and shareholder dependence in contractual terms. The shareholders' very dependence on management leads them "reasonably to expect" management self abnegation. Their investment could not make business sense on any other basis. Reference to contract also helps explain corporate fiduciary law's allowance of fully disclosed and fairly priced self-dealing transactions. Full disclosure moves the party towards an arm's-length posture, and fair price tends as a practical matter to mean comparison with comparable arm's-length transactions.¹⁴⁸ This implies a contractual norm that tolerates self-dealing so long as freely situated parties would do the same deal. On this reading of shareholder expectations, articulation of the content of fiduciary duties becomes a corporate playing out of the contractual search for the intention of the parties.

Expectations theory posited congruence between fiduciary responsibility, economic welfare, and the contractual aspects of corporate relationships. As noted above, that equilibrium depended on a descriptive grounding in the Berle and Means picture of corporate relationships. A change in prevailing description of shareholder expectations could disrupt it, leaving legal theory without a strong basis of support for corporate law's fiduciary regime. The contractarian paradigm effected just that change. It brought mandatory fiduciary rule into question by reversing Berle and Means' presumption favoring regulation. It also replaced expectation theory's reliant shareholder with a rational economic actor expecting the worst and ready to self protect. The assertion that control by itself should give rise to strong fiduciary duties came in for particularly sharp criticism: A gain-sharing rule attending control transactions would chill deals and thereby prevent corporate assets from going to higher valuing users; this in the long run would disserve even minority shareholders.¹⁴⁹

Corporate fiduciary law has survived the contractarian assault. The incentive justification articulated by Berle and Means for the basic rule against self dealing still holds. A control party, they noted, has every incentive to maximize its own returns at the firm's expense: A 60 percent shareholder who sells worthless

¹⁴⁷Bratton, *supra* note __, 413-14.

¹⁴⁸Eisenberg, *supra* note __, at 998-99.

¹⁴⁹EASTERBROOK & FISCHER, *supra* note __, at 109-44.

property to the firm for \$1 million loses only a proportional \$600,000 on the deal and so comes out \$400,000 ahead at the minority's expense.¹⁵⁰ On the other hand, equal sharing of gains never became the rule respecting transfers of control. The two famous cases that move in that direction, *Perlman v. Feldman*,¹⁵¹ and *Jones v. H.F. Ahmanson & Co.*,¹⁵² sit quietly by themselves in the reporters. Their invitations to a generalized gain-sharing constraint have not been accepted. But they seem to be good law in their narrow spheres, constraining parties in sale of control transactions. More importantly, gain-sharing concerns now pervade the law of mergers and acquisitions. They motivate Delaware law's procedural rules respecting the accomplishment of cash out mergers between parents and majority-held subsidiaries¹⁵³ and its fiduciary constraints on defenses against hostile takeovers.¹⁵⁴ Meanwhile, even as the presumption in corporate legal theory lies against new regulation, the inherited fiduciary regime enjoys a steadily-expanding base of support from economic theory.¹⁵⁵ It also enjoys strengthening empirical support from comparative studies of corporate governance regimes world wide. These show a direct correlation between fiduciary protection, shareholder value, and depth of trading markets.¹⁵⁶

3. Judicial Enforcement.

Berle and Means' trust model differs from Douglas' Chapter X in following legal realism's private law side in its view of the common law judge. It presupposes that judges can master complex business fact patterns and then successfully apply a fairness rule or standard. But the book also expresses serious doubts: As the passage quoted above shows,¹⁵⁷ it questioned whether most judges had talent or courage

¹⁵⁰BERLE & MEANS, *supra* note __, at 114. For a contemporary restatement, see Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1462-63 (1992).

¹⁵¹219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

¹⁵²460 P.2d 464 (Cal. 1969).

¹⁵³*See, e.g.,* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

¹⁵⁴*See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989); Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

¹⁵⁵*See, e.g.,* Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J. L. ECON. & ORG. 487 (1999); Talley, *supra* note __.

¹⁵⁶*See, e.g.,* La Porta, et al, *supra* note __; Raphael La Porta, et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

¹⁵⁷*See supra* test accompanying note __.

needed for the realist role of judge as regulator; even if the judges had the right stuff, it was not clear that plaintiffs would have incentives to prosecute the necessary lawsuits. Berle and Means hedged their predictions accordingly. The hedge extended even to judicial constraint of corporate control transactions, so central to the program: Control transfers would most likely remain outside the “normal cognizance” of corporate law.¹⁵⁸

Despite the doubts, Berle and Means remitted the problem of separation of ownership and control to a “flexible and realistic” judiciary. They thereby tied their paradigm’s plausibility to the level confidence in judicial enforcement. Confidence waned even as the paradigm held sway. We see this in the work of two of its later exponents, Victor Brudney and Marvin Chirelstein. In a series of articles making strong, practical cases for gain sharing, Brudney and Chirelstein dispensed with the Berle and Means’ open-ended standards. Echoing the Douglas of Chapter X, they substituted *per se* rules, directives that flatly prohibited certain suspect practices, tying the case for extending the fairness regime to a call for a diminished zone of judicial discretion.¹⁵⁹

Brudney and Chirelstein’s suggestions did not for the most part find their way into the case law¹⁶⁰ any more than did Berle’s. But the cumulated pressure of these and other commentators did prompt some changes. Quite a few control transactions came under legal cognizance in the post-war period. But the trend favors process scrutiny. Reference is made again to Delaware’s cases on cashout mergers. These deal with a one-sided control transaction by encouraging the dominant party to participate in a constructed bargaining process. A specially-designated fiduciary is inserted to bargain on behalf of the formerly powerless minority shareholders. The judge then reviews the process, including the resulting bargain. If the process passes, the transaction itself avoids substantive fairness scrutiny under an open-ended standard.

The move to a fiduciary regime built on bargaining under constraint parallels the development of the law of corporate reorganization in the transition from Chapter X to the Bankruptcy Code. In both contexts (1) plausible, if imperfect, contractual solutions are favored over direct judicial application of a fairness standard; (2) judicial review remains integral to the system, but proceeds in the less highly-charged and less technically-demanding framework of process review, and (3) fairness

¹⁵⁸BERLE & MEANS, *supra* note ___, at 218.

¹⁵⁹See Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978)(suggesting that all going private transactions be prohibited); Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974)(suggesting that gains resulting from mergers of subsidiaries into parent corporations be divided equally between the parent and the subsidiary as a percentage premerger values).

¹⁶⁰The exception is *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir.), *cert. denied* 434 U.S. 922 (1977).

scrutiny plays a shadowy role, looming in the background as a threat to encourage the parties to keep the constructed bargaining process reasonably clean. The shift to process scrutiny serves the same institutional purpose in both contexts: The judge no longer has to determine the fair value of the company in reliance on valuation evidence proffered (and manipulated) by expert witnesses. Both Chapter X and the trust model fell short at this point in the scenario. Corporate value depends on projections about uncertain future events, events that unfold in a dynamic environment. Of course, such projections of value must be grounded in historical results, even in volatile securities markets.¹⁶¹ Judicial valuation through fact finding therefore is at least plausible. The problem comes at the bottom line. There financial science fails to yield a single, ascertainable true or intrinsic value figure, only a range of possibilities. Selection of a figure in the range follows from intuitions. Such an intuitive result carries greater legitimacy when derived in a bargaining process than when derived in a litigation process.

It bears noting that a fairness regime could be constructed so as to ameliorate valuation's indeterminacy. A system could, for example, make a normative commitment to the welfare of the disadvantaged party and instruct the judge to choose a value from the end of the range aligned with that party's interests. But just as the 1978 bankruptcy reform lacked a strong normative commitment to the bondholder interest, so corporate law has remained unwilling either to elevate the interest of the minority shareholder or even to mandate value maximization for the shareholders as a group. At this normative level Delaware law plays the leading role. Indeed, Brudney and Chirelstein's disenchantment with judicial discretion may have reflected dissatisfaction with the Delaware courts' normative performance.

The Delaware courts shut the trust model out of decided cases throughout the period of Berle and Means' paradigmatic ascendancy. They responded to a market demand in so doing. Large corporations tend to choose Delaware incorporation and Delaware judicial responsiveness to management concerns figures importantly in those choices.¹⁶² The Delaware courts demonstrated that responsiveness by refusing to open themselves to Berle and Means' influence. They thereby foreclosed the possibility of a theory to practice transition for Berle and Means' prescriptive program.

Significantly, *The Modern Corporation and Private Property* mentions its future judicial nemesis only once. It acknowledges Delaware as "the loosest of jurisdictions" even as it credits its judiciary with

¹⁶¹The prices of dot com stocks provide a recent case of an exception. But as the statement in the text would predict, such exceptions tend to be short-lived and dot com prices did indeed collapse during the latter part of 2000.

¹⁶²ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 32-40 (1993)

adherence to equitable principles,¹⁶³ citing a dictum in a 1928 Chancery opinion¹⁶⁴ that endorsed the vested rights theory of preferred stockholder protection. The book's characterization quickly turned out to be inaccurate. Eight years after the books' publication, in the landmark case of *Federal United Corp. v. Havender*,¹⁶⁵ the Delaware courts rejected vested rights protection for preferred stockholders. *Havender* also took a giant step toward containing judicial discretion to police transactions for unfairness by inventing Delaware's doctrine of independent legal significance. Under this, the courts apply the state's corporate code literally, like a collection of legal forms in an office file drawer, and refrain from drawing policy inferences that might constrain corporate actors' transactional discretion. *Havender* amounts to a judicial review of Berle and Means' book. The book singles out the courts and their equitable discretion as a bulwark against laxity in the drafting of corporate codes and charters. *Havender* falsified the book's description as it narrowed the field for equitable intervention.

Berle, then, failed to appreciate charter competition's institutional implications and to predict the leading role of the Delaware courts. The miss presents a bit of a puzzle, for Berle was well aware of Delaware's success as a charter-mongerer. His casebook includes an empirical study (conducted by Means) of the states of incorporation of New York Stock Exchange companies. It shows a clear trend in Delaware's favor, with a 55 percent share of charters since 1922.¹⁶⁶ Berle also had served, in 1928-1929, on a committee organized by The Corporation Trust Company to recommend changes in Delaware's corporate code. There Berle got a first hand look at Delaware's corporate legislative process. Changes approved by the committee and sent on to the Delaware Bar Association were rubber stamped. But Berle's recommendations of provisions to protect small shareholders never got out of committee.¹⁶⁷ Soon thereafter his book would describe all corporate law judges, in Delaware and elsewhere, as wielders of equitable principles from positions of independence, impervious to competitive pressure.¹⁶⁸ He saw Delaware and charter competition as implicating laxity in corporate legislation but not in corporate judging. The judicially-enforced trust model, he hoped, simultaneously would ameliorate the competition problem and the problem of the separation of ownership and control.

¹⁶³Berle & Means, *supra* note __, at 237. They assert confidently that Delaware adheres to vested rights protection of preferred stockholders. Delaware was to abandon that position only a few years later.

¹⁶⁴*Davis v. Louisville Gas & Elec. Co.*, 142 A. 654 (Del. Ch. 1928).

¹⁶⁵11 A.2d 331 (1940).

¹⁶⁶BERLE, *supra* note __, at 122-125.

¹⁶⁷SCHWARZ, *supra* note __, at 55.

¹⁶⁸CF. BERLE & MEANS, *supra* note __, at 197, noting that fiduciary duty was the only are of corporate law that had not weakened and commending judicial intervention "untrammled by statute."

He hoped in vain. But we can forgive Berle this one last shortcoming. The solution to the puzzle lies in *Erie Railroad Co. v. Tompkins*,¹⁶⁹ decided in 1938. Prior to *Erie* a corporate law plaintiff who could establish diversity got to choose between not only state and federal venues but state and federal common law. The case law synthesis in *The Modern Corporation and Private Property* includes federal common law cases as well as state cases, without noting any distinction between the two.¹⁷⁰ Given an independent, competing federal common law judiciary, Berle's assumptions about the judicial role are not unreasonable.¹⁷¹ Delaware could take the charters and legislate the code, but many plaintiffs could circumvent its courts and case law by going into federal court under federal common law. For Berle, then, the key point was to make sure that that common law fiduciary duties remained mandatory. *Erie* frustrated the plan by according the Delaware judiciary an authoritative voice.

The Modern Corporation and Private Property came to need a pocket part responding to the appearance of the authoritative (and hostile) Delaware judiciary. Berle never wrote the sequel.

¹⁶⁹304 U.S. 64 (1938).

¹⁷⁰See *Handley v. Stutz*, 139 U.S. 417 (1891); *Barclay v. Wabash R Co.*, 30 F.2d 260 (2d Cir. 1929); *Atlantic Refining Co. v. Hodgman*, 13 F.2d 781 (3d Cir. 1926); *Jones v. Missouri-Edison Elec. Co.*, 144 F.2d 765 (8th Cir. 1906); *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.2d 533 (D.R.I. 1929); *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924); *Brown v. Pennsylvania Canal Co.*, 229 F. 444 (E.D.Pa. 1916). Cf. *Strong v. Repide*, 213 U.S. 419 (1909)(deciding dispute respecting corporation doing business in the Phillipines). All of these cases follow the same practice respecting case law authority. Reference is made indiscriminately to other federal court corporate law decisions and to state court decisions, principally from New York and New Jersey. No special recognition is accorded the case law of the state of incorporation.

¹⁷¹Federal courts in corporate cases where jurisdiction was based on diversity did not ignore the chartering state and its law completely, however. The internal affairs doctrine also came to bear with the result that a federal court in diversity not located in the chartering state might decline to take jurisdiction and remit the parties to courts in the state of incorporation. But where assets and parties had only nominal contacts with the chartering state, it was deemed expedient to take jurisdiction provided the relief requested did not implicate "visitorial" powers. Once jurisdiction was held to obtain, the case was decided as a matter of federal equity. *Williamson v. Missouri-Kansas Pipeline Co.*, 56 F.2d 503, 507-10 (7th Cir. 1932)(taking jurisdiction over a Delaware corporation the assets and parties of which resided in Illinois). See also *Rogers v. Guaranty Trust Co.*, 288 U.S. 123 () (holding that a federal court should decline jurisdiction over a shareholder suit implicating internal affairs where convenience efficiency and justice pointed to the courts of the chartering state). State courts reasoned analogously, despite the internal affairs doctrine. See JOSEPH HENRY BEALE, JR., *BEALE ON FOREIGN CORPORATIONS* §§ 305, 312 (1904)(noting that in the case of a "quasi public corporation" with nominal contacts with its chartering state, the courts of the shareholders' state will take equitable jurisdiction to prevent theft).

Appropriately enough, when a sequel did appear it came from a member of the Columbia law faculty. This occurred in 1974 in the form the famous indictment of Delaware law in William L. Cary's *Federalism and Corporate Law: Reflections on Delaware*.¹⁷² Cary reviewed leading Delaware opinions and concluded that Delaware had "no public policy left . . . other than the objective of raising revenue."¹⁷³ A reference to Berle and Means helps us understand Cary's anger. They had shown the high road and Delaware had chosen not to take it.

CONCLUSION

Berle and Means' trust model never came to be adopted in either corporate law or corporate legal theory. But the part succeeded where the whole did not: Shareholder value maximization is more embedded than ever as the field's governing norm, and Berle and Means are its leading historical exponents. Of course, the shareholder value norm succeeds today at a self-regulatory level to some extent, confirming the judgment Berle reached as a Wall Street lawyer prior to becoming the Berle of law and economics. But the degree and persistence of self-regulatory success remains unclear. Berle and Means and the separation of ownership and control therefore remain relevant and fiduciary standards remain a primary concern in corporate governance.

Berle and Means have played a secondary, but still critical role in the shaping of corporate fiduciary law. There the trust model has been the thesis deployed against the antithesis of contractarianism, first as wielded by early twentieth century lawyers and later as wielded by late century lawyer economists. Although neither the thesis nor the antithesis has prevailed in theory or in law, each has highlighted the weaknesses in the other and influenced the emergent synthesis. The synthesis is process scrutiny under the fiduciary rubric. It bespeaks a consensus that Berle and Means (and Douglas) were right to reject free contract as an institution suited to securityholders with collective action problems, but wrong to assume strict legal scrutiny in the trustee-beneficiary mode to be the only viable remedy. The synthesis evolves by trial and error. Crucial contributions have come from variant sources--the drafters of the 1978 bankruptcy reform, the Delaware judiciary, the institutional investor activists, and the academics who worked out the real world implications of the microeconomics of corporate governance. Where contract proves plausible, it deflects full dress fiduciary treatment. But contract is not always plausible. So the trust reproach remains essential to the evolutionary dynamic and Berle and Means' book remains its essential text.

Berle and Means also have a place in the global venue. Fiduciary standards have become a concern in other corporate governance systems. In Europe, for example, protection of the rights of minority shareholders sits atop the agendas of today's corporate law reformers. They seek to expand the depth of

¹⁷²William L. Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L. J. 663 (1974).

¹⁷³*Id.* at 684. See also Marvin A. Chirelstein, *Towards a Federal Fiduciary Standards Act*, 30 CLEVE. ST. L. REV. 203 (1981).

their domestic trading markets and reason, along with Berle and Means, that robust markets depend on legal infrastructures that constrain insider self-dealing.¹⁷⁴ Berle's back-and-forth on corporate social responsibility also echoes in the global conversation. The usual argument made by those who side with the Berle of the Berle-Dodd is that social demands should be met by external regulation or wealth redistribution through taxation and transfer payments. The argument has had its effect, providing the definitive response to proposals for corporate governance reform that look to enhanced social responsibility. But it rings hollow in the global venue, which lacks a plausible sovereign regulator. Corporations take advantage of this open territory, using various means of regulatory arbitrage to escape domestic regulation and avoid paying taxes.¹⁷⁵ The corporate responsibility question becomes more serious as the arbitrage succeeds. We could yet see the global conversation lurch to the Berle of Berle and Means and renew the demand for a "neutral technocracy."

¹⁷⁴William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANS. L. 213, 268-71 (1999); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999).

¹⁷⁵See generally Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).