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Changes in government policy occur frequently and can significantly affect the value of investments. Depending on the type of action and design of the policy, the government may be obligated to provide compensation for losses in investment value. As a normative matter, whether these losses should be compensated has inspired a long-running academic discussion, with arguments against government compensation currently holding the high ground. But, this discussion has failed to investigate whether changes to corporate governance policy are similar to the standard model against compensation for policy change. In particular, a corporation combines a variety of economic interests and decisionmakers that permits opportunistic behavior in ways not considered in the compensation debate. The ongoing development of corporate governance in the United States and abroad raises concerns whether the presumption against compensation sufficiently addresses this risk of opportunism due to changes in corporate policy. This article identifies the potential for opportunistic behavior within a corporation and proposes a scheme of redistributive compensation to mitigate such behavior. Requiring an equitable distribution of gains created by policy change can reduce the potential for opportunism under a market approach and substantially improve the quality of corporate decisions.

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INTRODUCTION

As part of daily operations, governments make decisions and implement legislation that change the value of corporate rights. The decision to promote one policy may have a tremendous effect on the constituents of a corporation. For example, the takeover wars of the 1980s prompted policy changes that reallocated corporate rights and wealth: constituency statutes empowered boards and non-shareholder constituents vis-à-vis shareholders.[1] More recently, Europe has continued its steady march of improving corporate governance through community-wide regulations and member-country legal reform, including a review of the role of disparate shareholder voting power and introduction of a European community-wide corporate entity.[2] Each of these changes creates the potential for unintended changes in corporate rights and wealth.

This article addresses whether compensation should be provided for decreases in value caused by corporate governance policy change. In most countries, the government's power to take or destroy private property is constrained by the requirement that owners be compensated for their losses. While the exercise of eminent domain powers by a government is a textbook situation for government compensation, the compensation doctrine has been extended considerably.[3] This includes legal decisions paying compensation for regulatory takings and academic works assessing the general scope and efficiency of government compensation.

Scholarship discussing compensation has, predictably, ranged from endorsing full compensation for all losses stemming from

1. Constituency statutes were subject to considerable academic debate: Proponents defended the additional protection while opponents were shocked by the apparent sleight of hand. *See* Henry N. Butler, *Corporation Specific Anti-takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365, 366 *1988) ("Takeover-specific laws typically are passed in emergency legislative sessions, with little if any notice to shareholders, and often result in the defeat of takeovers that had promised to pay a substantial premium to the target corporation's shareholders."). S*ee generally* Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987); Ronald Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982).

2. An example is the development of the European Company Statute (Societas Europaea, or SE company). *See, e.g.*, Council Regulation 2157/2001, 2001 O.J. (L 294) 1 (EC). Effective as of October 2004, the legislation permits the formation of a limited liability SE company. This is in line with the broader trend for facilitation of intrastate interaction rather than community-wide mandatory regulation. This was the recommendation of the 2002 Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States, which urged the EU not to focus on a community-wide corporate code but instead focus on reducing legal and regulatory barriers to cross-border voting and governance. *Id*. at 7. Similarly, the European Union also considered mandating proportional voting for European companies in 2005. For further discussion, *see infra* notes 150–52.

3. *See* discussion *infra* Part II.

government action[4] to arguments against providing any compensation.[5] The former perspective finds a legal foundation in the Fifth Amendment, which creates a private right to receive compensation from the federal government when private property is taken for public use,[6] and efficiency arguments.[7] In contrast, the transitional policy arguments advocated by Louis Kaplow are the best example of the no-compensation perspective, arguing that government policy change is similar to market risk and traditional market mechanisms, such as insurance and investment diversification, are sufficient to mitigate the associated losses.[8]

There is potential for intracorporate opportunism in corporations that differs from previous compensation analyses. Efficiency arguments have focused on ensuring optimal behavior by decisionmakers, with compensation being viewed either as necessary to correct market failures[9] or as a damaging externality.[10] These arguments have correctly set the stage—can compensation ensure efficient behavior in light of corporate governance policy change—but have not examined the complexity introduced by a decisionmaker with the power to externalize decision costs and hoard decision-related gains. Instead, the variety of interests compacted into a single corporation means that neither government compensation nor a no-compensation policy results in efficient decisions.

Corporations differ significantly from the models used in prior compensation analyses. An implicit assumption in most prior works is that the decisionmaker benefits from all gains, and bears all risks, of his or her decisions. Corporate governance change may have a different impact on the various corporate constituents, including the board of directors, shareholders and stakeholders, which may permit decisionmakers to assess the risk of government change *ex ante* and

4. *See generally* RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN (1985).

5. Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 541 (1986) [hereinafter Kaplow I].

6. The meaning and reach of this amendment has been subject to numerous critiques, the preference for assessing whether the government should provide full compensation, meaning an amount equal to the entire value of the taking ("just compensation"), for a government taking has generally been the starting point for compensation critiques.

7. Lawrence Blume and Daniel Rubinfeld have argued that compensation is efficient for real property takings. *See generally* Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CAL. L. REV. 569 (1984). *See also* Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129 (1996).

8. Kaplow I, *supra* note 5, at 513; *see also* David M. Hasen, *Legal Transitions and the Problem of Reliance*, 1 COLUM. J. TAX L. 120 (2010) (discussing and critiquing legal transition literature in general for its conceptual shortcomings).

9. Blume & Rubinfeld, *supra* note 7, at 582.

10. Kaplow I, *supra* note 5, at 531.

shift the costs of corporate policy. This complication considerably weakens arguments for relying on the market to properly discipline decisionmakers.

Existing rules have not fully accounted for opportunistic intra-corporate wealth transfers caused by a change in the controlling corporate policy or provided a comprehensive approach to the risk of opportunism within the corporation, including between the board and employees or between shareholders. Traditional corporate governance has coped well with the risk of misbehavior by management and general agency problems, through general fiduciary duties[11] and situational mandates reducing the risk of abusive behavior.[12] Recognition of control problems once the ownership of business entity becomes dispersed[13] and the costs of trying to mitigate these problems, in particular, agency costs,[14] have been a contested area of scholarship for the past eighty years. But, corporate governance policy change permits opportunistic transfers of wealth and inefficient decisionmaking that are not fully captured by corporate governance norms.

This article proposes requiring redistributive compensation in situations prone to opportunistic behavior. Requiring redistribution of gains received from opportunistic behavior from winners caused by government policy changes can mitigate key problems that are unique to the corporation. First, redistribution can force decisionmakers to internalize the costs of *ex ante* decisions that exploit other corporate constituents and reduce the potential for moral hazard. Second, requiring equitable redistribution of unanticipated gains and losses due to policy change can significantly reduce opportunism.

Part II of this article introduces an example of opportunism in the context of an *ex ante* corporate governance policy change. Using codetermination as an example, Part II will illustrate how the current approaches to government compensation, no-compensation and full government compensation approaches, fail to ensure efficient decisions due to moral hazard problems that are not adequately integrated into either approach. Similarly, standard corporate

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11. In the United States, the fiduciary duties of care and loyalty provide a general mandate that the board of directors and managers of a corporation must strive to enhance shareholder, rather than personal, value.

12. This would include duties on controlling shareholders not to permit looting and the judicial protections imposed in worrisome transactions, like freeze-out mergers. *See generally* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

13. *See generally* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Transaction Publishers rev. ed. 1991).

14. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 10 (1991).

governance protections against intracorporate opportunism fail to address this type of risk and permit unguarded abuses.

Part III discusses the potential for redistributive compensation to promote efficient decisions. Establishing a default rule requiring redistribution of windfall gains to transition losers can ensure that decisionmakers properly include the cost of corporate wealth transfers in their decisions. Thus, redistribution forces an accurate accounting of transaction costs, rather than permitting opportunistic wealth transfers to be obscured by legal impotence. Not only can redistribution cure opportunism, the corporation provides an ideal environment for equitably distributing wealth. Corporate hierarchies include bodies that can act by fiat and accounting competencies that can properly assess gains and losses. This Part will also provide a test for determining when redistribution is required.

Part IV extends the analysis from *ex ante* to *ex post* efficiency. Investments in firms by corporate constituents differ from market investments in that they are firm specific, and may not be fully diversifiable. Similarly, corporate constituents may not be in position to respond properly to risk due to collective action problems or liquidity constraints or the lack of appropriate insurance or other risk management mechanisms. If we assume that parties are generally content with the status quo, any attempt to restore the status quo can be beset with opportunism by the beneficiaries of the governance change. This can be particularly galling for investor-specific governance features, like control rights. This Part will look at how a default rule in favor of redistributive compensation can result in efficient wealth transfers upon the elimination of multiple-vote shares.

Part V briefly discusses some of the complications related to implementing a redistributive compensation scheme. Many of the existing state-law corporate governance mechanisms are based on fiduciary duties, while federal rules have imposed an ever-increasing number of requirements on the boards of publicly traded companies. To the degree that redistribution creates additional duties within the corporation, it will ultimately conflict with existing corporate governance norms, including the business judgment rule. Bookending the previously described Parts, Part I provides a general background on takings, transitional policy and efficiency-based compensation arguments and Part VI is the conclusion.

II. THE DEBATE REGARDING COMPENSATION

Whether a party should be compensated for losses incurred due to government action has been fraught with debate.[15] Literature related to this question tends to focus on a single area of law, like property takings or taxation, and strives to establish a general principal. Yet, when reviewing compensation works, it is difficult to find articles addressing problems that are fundamental to corporations.[16] Discussions about compensation are often focused on full compensation for losses provided by the government, with its genesis in the Fifth Amendment.[17] In contrast, Louis Kaplow's discussion of transitional policy significantly expanded this inquiry to include whether compensation for any losses caused by changes in government policy should be compensated.[18] He proposed that government compensation distorted investment decisions and market mechanisms were more efficient.[19] This Part will briefly introduce takings jurisprudence and transitional policy to provide a foundation for the discussions that will follow. In this article, compensation refers to any amelioration of losses in investment value due to a policy change by the government, whether provided by the government or private parties.

A. TAKINGS

Takings compensation by the government provides the foundation for government compensation for private loss.[20] The Fifth Amendment to the Constitution prohibits the taking of private property for public use without just compensation.[21] The most

15. One commentator nominating the issue for "the doctrine-in-most-desperate-need-of-a-principle prize." Jed Rubenfeld, *Usings*, 102 YALE L.J. 1077, 1081 (1993).

16. Ronald Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 233 (2008).

17. The meaning and reach of this amendment has been subject to numerous critiques, the preference for assessing whether the government should provide full, meaning an amount equal to the entire value of the taking ("just compensation"), for a government taking has generally been the starting point for compensation critiques. For example, "just compensation" or "fair market value" ignores the private value that an individual may have for a property that includes sentimental attachment. Similarly, the incentives presented by compensation have played a major role in compensation analyses. *See* Blume & Rubinfeld, *supra* note 7, at 618.

18. Kaplow I, *supra* note 5, at 515.

19. *Id.* at 541.

20. For a general history of the taking clauses, *see* William Treanor, *The Original Understanding of the Takings Clause and the Political Process*, 95 COLUM. L. REV. 782 (1995).

21. "[N]or shall private property be taken for public use, without just compensation." U.S. CONST. amend. V.

common application is eminent domain, which is justified by the government's ability to provide increased public benefits at the expense of a private individual such as the destruction of a private residence to build a freeway.[22] In this example, the general populace benefits from the use of the freeway, and any growth and economic benefits provided by the freeway.[23] The compensation provided to the private party is due to the inequity of "forc[ing] some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[24]

In *Pennsylvania Coal Co. v. Mahon* the traditional takings doctrine was extended to include compensation by the government for the destruction of property value, even absent a corresponding destruction of physical property.[25] Previously, the United States Supreme Court had consistently held that regulation of harmful acts utilizing police power could be accomplished without compensation, regardless of diminution of value.[26] *Pennsylvania Coal* concerned a family who lived on a property bought from the Pennsylvania Coal Company, which had retained the mining rights associated with the property.[27] When the Pennsylvania legislature enacted a statute prohibiting mining that could cause the subsidence of residences, the family brought suit arguing that the no-liability provision was invalid.[28]

The Supreme Court recognized that excessive regulation could constitute a taking requiring appropriate compensation for the lost value, with Justice Holmes declaring that "while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."[29] The difficulty of consistently implementing this test has dogged takings cases ever since.[30] In *Penn Central*

22. *See, e.g.*, Kelo v. City of New London, 545 U.S. 469 (2005) (holding government use of eminent domain power is permissible to transfer private property to another private owner, provided that general benefits to the community were sufficient to satisfy the public use component).

23. Blume & Rubinfeld, *supra* note 7, at 571 ("[A] government's decision to 'take' property is best seen in light of the efficient distribution of costs associated with land use regulation.").

24. Armstrong v. United States, 364 U.S. 40, 49 (1960). But *see* Treanor, *supra* note 20 ("[I]t appears that the just compensation requirement was inspired by the fear that the political process could not adequately protect physical possession of property.").

25. 260 U.S. 393 (1922).

26. Treanor, *supra* note 20, at 801.

27. *Pennsylvania Coal*, 260 U.S. at 411.

28. *Id.* at 413 (referring to the Kohler Act approved in 1921).

29. *Id.* at 415. The court did not actually require government compensation in this instance; instead, the Pennsylvania statute was invalidated. Blume & Rubinfeld, *supra* note 7, at 570.

30. This decision has been extremely controversial due to its expansion of the takings doctrine and the uncertainty it introduced. William Treanor argues that the original intent of the Fifth Amendment was to apply the takings clause only to physical takings. *Supra* note 20. He further argues that *Pennsylvania Coal* "represented the culmination of Justice Holmes's career-long critique of a physicalist view of property and the attendant view of the Takings Clause" and

Transportation Co. v. New York City, the Court enunciated a tripartite test that distinguished between compensable permanent physical invasions, noncompensable regulation of noxious uses and the compensable destruction of all value associated with property.[31] This test has been used in a variety of cases, including ones which have provided compensation for an airport flight path destroying the value of property directly beneath it (although excluding any neighboring properties)[32] and compensation to a property developer when new regulations prohibited plans for developing beachfront properties.[33]

Discussion of the merits of government compensation has not been limited to judicial interpretation—the takings clause has also been subject to considerable academic discussion.[34] Lawrence Blume and Daniel Rubinfeld performed an economic analysis in favor of providing government compensation in limited situations. They argued that compensation is efficient as a form of insurance against regulatory risks, provided that the loss is substantial and a party is risk averse.[35] Importantly, Blume and Rubinfeld established a discussion regarding the positive effect that compensation could have on market efficiency by divorcing social benefits of policy change from the contingent income redistribution. Blume and Rubinfeld noted that a number of problems with simply implementing beneficial legislature, including unfair wealth distribution and free-riding, can be addressed through payment of compensation.[36]

While not part of legal canon, the standard takings analysis has also been analytically extended by Abraham Bell and Gideon Parchomovsky, who argue that there are in fact three types of takings:

was an opportunity for the Court to "review the full range of majoritarian decisionmaking concerning property rights." 260 U.S. at 798, 802. This decision is also criticized by Jed Rubenfeld. *Supra* note 15, at 1088.

31. 438 U.S. 104, 130 (1978).

32. *E.g.*, United States v. Causby, 328 U.S. 256, 262–63 (1978).

33. Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1020–22 (1992).

34. Abraham Bell & Gideon Parchomovsky provide a brief introduction to several of these theories in their essay, *Takings Reassessed*, 87 VA. L. REV. 277, 287–89 (2001) [hereinafter Bell & Parchomovsky I]. They note, though, that "[f]ew of these theories attempt to do more than identify the difference between regulatory takings and noncompensable exercises of the police power." *Id.* at 289.

35. Blume & Rubinfeld, *supra* note 7, at 609. This discussion was specific to compensation for taking real property and focused on the risk of market failure for small landowners. *See id.* at 597.

36. *Id.* at 581. Note that every article discussing the efficiency of compensation is premised upon the government's desire to implement socially beneficial change. The government's ability to actually affect beneficial change is a different question plagued with a considerable murkier answer. *See* Bell & Parchomovsky, *supra* note 34, at 292 (describing the treatment of the South Carolina beachfront property, which included losing money on a subsequent resale to a different developer).

physical takings, regulatory takings, and derivative takings.[37] Their innovation, the derivative taking, "is present whenever a taking diminishes the value of surrounding property."[38] Derivative takings address any other losses that occur with a taking but are not covered by current doctrine. For example, derivative takings address the inconsistency of permitting an individual who loses the entire value of his property to be made whole, while his neighbor, who loses a portion of her property value, is unable to recover anything.[39] These results are inconsistent and indicate that that the victim of the derivative taking should be entitled to some right to compensation for losses.[40]

B. TRANSITIONAL POLICY

A transition is defined as "whenever an act has future consequences and the legal regime applicable to those future consequences is not known with certainty at the outset." Louis Kaplow's work on transitional policy raised a new question regarding whether compensation should be provided for decreases in value of any investment due to government action. In contrast with existing work on compensation, grandfathering and other beneficial transitions, Kaplow built on previous arguments by Michael Graetz and argued that no transitional relief should be provided.[41] Kaplow asserted that market forces were sufficient to motivate market players to make optimal investment choices.[42] He further argued that this analysis was applicable to *all* types of government policy change because most decreases in value caused by government action have substantial similarities.[43] Thus, compensation "disturbs rather than

37. Bell & Parchomovsky I, *supra* note 34, at 297–81. This essay argued for an evaluatory framework for derivative takings that focused on using self-assessment to reach a fair price.

38. *Id.* at 280. While derivative takings share some similarities with regulatory takings, derivative takings are distinguished by the fact that they can arise from a physical taking. *Id.*

39. In *United States v. Causby*, for example, the neighbors of the homeowners suffered similar problems but received no compensation. Bell & Parchomovsky I, *supra* note 34, at 293.

40. The obvious problem is determining how much the derivative taking should be compensated. Bell and Parchomovsky propose a system of self-assessment that penalizes lying and requires the recipients to fairly estimate their losses. *Id*. at 300–10.

41. Louis Kaplow, *Transition Policy: A Conceptual Framework* 2 (Harvard Law Sch. John M. Olin Center for Law, Econ. & Bus. Discussion Paper Series, Working Paper No. 412 2003), *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1200&context=harvard_olin [hereinafter Kaplow II].

42. This is based on three assumptions: a market participant is aware of the transitional policy at the time of investment and can anticipate the disposition of the investment after a governmental policy change, a given transitional policy will be consistently applied in the future and the proposed change is beneficial. Logue, *supra* note 7, at 1153.

43. *Id*. at 1135 ("Although [Kaplow's] article focuses on the issue of tax transition losses, much of the analysis applies to other legal transitions as well.").

corrects a properly functioning market" by distorting risks and incentives for market participants.[44]

The transitional policy analysis sets risk and incentives as proper factors for assessing investment decisions *ex ante*. Kaplow argued that the risk of governmental policy change is similar to the risk associated with typical market change and, as such, can be handled in a manner similar to market change.[45] First, traditional risk spreading, such as diversification, can be employed to mitigate transitional losses rendered in the *ex post* distribution.[46] Second, privately provided insurance can more effectively assess and pay for losses caused by transitional policy than a government-administered program.[47]

Similarly, any compensation for decreases in investment value is inefficient because it insulates investors from the effects of their decisions and distorts otherwise efficient behavior. Kaplow views government compensation as "[s]imply put . . . an externality that otherwise would not be present."[48] Without compensation, the investor would factor in the risk of change and only make investments that are likely to be profitable on their merits. This consideration is based on how a rational actor responds to the incentives of a transitional policy. Ultimately, "[t]he efficient level of investment is that induced when investors bear all real costs and benefits of their decisions. Therefore, the encouragement resulting from the assurance that compensation or other protection will be provided in the event of change results in overinvestment."[49] Kaplow's transactional policy argument generated considerable commentary since its inception.[50]

44. Kaplow I, *supra* note 5, at 520.

45. Logue, *supra* note 7, at 1153 ("The Graetz-Kaplow position is simple yet powerful: Just as the government does not generally provide insurance to private investors for market contingencies (such as the risk of a change in consumer preferences or a change in the cost of some input), it should not insure them against the risk of change in government policy. Under this view, market risk and government risk are indistinguishable, and, to achieve efficiency, investors must be forced to take both types of risk into account when making investment decisions.").

46. *See* Kaplow I, *supra* note 5, at 528. However, one critic summarized Kaplow's arguments in the tax field as "[s]o long as the market incorporates the risk of new tax rules, new ones should be no worse than old" because of the market's efficiency. J. Mark Ramseyer & Minoru Nakazato, *Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow*, 75 VA. L. REV. 1155, 1157 (1989).

47. Kaplow I, *supra* note 5, at 535.

48. *Id.* at 531.

49. *Id.* at 529.

50. In the tax field, Kaplow's approach was dubbed the "new view" and the issues raised implications in other areas. Logue, *supra* note 7, at 1138; Kaplow II, *supra* note 41, at 3.

III. MORAL HAZARD ISSUES IN CORPORATIONS AND *EX ANTE* DECISIONMAKING

There is an obvious tension between the constitutional endorsement and positive law providing compensation for takings and the normative transitional policy arguments. While takings jurisprudence may have internal inconsistencies, especially in its regulatory takings form, it nonetheless has practical effect.[51] Moreover, the liberalization of the takings doctrine has indicated a judicial comfort with expanding the range of compensable actions.

Despite the increasing scope of compensation, there is little evidence that academics have considered compensation in the context of corporate governance policy changes either as a normative or positive matter. This is troubling because the corporate form can complicate the compensation analysis. Most efficiency analyses imagine a single investor who reaps all benefits and bears all costs of their decisions. The frailty of this notion is highlighted by the dispersal of such responsibilities in a modern corporation, as noted by Eugene Fama[52] and Yuri Biondi.[53] The simple image of a firm as a unitary construct needs to be unwound to force an exploration of a corporation's internal workings and the influence of compensation on corporate decisions and cost bearing.

With these concerns in mind, the normative arguments against providing compensation for investment decisions are questionable when applied to corporations.[54] Corporate decisions differ from those of a single entrepreneur, and the associated risk and incentives analysis employed in many compensation articles must change as well. The separation of corporate power permits the externalization of the costs of decisions and blunts the influence of market risks and

51. Examples can be provided for the poor use of the takings power. *See supra* note 36; *see also* Law is not justice but process, Comment to *Crony Capitalist Land Grab in California*, (Apr. 7, 2012, 3:58 PM), http://www.freerepublic.com/focus/f-news/2869252/posts ("The city eventually agreed to move Susette Kelo's house to a new location and to pay substantial additional compensation to other homeowners. The redeveloper was unable to obtain financing and abandoned the redevelopment project, leaving the land as an empty lot, which was eventually turned into a dump by the city.").

52. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980).

53. *See* Yuri Biondi, *The Firm as an Entity: Management, Organisation and Accounting* 10 (Universita degli Studi di Brescia Working Paper No. 46, 2005), *available at* http://papers.ssrn.com/ sol3/papers.cfm?abstract_id=774764.

54. Even determining who is responsible for decisions and bears costs in a corporation has led to a considerable amount of literature. The limited power of shareholder voting has been discussed in a number of different contexts. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559 (2003); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 277 n.63 (1999).

incentives.[55] The ability of a corporate decisionmaker to offset decision costs to different parts of the corporate hierarchy presents a significant risk of moral hazard and collapse of market incentives for decisionmakers.

A. HOW THE CORPORATE FORM DISRUPTS THE STANDARD ASSUMPTIONS: AN EXAMPLE

A successful transitional policy must promote efficient action by corporate decisionmakers and, in particular, whether such a policy that is known *ex ante* will ensure efficient behavior.[56] This example shows how policies requiring government compensation or no compensation are functionally equivalent to the owner of a company: Either regime results in a significant increase in owner wealth at the expense of employees if codetermination is proscribed. Similarly, the example shows how a corporate decisionmaker will make an inefficient decision due to her ability to externalize the cost of that decision.

A company, Growthco, has less than 2,000 employees and is considering expanding its business and crossing a codetermination threshold. The most attractive option is to open new facilities and increase its workforce to take advantage of growth opportunities. Growthco is worth $5 million dollars but if it undertakes expansion, its value will increase to $10 million. However, it will be required to comply with codetermination requirements and cede certain control rights to its employees.

Codetermination, which is popular in central and northern Europe, eschews a single board of directors for a divided supervisory board composed of nonexecutives and a lower management board of executives.[57] For example, in Germany, stock corporations with more

55. Corporate governance is the study of how to mitigate the conflicts of interest that arise with the division of the ownership and management of a corporation. Berle and Means argued that the shareholders of widely held public firm were incapable of controlling firm management and have to rely on professional observers to ensure that the firm is operated in the shareholder's best interests. *See generally* BERLE & MEANS, *supra* note 13. In the United States, this arrangement generally involves a board of directors with statutory control rights over the firm. The conundrum is whether the incentives of the board and the shareholders are sufficiently aligned for the board to act in the shareholders' best interests.

56. Kaplow I, *supra* note 5, at 513.

57. The two-tier model differs from the Anglo-Saxon model by "giv[ing] economic power to those who control the means of production and us[ing] employee participation as a tool to counter the interests of capital." Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163, 163 (Margaret M. Blair & Mark J. Roe eds., 1999). Pistor continues to distinguish the two systems by stating that codetermination provides social governance, the Anglo-Saxon model provides firm-level governance. *Id*. Possible benefits include the employee representatives' ability to limit

than 2,000 employees must have one half of the supervisory board filled by employees, and a worker representative on the management board.[58] In this configuration, there is not a company executive officer, only a chairman who heads the management board.

For the purposes of this example, the value of Growthco consists of two components: economic rights and control rights.[59] Prior to codetermination, the owner of Growthco owns and controls the entirety of the firm: She has all of the control rights and benefits from all money generated by Growthco. However, if codetermination is implemented, while the owner will continue to enjoy all of the economic rights, the employees will gain a portion of the control rights. For all intents, the transfer of control rights to the employees is analogous to a cost of the investment for the owner.

Table A

Growthco Value	Economic Rights	Owner Control Rights	Employee Control Rights
$5 million	$3.5 million	$1.5 million	—
$10 million	$7 million	$1.8 million	$1.2 million

Table A illustrates how this wealth change could occur. The value of the owner's investment increases from $5 million ($3.5m + $1.5m)

exploitative shareholder behavior, increase the likelihood of employees developing firm specific skills, and monitor management. Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 J. EUR. ECON. ASS'N 863, 864 (2004) (examining empirically whether employee participation at the board level improves corporate decisionmaking); *see also* Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 HARV. INT. L.J. 129, 169–70 (2009). In addition, there are Montan codetermination companies, which are subject to specific rules for mining and coal companies. *See* Pistor, *supra*, at 168–69. The Fifth Directive on Company Law in the 1970s proposed implementing two-tier boards for the entire European Community but was not put into force.

58. This is an oversimplification of the codetermination system. Under the *Mitbestimmungsgesetz*, codetermination applies to private limited companies (GmbH) with greater than 500 employees and stock corporations (AG). Stock corporations with greater than 2,000 employees must have one half of the supervisory board filled by employees and a worker representative on the management board (smaller firms only require one third of the supervisory board be filled by employees). Gorton & Schmid, *supra* note 57, at 864; *see also* Mark J. Loewenstein, *What Can We Learn from Foreign Systems? Stakeholder Protection in Germany and Japan*, 76 TUL. L. REV. 1673, 1675–82 (2002).

59. A significant amount of literature is concerned with the significance of having economic interest tied to control rights of a firm, in particular article in the agency cost vein. Similarly, modern derivatives and empty voting have shown that not only can these two attributes of ownership be separated, but that they also can be valued and sold. In a situation where a corporate governance reform contemplates granting and removing governance rights to a corporate constituency, it provides a suitable mechanism for assessing each set of costs.

to $8.8 million ($7m + $1.8m). The employees gain limited control and observation rights that are worth $1.2 million. While the owner's ownership of Growthco has decreased to 88%, the option of expanding Growthco will be appealing due to the significant increase in her personal wealth. As a wealth-maximizing individual, the owner will choose to expand the company; the employees benefit as well from the acquisition of certain control rights from this increase.[60]

At first glance, the owner's analysis changes little if there is a possibility that the law requiring employee control rights may be repealed. Assume that there have been discussions about possibly proscribing codetermination and the owner is weighing the risk of this corporate governance change on her decision. Accordingly, the owner calculates the risk of change to get the expected cost of reform. Assuming that the transitional policy regime for corporate governance change provides for no compensation, the owner would make the decision to expand the company regardless of likelihood of codetermination being revoked. If there were 100% certainty that codetermination would be proscribed, then the expansion would be worth $10 million and, if not, the owner would get the $8.8 million that was originally expected. In either situation, the owner will view the investment as a winner.

While the owner would be willing to invest regardless of the likelihood of a policy change, focusing solely on the value of the owner's rights disguises the fact that without a policy change a wealth transfer will occur: A former "cost" of the acquisition has been nullified by governance change.[61] Not only has a cost been removed, the economic value of $1.2 million held by a separate corporate constituent have been transferred, rendering the transferee poorer from the transfer. When the owner of Growthco faces an investment that permits intracorporate wealth transfer, the possibility of moral hazard is high and the ramifications several.

This threat is illustrated if we introduce another element to the owner's consideration in the form of a second investment opportunity worth $9.5 million that does not require adopting a codetermination regime. Without codetermination, the owner's value of this opportunity is higher than the $10 million investment that is worth only $8.8 million to the owner. Choosing between these two options may change depending on the likelihood of the corporate governance

60. This analysis is premised on the owner's control over the creation, and potential expropriation, of corporate governance rights and the risk of opportunism in that process. Whether the allocation of these rights is appropriate as a normative matter is a different inquiry and beyond the scope of this article.

61. In the same sense that paying for improvements to real estate or other expenditures are the costs of the investment, so too is the amount of control lost to employees.

regime changing. Under a regime that provides for no compensation, the removal of codetermination would effectively transfer the employee control rights to the owner resulting in a $1.2 million windfall gain for the owner.

In this example, if the owner does not expect the corporate governance rules to change, they will choose the $9.5 million investment rather than internalize the cost of decreased control rights. This seems to be appropriate: The owner is factoring in the expected cost of their decisions and rationally chooses the more profitable investment. However, depending on the risk of a change in the codetermination regime, the owner will come to favor the $10 million investment, as she are able to externalize the cost of codetermination.[62] The owner is the sole decisionmaker for the corporation, but depending on the risk of governance change, she can transfer wealth from a corporate constituent (employees) to herself.[63]

B. THE FAILURES OF EXISTING SCHEMES

The standard assumption is that when a market for investment decisions operates optimally, characteristics of a given market may affect risks and incentives and, if a market functions properly, it will not need further guidance or assistance.[64] In making decisions, investors will prudently invest based on a price that accurately reflects

62. Another more explicit example can be provided: Imagine that the only opportunity for Growthco is an investment where the total value of the company will increase from $5 million to $5.5 million. However, the loss of control rights due to the codetermination regime means that the expansion will reduce the owner's wealth from $5 million to $4.74 million; the employees will gain control rights worth $660,000. Assuming that there is no risk of corporate governance change, the owner would not undertake this expansion due to her expected losses. But, if the expected cost of codetermination decreases by $260,000 then the owner will begin to favor undergoing the expansion. For example, if the owner believes the risk of change equals 50%, the loss of control rights would cost $330,000, resulting in an expected profit for the expansion (at any expected risk greater than 40% the expected cost of the employee control rights is less than the expected gain in owner wealth).

63. This model has assumed that the owner of Growthco is an individual entrepreneur/owner. This was done to simplify the model; if management is separated from shareholding, a few additional assumptions would reach the same result. The single entrepreneur permits the model to ignore the distinctions between the board of directors, shareholders and management of Growthco. If divided, significant decisions would be delegated to the board of directors of Growthco and, as nominated by the shareholders, we would expect them to favor a more valuable company and maximization of shareholder control over the board. A separate, professional group of managers would possibly prefer a codetermination scheme but their recourse would be limited in the same manner as in the current example. The major complication would be if individuals fell in between the different categories, for example, a chief executive with significant shareholdings, and the resulting balancing act in terms of opportunism as a shareholder and protection of perquisites as a manager.

64. Blume & Rubinfeld, *supra* note 7, at 582.

available information[65] and only if the investor expects the investment to be profitable.[66] Compensation is viewed unfavorably because it adds an unneeded incentive.[67] In this context, market failures have provided the strongest arguments against trusting the market when assessing compensation.[68]

Yet, most models fail to appreciate the number of parties within a corporation and the subsequent potential for opportunism. For example, Blume and Rubinfeld's model is typical in only discussing three parties, a governmental body that makes policy decisions, private landowners and a governmental body responsible for determining payment of compensation.[69] Decisions made in a properly functioning market should reflect an assessment of the risks and incentives associated with a given investment. At first glance, the owner's decision to make corporate governance-contingent investment reflects a proper assessment of the risk of the transaction. But, the incentives are skewed by the distributional nature of corporate governance changes and prone to opportunism.[70] Here, the owner is not simply assessing the expected value of her investment, with codetermination as yet another cost of business, but instead the likelihood of receiving additional control rights without having to make payment to an aggrieved party.

When examined from this perspective, an intracorporate transfer of governance rights can effectively act as a subsidy. Receipt of gains due to a wealth transfer from one part of a corporation to another is analogous to the concerns with government compensation, whereby the windfall gains is a positive externality. Decisionmaking can instead be premised upon the intracorporate wealth transfer rather than the innate value of the investment. This internal transfer effectively subsidizes the decision and allows an investor to "ignore" potential investment costs; reliance on a government subsidy will promote

65. Ramseyer & Nakazato, *supra* note 46, at 1159.

66. One of the tenets of the law and economics approach is that "'resources tend to gravitate toward their most valuable uses' as markets drive out any unexploited profit opportunities." Christine Jolls, Cass R. Sunnstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1483 (1998), *citing* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 3–4 (5th ed. 1998). The other two core tenets of the law and economics approach are that (1) demand falls when prices rise and (2) incurred costs do not affect decisions on prices and quantity. *Id.* at 1481–82.

67. Kaplow I, *supra* note 5, at 541.

68. For example, the unavailability of insurance against certain types of policy change may indicate a market failure to provide risk minimization options for investors. The failure of the market to provide insurance for low risk losses was viewed as a justification for government compensation. Blume & Rubinfeld, *supra* note 7, at 597.

69. *Id.* at 583.

70. Arguably, a standard taking assessment would be comparing the rights of an individual to society, with a taking occurring when the distribution to society is beneficial.

overinvestment in subsidized areas. More importantly, the cost of subsidizing governance change is ultimately paid by society, rather than simply representing gains from worthwhile investments.

1. The Changing Nature of Property

A preliminary issue is whether "property" and "takings" should even create grounds for compensation claims. Property has increasingly come to be understood as a bundle of legally protected rights, rather than simple, tangible property. From Charles Reich's venerable work describing the proliferation of state provided rights as "new property" to a reinterpretation of property as a "legal construct to be reengineered at will by the legislature," property, and any associated claims for government compensation, is harder to identify and yet more important than the traditional model.[71]

The types of rights that courts have been willing to protect have only expanded with time.[72] Courts have been willing to expand the scope of public use to provide compensation for a growing variety of government actions. Perhaps the most recent, and mainstream, example of this liberalization of public use was in *Kelo v. The City of New London*.[73] In *Kelo*, the Supreme Court endorsed the transfer of property from one private party to another and payment of government compensation as a legitimate "public use," expanding on the scope of the traditional compensation requirement.

The expansive nature of property or rights that implicate government compensation is important when considering the preliminary question of whether compensation is applicable to corporate governance losses. For example, there has been a different debate in the shareholder primacy dialogue whether shareholders actually "own" a corporation and whether securities constitute a form of private property.[74] This is in contrast with a nexus of contracts theory, where shareholders do not own the firm, but rather simply have contractual rights associated with the firm.[75] Depending on which perspective holds sway, shares could represent a unitary property interest, which could only be compensated if all value is destroyed by the state, or a bundle of rights in relation to the firm,

71. Charles A. Reich, *The New Property*, 73 YALE L.J. 733 (1964); Bell & Parchomovsky I, *supra* note 34, at 285.

72. Logue, *supra* note 7, at 1160 n.106.

73. 545 U.S. 469 (2005).

74. *See* Bainbridge, *supra* note 52, at 564. Shareholder primacy posits that (1) a firm should be operated primarily for the benefit of its shareholders and, in its strongest form, (2) a firm is controlled by its shareholders.

75. Nexus of contracts refers to the idea that a corporation is not a thing but rather just the locus of numerous separate contracts between all associated parties.

where the destruction of one set of rights, rather than the entire bundle, creates a right to compensation for the discrete set of rights. The modern trend of both corporate governance and takings jurisprudence is conducive to including compensating the loss of discrete corporate governance rights and ameliorating transfers of wealth between private parties.

2. Takings and Government Compensation

Full government compensation would fail to ensure an efficient outcome for a governance change like Growthco.[76] If government compensation is available for a corporate governance loss, it would differ from the model generally employed in efficiency analyses and would be paid to the injured party, that is, the injured employees, rather than the decisionmaker. This is in contrast with the standard model that Kaplow and others find so objectionable, where compensation is made available to, and distorts, the incentives of the decisionmaker (the owners).[77] As such, any equitable concerns about employee losses are addressed by government compensation. But this does not solve the incentive problem. Instead, it merely shifts the loss from the employees to the government and does little to force the owners to internalize the costs of their decision. In a regime that provides for government compensation, the owners of Growthco would still decide to make the inefficient investment due to the potential for windfall gains in the event of a regime change.

As a preliminary matter, it is unlikely that corporate constituents would be able to bring a claim for compensation for a corporate governance policy change in the United States. In *Dartmouth College v. Woodward*, Justice Marshall applied the Contract Clause to a corporate charter to prohibit retroactive actions by the government.[78] However, Justice Story famously hinted in a concurrence that this result could be avoided by states explicitly reserving the right to subsequently modify state charters. As pointed out by one commentator, "[s]ince a corporate charter is somewhat different from a regular contract in that there is no consideration, the one-sided grant may include whatever limitations the state wishes to place on the corporation, and the latter, if it accepts the charter, accepts it with all the conditions stated

76. If the United States approach is assumed to be a no-compensation policy, then the arguments in Part II.B.2 are applicable and reflect the failures of this approach.

77. This differs from a basic assumption in Louis Kaplow's piece that values are fully weighted by the decisionmaker. Kaplow I, *supra* note 5, at 526 n.39.

78. 17 U.S. (4 Wheat) 518 (1819).

therein."[79] Since *Dartmouth College*, corporate charters have generally included provisions permitting the government to change the charter at will.[80] As such, for matters involving corporate governance change, most state governments have precluded the option for receiving compensation in the corporate charters.[81]

If government compensation were available, the results would be inefficient due to the division between decisionmaker and harmed party. As indicated in the Growthco example, the owner will make their decision based on the expected value of the investment and will be able to discount the cost of codetermination because compensation is not required for government policy changes. If the employees of Growthco brought a suit for compensation, they would sue the government for compensation for the loss of employee rights in favor of the public good.[82] The employees could allege that, similar to *Kelo*, employee control rights had been redistributed to a separate private party and the employees had suffered a loss as a result. Assuming the validity of the claims, any compensation would be paid to the employees for their losses.

The problems with this approach in terms of promoting efficiency should be fairly obvious. First, the decisionmakers not only do not need to consider the cost appropriating employee value in their investment decision, they in all likelihood will barely need to consider the cost of litigation (which ultimately would be between the employees and the state). This permits decisionmakers to externalize the cost of a decision onto a separate corporate constituency. Second, the government subsidizes the cost of the decision, with any payments being made from government coffers and decisionmakers reaping the windfall. This results in the employees being compensated for their loss, but it does not create market forces for efficient decisionmaking. Arguably, the decision is being doubly compensated because the decisionmakers are not required to pay for the costs of the decision and the government must pay the employees.

79. Melvin I. Urofsky, *Review: An Incomplete Portrait*, *in* 20 REVIEW IN AMERICAN HISTORY 426, 428 (1992).

80. *See, e.g.*, Norman D. Lattin, *Minority and Dissenting Shareholders Rights in Fundamental Changes*, 23 LAW & CONTEMP. PROBS. 307, 307 (1958). *See* Miller v. State, 82 U.S. 478 (1872); Pennsylvania College Cases, 80 U.S. 190 (1871).

81. Kaplow I, *supra* note 5, at 522–23. The political ramifications of this have been characterized by one commentator in the antitakeover statute context as "effectively let[ting] states transfer wealth from politically weak shareholders to politically strong managers." Larry Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 209 (2004).

82. This would actually be an inverse condemnation proceeding, where instead of a government-initiated action under the eminent domain power, the aggrieved party files suit claiming an unrecognized taking. *See* Bell & Parchomovsky I, *supra* note 34, at 301.

3. No Compensation and the Failure to Fully Internalize Costs

a. Impact on Incentives

Louis Kaplow argued against government compensation because it permits decisionmakers to externalize the cost of their decisions and "shifts part of the long-run cost of private investment to the government and thus distorts an otherwise efficient decisionmaking process" by insulating investors from downside risk.[83] Government compensation does little to improve the incentives of Growthco's decisionmakers; rather it simply ensures payments for passive parties.

The risk and incentive analysis presented in Kaplow's works does not properly reflect the realities of policy changes on corporate entities. A no-compensation transitional policy change effectively transfers wealth between corporate constituents, acting as a subsidy for inefficient decisions. For example, the owner of Growthco is confronted by a choice between two investments: One of which included a corporate governance-contingent cost and a lower total value option without a governance cost. A no-compensation policy effectively permits the decisionmaker to ignore the cost of corporate governance change; the very externalities and distorted incentives Kaplow argues undermine a compensation approach.

The loss of control rights due to governance change is in effect an uncompensated intracorporate taking. In contrast with a standard investment cost (risk of installing environmental upgrades or changing the tax treatment for a bond), corporate governance reforms have a real risk of transferring wealth between interrelated private parties.[84] While most policy changes are redistributional, in the corporate context the recipient of a windfall gain may have the ability to affect this process. This reflects directly on the incentives of a corporate decisionmakers: Are they making an investment decision based on the decision's profitability or the potential for wealth transfers within the corporate hierarchy that benefits the decisionmakers? There should be some concern if decisions are being made on the basis of internal wealth transfers, rather than productive utilization of capital.[85]

83. Kaplow I, *supra* note 5, at 531.

84. This recalls the idea of derivative takings and givings proposed by Abraham Bell and Gideon Parchomovsky: The reduction in one set of rights generally effects an improvement in another. Abraham Bell & Gideon Parchomovsky, *Givings*, 111 YALE L.J. 547, 554 (2001) [hereinafter Bell & Parchomovsky II].

85. This references a number of the retroactivity concerns discussed by Louis Kaplow. *See supra* note 50; *infra* Part V. Much of the argument in favor of a no-compensation policy implicates the retroactive effect of policy change on investment value: Terminating a tax-exemption policy effectively impugns the original price paid for a bond, not just the value of future income. *See generally* Kaplow I, *supra* note 5, at 516. A no-compensation approach is premised on the

This illustrates a classic case of moral hazard where decisions made by the owner affect a separate corporate constituent. This distortion increases as the risk of governance change increases. Michael Jensen and William Meckling famously noted that in any agency relationship, where one person is engaged on behalf of another, utility maximizing behavior will result in a divergence between the parties.[86] Similarly, moral hazard has been described as "any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly."[87] The result of this disparity is decisions that a decisionmaker would otherwise avoid.

There are mitigating factors that may limit the strength of a no-compensation argument. Kaplow identified four types of market failure that could potentially necessitate compensation: moral hazard, adverse selection, transaction costs and access to markets.[88] He argued that "[m]arket responses to moral hazard, however, even when not perfect, [were] generally superior to transitional relief . . . . [The remaining three] sources of market failure are less important when risk is spread through diversified ownership rather than through insurance contracts."[89]

But, Kaplow's arguments against recognizing moral hazard seem inapplicable in the current situation because his analysis is primarily concerned with the potential for moral hazard impeding the availability of insurance.[90] This reflects the governing assumption of his article that the decisionmaker is an individual who bears the costs, and reaps the benefits, of her decisions. Moral hazard, as discussed in this article, remains unaddressed, although the concern that compensation may be necessary in the event of market failure remains salient. In contrast, market failure is one major factor that may favor providing compensation: Kaplow acknowledged that market failure favored compensation from an efficiency standpoint and Blume and Rubinfeld's arguments in favor of government compensation were premised on market failure.[91]

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investor considering the risk of this change and pricing the risk appropriately, with compensation nullifying this efficient process. Similarly, a decisionmaker's ability to exploit other constituents *ex ante* exploits their ability to offset potential costs down the road.

86. Jensen & Meckling, *supra* note 14, at 6.

87. PAUL KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008 63 (2008). This is caused by an information asymmetry whereby one party takes advantage of their superior information to shift risk to a less knowledgeable third party.

88. Kaplow I, *supra* note 5, at 536–50.

89. *Id.* at 536–37.

90. *Id.* at 537 ("The major impediment to the market providing complete insurance against many risks is precisely the incentives problem . . . with regard to compensation, which in the insurance context is generally referred to as moral hazard.").

91. Blume & Rubinfeld, *supra* note 7, at 597. Bainbridge discusses the significance of market failures for corporations in his discussion of director primacy. He identifies four types of market

The potential for moral hazard highlights how a corporation with multiple constituents differs from a single investor or decisionmaker.[92] It has been argued that a no-compensation corporate governance regime forces a decisionmaker to internalize the costs of a decision. In this framework, government compensation is a type of externality that fundamentally distorts the incentives portion of the equation.[93] However, the previous example provided a corporate governance example where incentives and risk are significantly different than in the standard example.

b. Constituent Mitigation

One solution that may reduce concerns about the impact of intra-corporate wealth transfers would be if corporate constituents properly anticipated losses. That is to say, even if decisionmakers enjoy windfall gains (ignoring the poor incentives), the gains may not be objectionable if the other corporate constituents were fully compensated. For example, the loss of codetermination represents a loss of collective rights for the employees of Growthco. In this example, it may be possible for employees to approximate the control rights enjoyed under codetermination by purchasing shares and selling the cash flow rights. This may be sufficient to reduce any risk of loss due to governance change.

Outside of government compensation, though, it is hard to imagine that corporate constituents will be well positioned to mitigate governance change. Much of the risk and incentive analysis relies on a capable and sophisticated decisionmaker. In this example, it seems likely that any decisions made by employees acting as a group would be thwarted by collective action problems. Similarly, unless government compensation was provided, it seems unlikely that a group of employees would have the liquidity to purchase securities approximating the pre-transition control arrangement.

failures that may augur against permitting corporations private ordering (1) producer monopoly, (2) public goods, (3) information asymmetries, and (4) externalities. Bainbridge, *supra* note 54, at 585. *See* discussion *infra* Part IV.

92. Note that Louis Kaplow writes at length about moral hazard in his works on transitional policy. *See generally* Kaplow I, *supra* note 5, at 537–41. However, this Part refers to the risk of moral hazard damaging market risk mitigation, namely insurance. In particular, Kaplow argues that the risk of moral hazard by the insured vis-à-vis the insurer can be mitigated at low cost and therefore making it palatable as risk mitigation strategy. This addresses a different aspect of moral hazard than in the intracorporate opportunism addressed in this Part.

93. Kaplow I, *supra* note 5, at 531.

c. Changes to the Risk Component

The risk confronted by the decisionmaker in this example also differs from the standard case and actually flips the standard risk analysis on its head. Louis Kaplow argued that market risk was substantially similar to government risk. Market risk referred to "more commonly considered risks . . . arise from uncertainty with respect to such factors as the level of future demand (the general level of demand as well as demand for particular products), technological change, behavior of competitors, and prices of other goods (such as inputs) that in turn depend upon a variety of factors," whereas government risk referred to the potential for future changes in policy.[94] If the risk of government policy change is similar to market risk, then insurance, risk spreading or other market mechanisms can be employed to mitigate the risk.[95]

However, in the example presented in this Part, the status quo is detrimental and the risk is the potential for moral hazard and its associated gain. In contrast with insuring against the risk of loss, any attempt to hedge the risk of government policy change would focus on sharing the gains of the transition. That is to say, the moral hazard exists in betting on windfall gains in the event of policy change. It is unlikely that insurance would be developed for this type of risk; rather any arrangement would involve a third party paying the corporation a fee for the right to share in any later upside.[96]

While traditional insurance may not be readily available, other risk management mechanisms, like risk spreading, would be available to a decisionmaker. To the degree a company cannot successfully mitigate the risk of corporate governance change, this has typically favored arguments for providing government compensation.[97] That being said, risk mitigation for moral hazard reaches in both directions. On one hand, if risk mitigation is expensive, the cost of making moral hazard profitable may be high enough to force a party to internalize the costs of her decision. On the other, if it is simple to mitigate the risk of loss for moral hazard, this is one further example of how a decisionmaker can insulate herself from the costs of such decisions.

94. Kaplow I, *supra* note 5, at 533, 535.

95. Bell & Parchomovsky I, *supra* note 34, at 307 ("Various scholars have expressed the view that private insurance may be superior to government compensation in effecting efficient allocation of resources."). *Id.* n.105.

96. It seems odd but it seems possible to imagine, for example, a union hedging their bets on codetermination by insuring against the loss of rights by paying the corporation in order to gain in the event of a governance change.

97. Kaplow I, *supra* note 5, at 548 ("Perhaps the strongest case for some government response to risk is presented by situations in which certain actors underestimate the likelihood of loss and thus refuse to purchase insurance when it is in their interest to do so.").

4. *Failure of Corporate Governance*

The introduction of multiple parties to a compensation analysis that has primarily paid attention to individual decisionmakers raises concerns about opportunism. At first blush, one may assume that these issues are captured by traditional corporate governance rules. Corporate governance has identified and minimized opportunism in many areas where the corporate form can lead to abusive or inefficient decisions.[98] But, the inconsistencies of this approach beg the question of why one type of opportunism is permissible and another prohibited.

Corporate governance can be said to be the study of reducing agency costs between owners and managers. A broader definition is that corporate governance is "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."[99] Similarly, Luigi Zingales defines corporate governance as "the complex set of constraints that shape the *ex post* bargaining over quasi-rents generated by the firm"; his definition is broad enough to encompass mitigation of agency costs and promotion of corporate profitability.[100] These definitions have a broader scope than simple agency cost management.

In the United States, fiduciary duties are the primary restraint on intracorporate opportunism. The venerable duty of loyalty serves as an unwaivable obligation by the board and officers of a company to forswear self-interest in favor of the corporation and its shareholders. This duty has been extended from a limited reading against personal profit to include a more expansive duties of good faith and a variety of context specific requirements in suspect transactions, including the corporate opportunity doctrine and freeze-out mergers.[101] The potential liability for directors and officers in these situations may be sufficient for them to internalize the cost of opportunistic behavior.

The problem with relying on existing fiduciary duties is the significant disparities in treatment of intracorporate decisions, which only protect certain enumerated rights. The previous examples highlight principal-agent problems that may disadvantage shareholders vis-à-vis management. But corporate governance policy permits changes in wealth in ways that has been checked

98. A question that will be returned to *infra* in Part V.

99. OECD, OECD PRINCIPLES OF CORPORATE GOVERNANCE 11 (Paris: OECD ed., 2004).

100. Luigi Zingales, *Corporate Governance*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 4 (P. Newman ed., 1998).

101. *See, e.g.*, Kahn v. Lynch Comm'n Sys., Inc., 669 A.2d 79 (Del. 1995).

inconsistently. For example, in the 1980s, many states implemented constituency statutes, which permitted a board to consider factors outside of shareholder value when considering a hostile takeover bid.[102] One commentator noted that the addition of these statutes "effectively let[] states transfer wealth from politically weak shareholders to politically strong managers. For example, state anti-takeover statutes resulted from direct lobbying of corporate managers, and reduced the value of corporate shares by limiting shareholders' key right to transfer control in hostile takeovers."[103]

During the same period, the Securities and Exchange Commission ("SEC") instituted rules prohibiting the public trading if a corporation took actions to nullify or disparately affect the voting rights of existing shareholders.[104] This prohibition both recognized the ability of companies to have multiple classes of shares but prohibited their utilization without a shareholder vote in favor of a recapitalization.[105] Both dual-class shares and constituency statutes were viewed as ways to defend firm value but also had significant risk of entrenching management. But, while the SEC rules requiring a recapitalization could require a company to provide benefits to existing shareholders to ensure approval of a recapitalization, constituency statutes insulated management from shareholder censure.

The scenario presented in Growthco provides another example of the imbalances in fiduciary duties at corporations whereby the owner can inefficiently appropriate stakeholder rights through exploiting a corporate governance change. The types of opportunism present in corporate governance change can differ from regular areas of corporate governance inquiry: Management opportunism has been aggressively curtailed, while board-stakeholder opportunism is not checked. Generally speaking, the board or owners of Growthco do not owe a fiduciary duty to the employees that would provide grounds for recovery. Even in states that have constituency statutes, those statutes generally permit a board to include stakeholder interests in support of firm decisions, rather than permit stakeholder interests to trump

102. *See supra* note 1.

103. Ribstein, *supra* note 81, at 209. This transfer led to a number of articles discussing the propriety of the wealth transfer. Henry Butler was emphatic that any such transfer needed to be checked by a right for shareholders to exit prior to letting the statute go into effect. *Supra* note 1, at 382. This would be possible for publicly traded companies, although private companies would probably be constrained. In general, he proposed a waiting period "during which corporations could opt in only through a vote of the shareholders. This would allow time for dissatisfied shareholders to exit the firm with relatively small price effects." *Id.*

104. Voting Rights Listing Standards; Disenfranchisement Rule, Exchange Act Release No. 25,891, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) T 84,247, at 89, 208–09 (July 7, 1988).

105. A company could, however, do an IPO with multiple share classes. *See generally* Douglas C. Ashton, *Revisiting Dual-Class Stock*, 68 ST. JOHN'S L. REV. 863 (1994).

board discretion. Thus, Growthco falls outside the scope of traditional corporate governance duties.[106]

IV. CORRECTING OPPORTUNISM THROUGH REDISTRIBUTION

The previous Part illustrated how the *ex ante* policy of no-compensation and full-government compensation both fail to promote efficient behavior. Compensation between corporate constituents can correct this externalization problem and assure that any decision properly internalizes its costs; similarly, moral hazard and agency problems endemic in corporations should be reflected in a corporate governance transitional policy. The assumption that compensation distorts risks and incentives falters in light of the various interests bound into a corporation that permit decisions that externalize costs to corporate constituents.[107]

Redistributive compensation can ensure efficient decisionmaking and solve the incentive problems. Redistributive compensation requires decisionmakers who exploit their ability to externalize costs to compensate aggrieved corporate constituents for their decisions. A transitional policy for corporate governance change should default to redistributing gains procured in opportunistic decisions to penalized constituents. This addresses three issues: First, redistributive compensation will serve as an *ex post* settling mechanism and force a decisionmaking constituent to internalize the costs of its decisions. This restores a proper assessment of risks and incentives. In this manner, compensation ensures that decisionmakers will make socially optimal investment choices.[108] Second, it will ensure there is a source of compensation for value lost by a nondecisionmaking party, thus remedying the equity problem.[109] Third, redistribution applies to all corporate constituents equally and not simply to predetermined situations, reducing the inequity of incomplete *ad hoc* responses.[110]

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106. Which is unfortunate because fiduciary duties are fairly efficient to ensure good behavior. While D&O insurance, indemnification and other items may dull the process, fiduciary duties and associated liability shown require decisionmakers to internalize the cost of a decision.

107. Kaplow I, *supra* note 5, at 615.

108. Blume & Rubinfeld, *supra* note 7, at 582.

109. This makes sense due to a nondecisionmaking constituent's inability to control his or her investment decision or effectively control for the risk of loss.

110. Note that this requirement is restricted to certain opportunistic transfers. Corporate governance changes can redistribute corporate wealth; indeed, this often the point of the changes. The objectionable item is whether corporate constituents are positioned to exploit governance changes in a manner that promotes opportunistic gains rather than efficient decisions.

Note that this argument is focused on requiring private compensation for decisions inspired by moral hazard, rather than all windfall gains. This analysis is focused on specific distortions caused when decisionmakers are permitted to externalize the costs of their decisions to other corporate parties.[111]

A. REDISTRIBUTIVE COMPENSATION AS A CURE FOR *EX ANTE* MORAL HAZARD

In some ways, a redistributive compensation system is not that controversial. Previous works noted that government actions that "take" from one party generally "give" to a different party. For example, Abraham Bell and Gideon Parchomovsky wrote extensively about the significance of taxing givings (the mirror image of takings) to offset the cost of takings.[112] They argued that "[a]ny government redistribution of property necessarily involves givings and takings in equal amounts, and any government destruction of property can be matched with a government creation of property" and that ultimately the "taxonomy of takings applies with equal validity to givings."[113] In addition to the parties injured by government action, additional parties would benefit from the same government action.[114] For example, any physical taking must be for public use and therefore be a derivative giving to the public.[115] The benefits provided by government givings can be taxed to mirror the compensation provided to takings recipients. Louis Kaplow has also remarked several times on the symmetry between gains and losses.[116] This symmetry is a critical component in restoring proper incentives and fixing corporate decisions.[117] Thus a system of redistributive compensation corrects

As discussed later, this proposal is not meant to negate shareholder wealth management; rather, redistributive compensation is necessary to ensure that all transaction costs are included and decisions are optimal.

111. Abraham Bell, *Private Takings*, 76 U. CHI. L. REV. 517, 573 (2009); *see also* Bell & Parchomovsky II, *supra* note 84, at 565.

112. *See, e.g.*, Bell & Parchomovsky II, *supra* note 84.

113. *Id.* at 11.

114. Blume & Rubinfeld, *supra* note 7, at 578 ("Whenever the government regulates a noxious activity on a particular piece of land, many members of society benefit . . . . Thus, the compensation issue is more a question of distributing the costs and benefits created by government regulation.").

115. Bell & Parchomovsky II, *supra* note 84, at 13.

116. Kaplow II, *supra* note 41, at 4. Note that Kaplow continues to explain that this means that gains should not be taxed for the same reasons that losses should not be compensated. However, while this may appear to contrast with the argument presented in this paper, Kaplow argues against taxing compensation due to his deference to market mechanisms. The gains discussed in this Article are based on market failures and would presumably be frowned upon by Kaplow for the same reasons he is against compensation for transition losers.

117. Bell & Parchomovsky II, *supra* note 84, at 565. The problem that the government does not exactly have a corresponding givings power that would facilitate this. Kaplow II, *supra* note

suboptimal incentives and establishes a socially optimal transitional policy.

Charging recipients of windfall gains to remedy externalities has been examined in different contexts. Arthur Pigou examined setting taxes at a level sufficient to neutralize the risk of externalizing costs and ensure that a socially optimal level of investment is reached. Louis Kaplow also commented that insurance permits a party to externalize risk of their investment, but that this was efficient because the insurance premium forces the party to internalize this cost.[118] Unfortunately, these approaches have usually been stymied by concerns regarding the costs of implementation. The difficulty lies in properly identifying the appropriate amount to charge to force a decisionmaker to properly internalize the cost of their decision. In contrast, corporations present a different environment for implementing a redistribution scheme that may be more efficient.

A no-compensation transitional policy is based on a simple premise and has had considerable influence: "Just as the government does not generally provide insurance to private investors for market contingencies . . . it should not insure them against the risk of change in government policy."[119] Undergirding this argument are a series of risk and incentive analyses illustrating how government compensation can destroy market mechanisms that would otherwise promote efficient behavior. The potential for moral hazard within corporations significantly distorts decisionmaker incentives.

Redistributive compensation can effectively realign incentives and ensure optimal decisions. Redistributive compensation refers to requiring private compensation by beneficiaries of corporate governance policy change to compensate losers.[120] While various remedies exist for breaches of fiduciary duties in corporations a comprehensive approach to solving wealth redistributions between corporate constituents is not part of the common law. In particular, mandatory compensation for losses due to opportunistic behavior fixes decisionmaker incentives and restores the ability for a decisionmaker to mitigate risk.

The Growthco example showed that the company owners would be willing to make a suboptimal investment if they were confident that a change in the codetermination regime was imminent and that the employees would not be compensated for lost control rights: An

41, at 21. On the other hand, corporations are permitted at the pleasure of a state's legislature and the legislature has considerable flexibility in setting the ground rules for corporations.

118. Kaplow I, *supra* note 5, at 540.

119. Logue, *supra* note 7, at 1153.

120. As will be discussed *infra* Part IV.C, this remedy is bounded by tests designed to identify opportunistic behavior and not simply penalize all reallocations of corporate wealth.

investment that was worth $8.8 million to the owner could be worth more than a $9.5 million investment if the owners could capture the $1.2 million in employee control rights through a corporate governance change. However, if the owners had to provide compensation for this decision, they would need to recompense employees $1.2 million for control rights received due to the change. The owners would thus be forced to internalize the cost, leading them to choose the more efficient $9.5 million investment. A no-compensation transitional policy effectively allows the owner to ignore one of the costs of the investment: granting certain employee control rights. Requiring the owner to compensate the employees for this loss restores the original expected value of the investment and protects employees from a total loss due to corporate governance regime change. More importantly, requiring compensation ensures that the owners will not make a socially suboptimal investment.

This example highlights a few items. First, redistributive compensation can remedy the incentive problems of a no-compensation regime. The previously discussed moral hazard issues were premised upon corporate decisionmakers externalizing the costs of their decision. However, requiring private redistribution instead compels the decisionmaker to consider, and therefore value, the risk of paying corporate constituents for making opportunistic decision. This default forces the decisionmaker to consider corporate governance costs in the same manner as other costs. Second, redistributive compensation meets the equity concerns associated with the loss corporate rights due to corporate governance change. Whereas employees would generally be uncompensated, and poorly positioned to mitigate the risk of corporate governance change, redistributive compensation provides a fund to defray their transition losses.

B. ADVANTAGES OF A REDISTRIBUTIVE SCHEME

There are several reasons to imagine that a redistributive compensation scheme could be both efficient and effective at mitigating opportunism.

1. Transaction Costs

It is typically assumed that implementing a scheme to force the internalization of social costs will be expensive and inefficient. For example, Bell and Parchomovsky's work on givings explains how to establish a system that could successfully determine when a giving has occurred and how to manage a compensation process.[121] This system assesses what "a giving is, when the government must assess a charge for a giving, and how that charge must be collected."[122] This model is complicated by the variety of steps, audits and other logistics. Louis Kaplow felt that the process of the government reassessing the appropriate rate at which to impose *ex ante* taxes in order to mitigate externalities (with compensation serving as an *ex post* insurance payment) was logistically difficult to implement.[123] Rather, the market would be better prepared to provide insurance for the risk of change than the government determining and adjusting tax rates.

A major difference of redistributive compensation is the significance of private parties rather than public administration. Generally, public administration is viewed as inefficient due to the difficulty of assessing appropriate tax rates and adjusting these depending on the likelihood of a given governance change. By contrast, a private scheme jettisons the public administration and the bureaucracy associated with setting and revising cost adjustment mechanisms.[124] In this situation, a private decisionmaker is required to allocate the costs of policy change *ex post*, with the potential for an aggrieved corporate constituent to bring a private action serving as a less efficient backstop.[125]

2. *Accurate Assessment*

There is also reason to believe that a private redistribution scheme would result in more accurate risk assessment and pricing than a public mechanism. Concerns of whether the government or private parties can accurately assess the proper price to align incentives have plagued other efficient solutions.[126] A redistributive scheme changes this analysis in several ways.

121. Bell & Parchomovsky II, *supra* note 84, at 590–91.

122. *Id*.

123. Kaplow I, *supra* note 5, at 583.

124. Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations,* 61 AM. ECON. REV. 112, 113–14 (1971) [hereinafter Williamson I].

125. One concern is whether private distribution would result in a different, rather than superior, transaction cost distribution than a public distribution scheme. For example, it is possible that creating a right of action to litigate may result in expensive litigation that burdens courts and the various corporate constituents. It seems reasonable to assume that judicial affirmation of a redistributive approach would reduce future litigation to a manageable level. Similarly, it is likely that any suits would come in "waves": a new governance change would prompt demands from a number of firms for similar types of damages. As courts developed a consistent approach to these claims, litigation would become less speculative.

126. *E.g.* Lawrence Blume, Daniel L. Rubinfeld & Perry Shapiro, *The Taking of Land: When Should Compensation Be Paid?*, 99 Q. J. ECON. 71 (1984) (examined the complications of setting compensation levels when incentive effects can lead to moral hazard).

First, redistributive compensation would require decisionmakers to assess the risk of change before making a decision. Compared with the government, decisionmakers are likely to be knowledgeable about a given investment and be in a better position to determine the risk of making a compensation payment than the government. These decisionmakers will recognize whether there is a real risk of compensating corporate constituents upon a governance change, what other investment options are available and other factors that a government could not bake into a corrective tax.

Second, the payment enforcement mechanism will be effective following any governance change. An *ex post* assessment of the costs imposed by the change would accurately reflect the actual costs of the change. Instead of guessing the appropriate level with an *ex ante* tax, potential liability functions as an *ex post* settling mechanism.[127] For instances of *ex ante* moral hazard, rather than approximating the cost of opportunistic behavior, an aggrieved constituent will plead particular facts in a suit against a corporate decisionmaker. These particular facts make it more likely that any compensation will accurately reflect the cost of an opportunistic decision.[128] For *ex post* distribution problems, the hierarchy will be responsible for equitably divvying up a limited pool of transitional losses.

It is for this reason that this article assumes that corporate decisionmakers must fully compensate other corporate constituents for these types of decisions. If we assume that compensation is necessary to make a decisionmaker internalize the cost of a decision, then any decrease from full compensation is a distortion of the incentive correction. Full compensation is necessary for the owners to fully internalize the costs of their investment decisions.

3. Simpler Identification of Parties

One complication created by a redistributive scheme is identifying the appropriate recipients for compensation. A corrective tax posits a different distribution of money than a redistribution scheme: Such

127. The significance of having an *ex post* settling mechanism in opportunistic situations is understated in Kaplow's analysis of transitional policy. In examining agency problems in the firm, Eugene Fama examined how *ex post* settling was necessary to control manager's behavior. He commented that "a game which is fair on an *ex ante* basis does not induce the same behavior as a game in which there is also *ex post* settling up. Herein lie the potential losses from separation of security ownership and control of a firm. There are situations where, with less than complete *ex post* settling up, the manager is induced to consume more on the job than he would like, given that on average he pays for his consumption *ex ante*." Fama, *supra* note 50, at 296; *see generally id*. at 295–305. But, even if the incentives are appropriate for risk assessment prior to a transition, litigation provides a hook to ensure that such assessment is accurate.

128. Plus any reasonable fees and expenses associated with the litigation, of course.

taxes are designed to reduce socially suboptimal behavior in the aggregate, with taxes being paid to the government. While this approach may satisfy efficiency and equitable distribution concerns, it introduces the additional complication of identifying and paying the appropriate corporate constituents. By contrast, a private redistributive scheme is designed to correct individual examples of self-serving behavior and provide compensation to any disadvantaged parties.

Abraham Bell and Gideon Parchomovsky's work in *Givings* illustrates the difficulty of identifying aggrieved parties.[129] In *Givings*, they propose a self-assessment system that requires aggrieved parties to declare their losses and then a further review mechanism. This process includes a government identification of a giving, self-assessment of the giving value by recipients (randomly audited by the government) and an eventual payment.[130] The first step of this process actually builds on a four-part test to determine whether a chargeable giving has even occurred.[131] This lengthy process brings to mind efficiency concerns inherent in a government administrated taxing scheme, as discussed two Parts ago, or indeed in any system where the government must build infrastructure to determine what a financially motivated plaintiff would determine for free.

Assessments will be simpler in a corporate governance situation. The biggest difference between a corporate governance change and the givings framework is that corporate governance losses are limited to corporate constituents, rather than a broad swath of the community. By focusing solely on corporate constituents, the redistributive process limits the number of potential recipients. Not only will they be members of the existing collection of corporate relations, it is also likely that they will represent large homogenous claimants.[132] In contrast with derivative takings involving thousands of households with varying damages, a corporate governance change seems most likely to affect employees as a whole, or preferred shareholders as a group. The aggrieved constituents will be limited in number or similar in character. They will be able to quickly look at shareholder lists or employee charts to determine who may be a likely candidate.

Imposing liability on corporate opportunists also places the risk in the right place. The corporate decisionmaker in these situations is the most likely party to have the appropriate information when making

129. *See* Bell & Parchomovsky II, *supra* note 82, at 605–08.
130. *See* Bell & Parchomovsky II, *supra* note 82, at 557.
131. *Id*. at 555–56.
132. Generally speaking, one shareholder will have claims that are identical to the others. Similarly, one employee will have claims that are identical to other employees. Differences are most likely to exist between similar groups, like shareholders and preferred shareholders.

decisions. In this situation, "it is efficient to place the risk of opportunistic behavior on the opportunist."[133]

4. Applicable to All Corporate Constituents

The proposed redistributive compensation scheme is designed to reach beyond current forms of liability. Corporate governance regimes include a number of mechanisms for mitigating opportunism in the corporation, including the fiduciary duties that are imposed on directors and officers in American corporations. Yet, existing fiduciary duties only provide a limited framework for reducing opportunism for corporate governance change.

Fiduciary duties, for example, would not apply to wealth transfers between shareholder types or stakeholders to shareholders. Redistributive compensation would have to apply to all transfers between corporate constituents. This reflects a holistic interpretation that all corporate constituents have rights associated with their corporate participation, rather than a view of the firm as a simple nexus of contracts or agency problem. The ability of these participants to protect their rights depends significantly on the nature of this relationship: Shareholders have the benefits of fiduciary duties, while preferred stockholders may be in a better position to manage risk through *ex ante* contracting. Redistributive compensation should be applied when a wealth transfer that is prone to opportunism occurs. This will be, in all likelihood, when corporate constituents are poorly positioned to take advantage of risk mitigation techniques.

C. TEST

An optimal corporate governance transitional policy would include a default presumption requiring redistributive compensation upon wealth redistribution due to corporate governance change. Determining when a corporate governance change should trigger a right to compensation presents one challenge to implementing a redistributive compensation scheme.[134] Corporate governance changes occur all the time as promulgated by the federal or state governments, stock exchange listing requirements and court decisions, among things. Many of these governance changes will not raise the opportunism issues discussed above.

Limiting the scope of any redistributive compensation requirement is important. Other approaches to expanding

133. Logue, *supra* note 7, at 1155. This recalls the standard torts discussion of placing liability on the lowest cost avoider.

134. Rubenfeld, *supra* note 15, at 1097.

compensation or government intervention for efficiency purposes have struggled with establishing a rule that captures appropriate situations.[135] This article advocates providing compensation in situations that are prone to opportunism to restore incentives for decisionmakers. Accordingly, a test is necessary to ensure that liability is limited to those abusive situations. Similarly, a rule must be observant of improving efficiency while minimizing any increases in transaction costs.[136]

A two-step test can be used to determine whether compensation for a corporate governance change is appropriate. First, is there a benefit shift between corporate constituents? This prong is a threshold issue to determine whether the potential for opportunistic behavior has been created by a corporate governance change. Second, have the affected parties made contractual arrangements for the benefit shift? If evidence exists that the parties have reached an agreement for a type of governance change, it should be assumed that they have factored the risk of such change into their arrangement and should not be compensated. If this transitional policy were the default it would promote efficient behavior by companies prior to transitions by reducing wasteful decisions and have sufficient flexibility to account for situations where compensation is not warranted.

1. Presence of a Benefit Shift

A right to compensation may occur if there is a cognizable shift in value between corporate parties due to a corporate governance change. This initial assessment is designed to suss out whether the benefit shift has occurred in a situation where opportunistic behavior can or could occur. This formulation puts the emphasis on three separate items: the wealth transfer, the corporate parties and the policy change. As indicated above, redistribution is applicable both to

135. *E.g.*, Blume & Rubinfeld, *supra* note 7, at 576–78 (discussing a series of articles by Joseph Sax that propose compensation should only be paid if there are no "spillovers" or "externalities" in the regulated conduct). However, in limiting the scope of the compensation requirement, they note that "since most regulatory activity attempts to control such externalities, this approach awards compensation only in a narrow set of circumstances." *Id.* at 578.

136. Bainbridge, *supra* note 54, at 578 ("The content of a default rule, whether set forth in a statute or a private standard form contract, does not matter very much when bargaining and other transaction costs are zero. However, the default rules' content begins to matter quite a lot in the face of positive transaction costs. If transaction costs are very high, bargaining around the rules becomes wholly impractical and inefficient. In high transaction cost settings, we cannot depend on private contracting to achieve efficient outcomes. Instead, in such settings, statutes must function as a substitute for private bargaining. The public corporation, with its thousands of shareholders, managers, employees, and creditors, each with different interests and asymmetrical information, is a very high transaction cost environment indeed.").

force the internalization of opportunistic cost avoidance and to protect against opportunistic wealth distribution.

A cognizable shift in value refers to a post-governance change in wealth between the corporate parties. A simple reduction in general wealth is not sufficient; rather a direct decrease in one party's wealth at the expense of the other party is necessary. This is a zero-sum gain proposition for the decisionmakers. For Growthco, the gains enjoyed by the owners are directly at the expense of employees. Redistributional compensation is meant to mitigate opportunistic behavior and correct market failure; it is not meant to capture all wealth transfers between corporate constituents.[137] Accordingly, losses by a single corporate constituency without a corresponding gain by another do not create the risk of opportunism necessitating redistributive compensation.[138]

Most corporate governance literature has focused on the risk of agency problems between shareholders and corporate management. This concern is perhaps the most obvious place for abusive corporate decisions.[139] Redistributive compensation should apply to all of the parties with rights relative to the firm, including majority shareholders, minority shareholders, directors, supervisory boards and employees. For example, the codetermination example used previously posits the transfer a supervisory board control rights to the board of directors, affecting a benefit transfer from the employees to the owners. This is an example of shareholder or board opportunism. Importantly, it shows how wealth transfers can be between non-traditional corporate constituents.

The redistribution requirement should only apply to opportunistic decisions. While it is possible to imagine a general requirement to equitably distribute all wealth changes caused by governance policy changes, this would probably affect too many events. Rather, this element needs to incorporate the risk-incentive

137. Indeed some of these changes are captured by existing rules. There are many current corporate governance mechanisms that provide protection against corporate wealth transfers. For example, the duty of loyalty of prohibits a corporate fiduciary from diverting corporate opportunities or benefits for personal gain. This rule inhibits a wealth transfer from the corporate shareholders to a manager. This fiduciary duty recognizes that opportunities that may become available to a fiduciary due to their association with the corporation should belong to the corporation. The risk of liability for a breach of the duty of loyalty is meant to require fiduciaries to internalize the potential cost of a decision to appropriate a corporate opportunity. In addition, there are a variety of shareholder lawsuits, protections against controlling shareholders in certain situations and other measures that protect against benefit transfers. What is interesting that the type of wealth transfers examined in this Article are not covered by existing doctrines.

138. Opportunistically pushing corporate wealth outside of the firm is generally covered by the existing duty of loyalty.

139. The notion that this is the sole agency problem or primary problem has diminished with time. *See generally* Bainbridge, *supra* note 54.

framework and emphasize penalties for decisions that permit externalization of decisionmaking costs. For example, low-risk events in particular would be less likely to be viewed as opportunistic. Again, the goal of ensuring efficient decisionmaking within a corporation is designed to place attention on the *quality* of decisions, rather than purely distributional goals. While this requirement may fall most heavily on the board, it is broad enough to reach actions by shareholders, unions, creditors and other corporate constituents.

Finally, the wealth transfer needs to be precipitated by a corporate governance policy change. So far, this article has primarily focused on corporate governance change caused by legislative action. This is in part due to the significant role played by legislatures in developing corporate law in many jurisdictions. That being said, significant corporate governance change can be caused by judicial decision or changes to stock market listing requirements. That being said, legislation seems more susceptible to *ex ante* opportunism due to the pace and public nature of the legislative process. In contrast, as will be discussed below, *ex post* opportunism is easier to imagine following a surprise judicial decision.

2. Contractual Arrangement Addressing the Issue

The second step is inquiring into whether the parties have addressed the benefit shift through a contractual arrangement. A contractual arrangement would indicate that the parties have internalized the cost of the potential change through negotiations and pricing. For example, if certain controversial features of a preferred stock are at risk of being outlawed, a party may include a fallback provision indicating the intent of the parties if the controversial feature is outlawed. This kind of solution would indicate that the parties have considered the risk of corporate governance change and factored the risk into their decision.

The presence of a contractual arrangement contemplating a corporate governance change would suggest compensation is unnecessary. If the parties have negotiated a solution for a corporate governance change, or approved a change through a charter amendment or otherwise, it is reasonable to assume that the parties have actively bargained and priced the risk of such governance change. If a party were required to provide compensation, in addition to the negotiated concessions, a redistribution requirement would force a double payment. The general concern of this article is whether the costs relating to a corporate decisionmaker are fully incorporated into that party's decision and the deleterious effects if they are not. If there is evidence that such costs have been considered and accounted for in a corporate relationship, it would make sense to let the current arrangement stand.[140]

Note, though, that contractual arrangements may not be possible for certain types of governance change. Corporate governance rules consist of mandatory and optional provisions. These rules can change depending on the type of entity and the risks associated with the corporate form; for example, governance rules for partnerships are generally considered more flexible than corporations.[141] Whether the rule that is changing is mandatory can have a significant impact on the compensation analysis because, generally speaking, it is efficient to let parties negotiate to internalize the risk of corporate governance change. If the current legal regime is mandatory, corporate constituents cannot internalize the risk of regime change.[142]

A mandatory legal regime sets rules for a corporation that cannot be waived or modified. In the codetermination example, the mandatory rule was that any company with greater than 2,000 employees needed to implement codetermination rights. Similarly, while the duties of loyalty and good faith are mandatory for fiduciaries of a Delaware corporation, it possible for the duty of care to be waived, making it an optional rule. In general, if a legal regime is mandatory, it will be less likely that constituents can chose the most efficient allocation or easily internalize the risk of change. For example, Louis Kaplow has mused that compensation may be necessary in highly regulated industries where decisionmakers cannot act efficiently due to regulatory constraints.[143]

This requirement is also important when considering the nature of the corporate constituents. In the codetermination example, the affected parties are the owners and the employees. In this example, the owners are subject to a mandatory government regulation and the employees are simple beneficiaries. If there was a risk of governance change and the employees were permitted to negotiate, it is possible to imagine that they would accept different rights that hedged against the risk of governance change.

140. Assessing the inclusion of a term may not be simple. Easterbrook and Fischel considered the difficulty of determining the source of contractual incompleteness. Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 285 (1986).

141. Ribstein, *supra* note 81, at 213.

142. Easterbrook & Fischel, *supra* note 140, at 284.

143. Kaplow II, *supra* note 41, at 34.

V. *EX POST* OPPORTUNISM AND REDISTRIBUTION

Up to this point, this article has relied on Growthco to illustrate opportunistic behavior, which has been useful is assessing redistributive compensation within a consistent, *ex ante* framework. However, redistributive compensation can ameliorate *ex post* opportunistic behavior (it may even be more appropriate). Extending the redistribution requirement to *ex post* opportunism eliminates some complexities associated with a purely *ex ante* framework, namely the difficulty of transitioning to an ideal policy, and ensures efficient behavior for current investments. Moreover, it expands the number of situations where opportunism interferes with corporate governance change.

The timing of decisions made in response to a corporate governance change is an important component of the amelioration offered by a transitional policy. If an efficient, market-based transitional policy is in place, market participants will have had sufficient information at the time of investment (and since) to properly mitigate the risk of policy change and decreases in investment value.[144] However, there is a question whether compensation should be made available for the unanticipated policy changes. Louis Kaplow's argument that policy risk resembled market risk and could be assessed *ex ante* not only indicated that government compensation was inappropriate, it also by extension indicated that the transitional policy was retroactive (not only should an investor not expect compensation in the future, they should not be entitled to compensation for investments made in the past).[145] Kaplow famously argued that many nominally prospective policy changes are effectively retroactive.[146] His oft-quoted example focuses on a tax-exempt government bond: If the tax-exempt status is revoked after purchase, even though nominally prospective, much of the original value of the bond is destroyed.[147]

144. Kaplow I, *supra* note 5, at 512.

145. Kaplow extended this argument to include explicit retroactivity when the previous activity was "undesirable," with the incentives arguments gravitating against retroactivity if that were not the case. *Id*. at 551.

146. An act has been described as "retroactive if it alters the legal status of acts that were performed before it came into existence." *Id*. at 515, quoting Munzer, *Retroactive Law,* 6 J. LEGAL STUD. 373, 373 (1977). In particular, articles in the tax field have focused on the implications of retroactivity on existing policy.

147. Some traditional transitional policies in the United States, though, have erred towards a conservative view of retroactivity. Treanor referred to the combination of the takings clause and contract clause the "norm of repose," noting that the "government must respect 'vested rights' in property and contract—that certain settled expectations of a focused and crystallized sort should be secure against governmental disruption, at least without adequate compensation." LAURENCE TRIBE, AMERICAN CONSTITUTIONAL LAW 587 (2d ed. 1988). *But see* Kaplow I, *supra* note 5, at 564 ("The contract clause is also related to transition policy. Unlike the takings clause, which requires

The question of how to handle immediate transitional losses has not been assessed in detail in recent works. Louis Kaplow focused on *ex ante*, rather than *ex post*, solutions, but did note that market failures[148] or inability to mitigate properly[149] may both provide grounds for government compensation.[150]

A. MULTIVOTE SHARES

Mandatory one-share, one-vote corporate governance regimes have recently received attention.[151] One-share, one-vote ("OSOV") refers to the requirement that shareholders be limited to voting rights equivalent to their ownership of the firm, rather than permitting a separate class of shares with different voting rights (sometimes known as dual class share structures).[152] Whether a party that has 60% of the control rights and 6% of the equity rights of a firm will act optimally has been subject to considerable debate. Similarly, OSOV can be applied to restrict the growth of decoupling voting and economic rights, sometimes called empty voting, that has been facilitated by modern derivatives.

An OSOV corporate governance regime is one component of broader push to try to maintain optimal incentives amongst corporate shareholders by ensuring that shareholders have rewards commensurate with their risks.[153] However, if a corporate governance policy that permitted multi-vote shares transitioned to an OSOV policy,

just compensation, the contract clause can be seen as forbidding reform altogether—the comparison being similar to the distinction between property and liability rules for enforcement of entitlements.").

148. Kaplow I, *supra* note 5, at 356.

149. *Id*. at 548.

150. Butler argued that any destructive change must include a transition period to ameliorate the damage. *See supra* note 1, at 382.

151. European Commissioner for the Internal Market Charlie McCreevy announced his intention to pursue the proportionality principle in 2005. *See Report on the Proportionality Principle in the European Union*, May 18, 2007, www.ecgi.org/osov/documents/final_report_en.pdf. The one-vote, one-share principle is one of the Control Enhancing Mechanisms ("CEMs")—devices that deviate from the proportionality principle—examined in the report. *Id*. at 39. The EU examined the significance of OSOV governance in listed EU companies in a report in 2007. The report provided a detailed look at the various corporate governance measures the EU and indicated that there were significant variations between the different countries. *Id*.

152. Martin Gelter discusses the potential advantages of an OSOV governance regime and the various vote-multiplication mechanisms, such as cross-shareholding and stock pyramids, noting both the theoretical appeal of a OSOV regime and sometimes divergent real-world examples. *Supra* note 55, at 161–64.

153. The *Report on the Proportionality Principal* ultimately concluded that there was no causal relationship between deviations from the proportionality principle and economic performance of firms, although investor perception was affected by these mechanisms and leading McCreevy to state that "there is no need for action at EU level on this issue." *Shareholder's rights*, EC.EUROPA.EU (Dec 2007), http://ec.europa.eu/internal_market/company/shareholders/indexb_en.htm.

shareholder rights would be instantly reallocated amongst existing shareholders. In contrast to the codetermination example, where Growthco's owner can assess and adjust her investment activity, multi-vote shareholders would experience an immediate loss in their investment value.

Imagine that a company, Goldco, has two classes of stock. The Series A shares are common shares, with one vote per share; the Series B are multi-vote shares, with three votes per share. There are 50 shares of Series A stock and an additional 50 shares of Series B stock. The multi-vote shares own 50% of the equity, but have 75% of the voting rights of Goldco. In the event of a OSOV requirement, Goldco would be forced to either move to parity, with the multi-vote shares losing their extra voting rights but the equity ratio remaining at 50-50, or the equity rights would need to match the voting rights, with the multi-vote shares acquiring equity commensurate with the voting rights, 75-25. In either situation, the gain or loss is fairly obvious: The control party loses, and the passive party gains, control right over Goldco, while in the second situation, the control party gains, and the passive party loses, equity in the company.

Assuming that the multi-vote rights would be stripped from the multi-vote shares, the governance change would result in a 50-50 distribution of equity and voting rights in Goldco.

Table B

	Pre-Policy	Post-Policy
Series A Shareholders (50 shares)		
Votes	50 (25%)	50 (50%)
Cash flow Rights	50%	50%
Series B Shareholders (50 shares)		
Votes	150 (75%)	50 (50%)
Cash flow Rights	50%	50%

The transitional loss caused by implementing an OSOV governance regime is the decrease in voting rights held by the Series B shareholders. This includes the monetary value associated with the naked voting rights, any control premium and any additional specific losses.[154] Also, there are the transitional gains to accrue to the Series A shareholders that have gained an additional 25% of the vote overnight.

154. Specific losses could include provisions in the bylaws prohibiting corporate actions without a super majority vote. Series B shareholder may have satisfied these provisions prior to the change to OSOV but then unable to exercise the rights without the supermajority holdings.

If the control and passive parties were content with the arrangement prior to the institution of an OSOV regime, it is reasonable to anticipate that the parties would negotiate towards an arrangement that approximated the old regime. This expectation is premised on two similar ideas. First, parties will negotiate to reach an efficient outcome and, barring any changes, will continue to operate in this configuration moving forward.[155] Presumably the pre-transition arrangement represented a state of equilibrium. Second, this model is premised on changes to voting rights. Companies generally elect a multi-vote share structure prior to inviting in third parties who are comfortable with the disparate voting rights. In other words, the multi-vote and single shareholders made their investments premised on the premium or discount created by the existing share structure.

The disparity between the previous status quo and reallocation of rights after governance change creates a risk for opportunistic behavior. The simplest example may be to imagine that there is a single holder of Series A shares and a single holder of Series B shares. The Series B shareholder desires to restore its previous controlling position in Goldco. However, the Series A shareholder has no reason to sell shares (or consent to issuing new shares) at a fair market price. Moreover, due to their position of power as the sole holder of the Series A shares, they may refuse to sell shares unless they receive exorbitant premium. This can result in holdout problems.[156]

The ability of the Series B shareholder to restore the status quo is also questionable. The loss of voting rights in Goldco is not compensated under a no-compensation regime.[157] This creates an immediate decrease in the value of their investment in Goldco. If the Series B shareholders do not have additional resources, they may not be financially capable of paying for any shares held by the Series B shareholders. Moreover, it is unlikely that they will be able to reach their old voting power of 75%. Instead, it seems reasonable to expect that Series B holder to only purchase enough stock to gain a majority of the shares.

155. This is discussed further in the Coasean model at *infra* Part V.B.

156. Depending on the number of sellers and buyers, monopoly and monopsony fact patterns can also be easily imagined.

157. A perfect example of a corporation's ability to reduce the value of a shareholder's stock is the poison pill. The corporation is capable of substantially reducing the value of a single holder's shareholdings without providing compensation. Some countries, such as Japan, prohibit disparate treatment of shareholders.

B. COASEAN TRADITION

As the OSOV example indicates, implementing a corporate governance change can significantly alter the value of an investment, with the change in value between the two parties being a zero-sum gain. This potential gain and loss is reminiscent of Ronald Coase's work, *The Problem of Social Cost*, which addressed the issue of wealth distribution between two interlinked parties.[158] Coase's article, and subsequent works that have built on it, provide a framework that can be used for assessing intrafirm transition losses.

In 1960 Ronald Coase attacked traditional reactions to nuisance and torts remedies, which favored imposing liability or setting limiting taxes, by asserting that "[w]ith costless market transactions . . . liability for damage would be without effect on the allocation of resources."[159] One famous example included in *The Problem of Social Cost* involves two neighbors, a cattle-raiser and a farmer.[160] Coase's major innovation was observing that, in the absence of transaction costs, affected parties would bargain to the efficient result regardless of whether liability is placed on one party or the other party.[161] Specifically, he showed "the 'damaging agent' will make the same calculation of marginal cost whether charged with responsibility for damages or not."[162]

This argument has been plagued by two strains of criticism. The first focuses on the caveat that "transaction costs" are not, and

158. Yuri Biondi, *The Problem of Social Income: The Entity View of the Cathedral*, 34 SEATTLE U. L. REV. 1025, 1037 (2011) ("As Coase recognized, the problem of social cost has a reciprocal nature in that it implies interdependency between welfares of involved parties. One party's welfare critically depends on the welfare and decision-making process of the other. Thus, a collective dimension exists that must be considered. Specifically, a collective social income is at stake, either positive or negative, depending on the institutional design.").

159. R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2–7 (1960). G. Warren Nutter, *The Coase Theorem on Social Cost: A Footnote*, 11 J.L. & ECON. 503, 503 (1968) ("[Coase] showed that[] whenever the cost of market transactions can be neglected, the 'damaging agent' will make the same calculation of marginal cost whether charged with responsibility for damages or not.").

160. Coase, *supra* note 159, at 2–8. The example assumes that, without a fence, any increase in the size of the cattle-raiser's herd would increase damage to the farmer's crops. When the cattle-raiser contemplated increasing the size of his herd, he must also consider the marginal cost of each additional steer. At some point, though, when liability is imposed on the cattle-raiser, it may be more profitable for the cattle-raiser and the farmer to agree for the farmer not to plant any crops and the cattle-raiser can simply pay for his damages. *Id*. at 4. Coase continues to illustrate how even if liability is placed on the farmer that the same total wealth will be achieved. In this example, the farmer would instead be willing to pay to prevent damage to her crops and "it would be [as] if the cattle-raiser had to pay for damage caused by his cattle, since a receipt foregone of a given amount is the equivalent of a payment of the same amount." *Id*. at 7.

161. Although nailing down the definition of the Coase Theorem has been more difficult. *See* Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 14–15 (1982) (providing different definitions of the Coase Theorem).

162. Nutter, *supra* note 157, at 503.

generally cannot be, zero. Once this problem is realized, the resulting message of the work has been "study the world of positive transaction costs."[163] Coase discussed how courts have been cognizant of imposing additional costs and instead had refused to further inhibit a basically efficient process.[164] Second, commentators have noted that Coase's formulation only pays attention to the total cost of a business,[165] rather than examining wealth changes between parties.[166] In the example of the farmer and the cattle-raiser, the placement of liability changes whether the farmer is the recipient of a profit-increasing payment or required to make a payment to preserve a sliver of their original profitability.[167] The result is that even if the same total social benefit is reached, this may hide the fact that one party has suffered a significant decrease in wealth (i.e., an efficient result, but not Pareto efficient).[168]

While *The Problem of Social Cost* explicitly targeted how to handle costs imposed by a business on others, the logic has been more widely incorporated into institutional organization, game theory and other fields. Social cost presented a conundrum for many scholars in which a mutually beneficial solution was possible but not necessarily achieved due to the very reasons highlighted in the OSOV example: Changed positions of power, lack of information and other complications. For example, Oliver Williamson has written extensively about transaction cost economics. Williamson notes that institutional economics principle of "conflict, mutuality, and order prefigures the concept of governance as herein employed—in that governance is the means by which to infuse order, thereby to mitigate conflict and realize mutual gain."[169] Yet, by focusing on reducing transaction costs, which are the minor (but really major) caveat of Coase's work, Williamson tried to develop framework to minimize the disruptions a relationship that can occur with significant change.[170] Of particular note are his thoughts on efficient alignment, positing that the more specific assets are involved

163. Oliver E. Williamson, *Transaction Cost Economics: The Natural Progression*, 100 AM ECON. REV. 673, 676 (2010) [hereinafter Williamson II].

164. Coase, *supra* note 159, at 27–28.

165. Biondi, *supra* note 158, at 1025.

166. Coase admitted as much in his article, stating that "[w]hen an economist is comparing alternative social arrangements, the proper procedure is to compare the total social product yielded by these different arrangements. The comparison of private and social products is neither here nor there." Coase, *supra* note 159, at 34. Indeed, when he wrote *The Problem of Social Cost*, he was explicitly targeting the mainstream literature focused on private and social costs.

167. *See generally* Biondi, *supra* note 158, at 1028–34.

168. In particular, Biondi provides an example indicating that allocation of a control right can result in a swing of 20% of the social value using Coasean logic. *Id.* at 103–32.

169. Williamson II, *supra* note 163, at 674.

170. *Id.*

in a transaction, the greater the need for unified ownership and coordinated action to prevent defections from the transaction.[171]

C. LESSONS FOR CORPORATE GOVERNANCE CHANGE

The logic of the larger selection of theory of the firm and law economics literature relates to how redistributional compensation can cure transitional losses. Transitional losses can be viewed as examples of incomplete contracting where the parties failed to fully contract for investment related eventualities.[172] In the traditional transitional policy framework, compensated losses are equal to the amount of compensation received from a third party or the mitigation due to cost spreading or insurance. Failure to contract for a possible decrease in investment value due to a governance change is similar: If the parties had considered it *ex ante*, then they could have contracted to ensure that compensated losses approximated the actual losses.[173] In the Goldco example, the Series A and Series B shareholders each invested in a certain bundle of benefits, the value of which was reflected in the purchase price. The change in values due to a governance change reflects a change in the circumstances, rather than the preferences of the holders.[174]

The previous Part discussed the significance of requiring redistributive compensation to correct potential moral hazard

171. *Id*. at 681. Similarly, Yuri Biondi uses a Coasean analysis to initiate a comparative study between "institutional solutions of ownership, market, taxation, responsibility, and the accounting system of the joint entity." *Supra* note 158, at 1025. Biondi also focuses on the distributional deficiencies of Coase's original article. Biondi notes that a social cost, like a nuisance or tort, "has a reciprocal nature in that it implies interdependency between welfares of involved parties. One party's welfare critically depends on the welfare and decision-making process of the other. Thus, a collective dimension exists that must be considered. Specifically, a collective social income is at stake, either positive or negative, depending on the institutional design." *Id*. at 1037. Biondi's article argues that the firm as an entity perspective is the only means to assure a Pareto efficient distribution post-transaction. Biondi proposes that one institutional solution is to create a joint entity can be created with affected parties as stakeholders. The control right in this situation is allocated to the entity and an accounting system of the entity is drafted to establish the gains and losses due to the new activity. *Id*.

172. Incomplete contracting refers to the practical (rather than theoretical) inability of a party to fully contract for all possibilities *ex ante* and, therefore, the inability to properly distribute benefits from the contractual relationship. Transitional losses are the difference between a party's actual losses and their compensated losses.

173. Another argument would favor creating an exit right for shareholders in this situation. *See* Butler, *supra* note 1, at 382 ("Consistent with the contractual theory of the corporation, shareholders must have an opportunity to exit the corporation before an anti-takeover statute becomes effective or has significant price effects.").

174. In this situation, the Series A owners had accepted a controlling shareholder and the risk of governance change negating the control right was minimal. It is likely that, had the Series A and Series B holders negotiated, the price would be similar and post-transition control rights would be maintained.

problems *ex ante*. This argument was premised on the idea that requiring post-policy change redistribution would require decisionmakers to calculate, and internalize, the cost of abusive decisions. This approach is consistent with the efficiency arguments presented in transitional policy works. However, Kaplow was generally much more circumscribed when discussing application of a new transitional policy to currently pending reforms.[175] In particular, he was concerned with the difficulties of managing immediate transition gains and losses.[176] The rules proposed for redistributive compensation also have the potential to mitigate unanticipated transition losses.

Redistributive compensation can exploit the corporate structure to enforce equitable distribution of transition gains and losses. Goldco presents a problem where a change in policy significantly reallocates corporate governance rights. Any attempt to restore controls similar to the pre-transition allocation of rights presents the risk of opportunism and holding out by the newly empowered parties. The previously passive Series A holders will gain a controlling position in the firm, while the Series B holders, who probably have made significant firm-specific investments consistent with the controlling position, will be unable to realize the value of these investments without restoring their control position. The difficulty presented by this is one of contractual incompleteness: While the parties would have originally desired to preserve their pre-transition rights, contracting for all possible types of change can be prohibitively expensive.[177] Yet, if the manner of change is not anticipated, it becomes hard to argue

175. Kaplow I, *supra* note 5, at 557 ("Because of this discrepancy, it does not necessarily follow from the analysis presented in this Article that the transition policy deemed optimal should be applied to reforms now pending or to those in the immediate future—even aside from all the other qualifications noted thus far. The reason is that the incentives argument presented here derives from the *ex ante* effects of the anticipated transition policy, whereas when a reform is enacted, any *ex ante* effects, for better or worse, are confined to the past. Therefore, the analysis does not directly resolve the question of what to do *ex post*."). Note, though, that Louis Kaplow did support retroactive application of policies if the prior behavior had been disapproved: "Sometimes new legal rules should be made fully retroactive: they should be applied to time periods before the enactment date, even as to investments no longer in existence . . . . The incentives analysis developed above favors precisely such retroactive application when the justification for a reform suggests that the prior activity was undesirable. For example, when the government bans a product on the basis of recently completed studies indicating that the product had always been harmful, penalties should also be applied to production prior to the date of the announcement; failure to do so would decrease the incentives for manufacturers to take such risks into account ex ante." *Id.* at 551.

176. Kaplow deferred on prescribing how to proceed with this sort of implementation. *Id.* at 558.

177. Williamson I, *supra* note 124, at 117 ("Contractual incompleteness problems develop where there is *ex ante* but not necessarily ex post uncertainty.").

that the parties can properly contract to mitigate transition losses.[178]

Absent explicit contractual or statutory provisions, property rights can function as a gap-filler that vests certain rights in corporate constituents. Goldco shows how the default allocation grants power that can be used abusively.[179] Including a default rule in favor of redistribution of windfall gains can cure this problem: Redistribution would require an equitable wealth distribution while achieving the efficiency gains of implementing the new legislation. The changed default would alter any leverage in any negotiations about post-transition ownership in favor of fair redistribution, rather than permitting hold out strategies. For example, in the Goldco example, if the Series A holders would be liable for opportunistic behavior in selling shares to the Series B holders.[180] In this context, redistribution requirement prevents holdout and prevents gains procured through abusive behavior.

The application of redistributive compensation recalls, and relies on, the symmetry between gains and losses, where recipients of windfall gains are perfectly positioned to provide recompense to the transition losers but legal rules fail to facilitate an efficient transaction. Redistribution would require that the pre-transition interests of the Series A and Series B be preserved. Requiring compensation of the Series B holder losses by the Series A holders is facilitated by the very wealth gain received from the corporate transition: the increased value of Goldco common shares. These gains can be used to finance payment, or even serve as the compensation itself, for the Series B losses.

178. This is important because redistribution is consistent with the rationale for a firm: integrating separate market players into the firm can reduce opportunistic behavior that may occur between parties. Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1120 (1990) (explaining how redistribution is consistent with the rationale for a firm because integrating separate market players into the firm can reduce opportunistic behavior that may occur between parties). Zingales has stated that one role of governance is to remedy ex-post bargaining efficiency, which is "tantamount to . . . the degree to which the assumptions of the Coase Theorem are violated." Zingales, *supra* note 100, at 9.

179. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 108 (2004).

180. Of course, the rule proposed in Part IV.C requires a poor decision to trigger redistributive compensation. Whether *ex ante* actions should require a decision, and *ex post* should not, is one additional consideration. Note that this sort of duty is similar to the fiduciary duties imposed between shareholders in a closelyheld corporation. The major differences include: (1) if it is triggered merely by the governance change and (2) applicability to public corporations.

VI. IMPLEMENTATION AND CORPORATE CONTROL

The final issue presented by a redistributive compensation scheme is implementation. While the rules discussed in the previous parts for mitigating opportunism may be simple, incorporating such a system into existing legal procedures adds several complications. This article has primarily focused on potential problems with corporate governance policy change and the normative appeal of requiring redistributive compensation. The questions raised by implementation, though, can complicate the analysis considerably.

First, implementing a redistributive compensation norm could be achieved in a number of different ways. One option is to create an additional fiduciary duty. Fiduciary duties, and associated liability for breaches, play a significant role in mitigating insider opportunism and perform much of the heavy lifting in American corporate governance. Assuming a corporate governance change has come to pass, a member of a corporate constituency could file a claim requesting disgorgement of any opportunistic gains. Another option would be tasking firm mechanisms with allocating resources at the time of a corporate governance change. For example, an independent board committee could be tasked with assessing the value of an intracorporate transfer and equitably distribution the changed value. This would take advantage of the existing firm-specific knowledge and permit good faith efforts by the committee to mitigate abuses of corporate constituents.

Second, though, implementation of a redistributive scheme interacts with larger dialogues on the manner and goals of firm governance. Whether a firm should focus on shareholder or stakeholder wealth maximization and the foundation for corporate control presents a more complicated arena for new duties.[181] In proposing an additional fiduciary duty to stakeholders or additional wealth redistribution responsibilities for corporate boards, the first Part stumbles into these larger debates about the significance of the board and the corporate form in general. In particular, should duties in a corporation run to parties other than shareholders?

Finally, a fiduciary duty or additional board responsibility imagines a comprehensive solution to corporate governance opportunism. But, the current corporate governance statutes and case law provide *ad hoc* collection of restraints that attempt to address opportunism in different situations. For example, shareholder-shareholder opportunism is generally proscribed in closely-held

181. Margaret Blair, *Corporate Law and the Team Production Problem* (Vanderbilt Univ. Law Sch. Working Paper No. 12-14, 2012); Blair & Stout, *supra* note 52.

corporations and constituency statutes often explicitly exclude stakeholders from having a right of action. A final consideration is whether these provisions are sufficient to reduce the specific risks of opportunism, rendering a default rule in favor of redistribution unnecessary.

A. FIDUCIARY DUTY OR CORPORATE CONTROL

Redistribution could be handled at the firm level in two different manners. First, a private right of action for corporate constituents could be created. Fiduciary duties perform a lot of the heaving lifting for state-level corporate governance. The traditional duties imposed on directors and officers, combined with the risk of direct or derivative suits, permit shareholders to force decisionmakers to assess the quality of decisions and potential for liability. In this manner, fiduciary duties help internalize the cost of opportunistic decisions in a variety of situations.[182] Similarly, enforcement of federal rules by the SEC and Department of Justice adds another stick prodding decisionmakers in the right direction. Imposing an additional duty on corporate constituents to redistribute governance losses and gains, with the threat of liability, would place liability on a similar track as those existing remedies.

A general duty to redistribute compensation after a corporate governance change may be unwieldy. While there may be normative appeal to redistributive compensation and familiarity with fiduciary duties, effectively implementing duties that run between all corporate constituents may be difficult. Relying on diverse employees or third parties, such as suppliers or communities to properly police corporations would be ambitious.

Second, a different option that has support in the institutional organization literature would be enforcing wealth distribution within the existing hierarchy. When confronted with organizational situations that could result in inefficient decisions, Williamson advocated imposing a hierarchy, while Biondi supported a joint entity with decisionmaking powers. Both solutions, along with others, are premised on combining control and rationality on an otherwise chaotic process by forcing a decisionmaker to internalize the costs of their decision.[183] In particular, these approaches acknowledge that opportunistic behavior may occur when there are multiple parties with

182. The availability of indemnification, D&O insurance and other processes can reduce the influence of the different types of liability, but in theory fiduciary duties should force internalization of decision costs.

183. *Supra* note 178 (providing a detailed look at how control and assets should be combined).

differing interests and instead create a decisionmaker that has the proper incentives to make an efficient decision. Luigi Zingales defines corporate governance as "the complex set of constraints that shape the *ex post* bargaining over quasi-rents generated by the firm," and this broad definition highlights the function of rules in restraining inequitable behavior.[184]

In particular, reallocation of existing property rights is a transaction where hierarchy can reduce inefficient transactions. Oliver Williamson distinguishes between generic transactions and those that involve specific assets with significant prior investment. While the former match most hypothetical law and economics transactions, transactions relating to the latter are subject to considerable coordination problems. The types of corporate governance transitional losses that present the most acute examples for redistribution (proprietary rights for certain corporate constituents) match the types of firm-specific assets that are most likely to lead to troublesome transactions.

The imposition of internal order on corporate governance transactions builds on the existing corporate structure. The threat of transitional loss is that corporate governance change will reallocate corporate rights and that lost rights will be difficult to recover. By imposing a hierarchy on the affected parties, "internal organization attenuates the aggressive advocacy that epitomizes arm's length bargaining . . . . In circumstances, therefore, where protracted bargaining between independent parties to a transaction can reasonably be anticipated, internalization becomes attractive."[185] Thus, in a situation like Goldco, where transition losers may attempt to regain their previous control position and confront opportunistic former minority shareholders, the imposition of a hierarchy may be necessary to reallocate rights that are otherwise distributed by chance.

Not only can imposing a hierarchy reduce transition losses, the infrastructure may already be in place at a transitioning firm. For example, publicly traded companies in the United States are required to have audit committees composed of independent directors. Some corporations even have corporate governance committees that specialized in corporate governance matters and there is reason to believe that these entities may be well positioned to manage distribution questions.[186] These committees can serve as the decisionmakers when distributing transition gains and losses.[187]

184. Zingales, *supra* note 98, at 250.
185. Zingales, *supra* note 98, at 255.
186. Williamson I, *supra* note 124, at 114.
187. Of course, the argument can go the other direction: To the degree we are concerned that the board is subject to control by management or other powerful insiders, it may not be the best

B. SHAREHOLDER PRIMACY

Comparing a hierarchy approach or fiduciary duty approach implicates larger discussion about shareholder primacy and the nature and goals of a corporation. The principal-agent model has had a significant influence on the conception of firm governance and purpose: shareholders own the firm and the directors and officers serve as their agents. Decisions are made for the benefit of the shareholders. However, this story has always been complicated by the fact that directors and officers are not controlled by the shareholders but rather controlled by statutory requirements and legal norms. A number of theories have been proposed to describe this relationship, but a few are worth highlighting to show how the corporate form and control interacts with intracorporate redistribution.

In discussing the corporation, academics have struggled with the means and ends of the entity, which "strive[s] to answer two basic sets of questions: (1) as to the means of corporate governance, who holds ultimate decisionmaking power? and (2) as to the ends of corporate governance, whose interests should prevail?"[188] Margaret Blair and Lynn Stout famously proposed a team production theory of corporate law in 1999.[189] They proposed that a public corporation was not designed for minimizing agency costs and shareholder wealth maximization but rather that the board acted as mediating hierarch.[190] The board members were responsible for coordinating the various corporate constituents and allocating corporate wealth.[191] This recognized that corporations, rather than shareholders, own corporate property and the central role played by directors and officers in managing corporate wealth.

Later, Stephen Bainbridge penned a similar work proposing that a director primacy provided a better explanation for corporations. Rather than managers, shareholders or stakeholders controlling the corporation, the directors were completely responsible for control.[192]

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guardian for the interests of other corporate constituents. Nonetheless, there is a significant difference between permitting a board or committee to simply make decisions and adding an additional requirement that decisions reflect an equitable distribution of corporate governance change wealth. Adding additional requirements will both ensure the consideration of redistribution issues and support for equitable distributions.

188. Bainbridge, *supra* note 54, at 549–50. The quote continues "[w]hen the ultimate decisionmaker is presented with a zero-sum game, in which it must prefer the interests of one constituency class over those of all others, which constituency wins?" *Id*.

189. *See* sources cited *supra* note 181.

190. Blair & Stout, *supra* note 54, at 277 ("The act of forming a corporation thus means that *no one team member is a "principal" who* enjoys a right of control over the team.").

191. *Id*. at 250–51.

192. Bainbridge, *supra* note 54, at 550.

Directors were ultimately responsible for shareholder wealth maximization, in contrast with promoting stakeholder interests.[193]

At a superficial level, both theories recalibrate assessments of corporate decisions. Both imagine the empowerment of the board and a recognition that it does not simply function as an agent for shareholders.[194] Indeed, both models can support imposing redistribution responsibilities on the board. This function is almost implicit in the Blair-Stout mediating hierarch, tasked with protecting enterprise-specific investments. Similarly, Bainbridge's argument that the "ends" of director primacy is shareholder wealth maximization is consistent with the efficiency arguments presented in favor of redistributive compensation. Bainbridge's directors are well positioned to handle general intra-corporate redistribution.

Imposing a fiduciary duty on the various corporate constituents may make this process more difficult. Bainbridge argues against tasking boards with responsibilities other than shareholder wealth maximization; he refers to the "two masters problem" whereby a servant cannot serve two different masters faithfully.[195] At first glance, this would gravitate against imposing a fiduciary duty to corporate constituents on the board. That being said, redistributive compensation is consistent with shareholder wealth maximization and does not create a broad, constituent-primacy standard: Redistribution is designed to focus on accurately calculating the expected value of investments, including costs that a no-compensation approach may otherwise ignore. For example, Growthco should choose the most profitable investment that accurately reflects all costs, not simply one that is subsidized by omissions in the transitional policy. Similarly, Goldco would require an equitable distribution, rather than permit extortion in the sale, of lost corporate rights.

C. SIGNIFICANCE

One additional concern is whether the law manages to address the risk of corporate governance opportunism in an *ad hoc* fashion, rather than necessitating a default rule. This article has expressed concern that the protections against opportunism can be arbitrary and fail to provide efficient default rules. Instead, though, it may be argued that

193. Bainbridge, *supra* note 54, at 572.

194. Blair & Stout, *supra* note 54, at 253.

195. Bainbridge, *supra* note 54, at 582. In regard to the two master problem, Bainbridge invokes Matthew 6:24 "that 'no one can serve two masters.' As that passage goes on to explain: 'Either he will hate the one and love the other, or he will be devoted to one and despise the other. You cannot serve both God and Money.' In the corporate governance context, I argue herein, directors likewise cannot serve both shareholders and nonshareholder stakeholders.") (citations omitted). *Id.* at 581 n.170.

the law is effective at implementing restrictions or requiring redistribution only where it is most efficient; a general requirement would be too difficult to implement effectively.

For example, shareholder-shareholder relationships can create a fiduciary duty between shareholders in a closely-held corporation. Similarly, constituency statutes have specifically excluded stakeholders from having a right of action.[196] In a different vein, substitutes for redistribution rights may also be an effective protection: Bainbridge states that stakeholder concerns are inferior to shareholder concerns because of additional stakeholder protections, like unions.[197] Each of these examples may indicate that a system without redistributive compensation is workable.

While a detailed discussion would take time, even these preliminary examples are enough to cause concern that other mechanisms are sufficient to protect all corporate constituents. For example, the fiduciary duties imposed on shareholders in closely held corporations may address the type of situation examined with Goldco.[198] But, current fiduciary duties do not reach far enough to require distribution. Remedies available in closely held corporations general include appraisal, dissolution and certain types of judicial intervention. While a shareholder-shareholder duty may ensure that a fair price in these situations, it does not require an equitable distribution of transition gains and losses. Similarly, it does not apply to publicly traded companies.

Constituency statutes specifically addressing constituent standing show those legislatures have considered stakeholder involvement. This presents a second option: Legislatures are capable of assessing the different constituencies affected by policy change and defining the range of available remedies. On first impression, this process should not contradict redistributive compensation because legislation can expressly preempt a default rule. That being said, the operation of redistributive compensation should provide a backstop to changes that do not address compensation.

196. *See* Anthony Bisconti, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land*, 42 LOY. L.A. L. REV. 765, 783 n.130 (2009).

197. Bainbridge, *supra* note 54, at 590.

198. Note that these rules may be specific to abuses by controlling or dominant shareholders, rather than all inter-shareholder claims. For general information on fiduciary duties in closely-held corporations, see Joseph W. Anthony & Karlyn Vegoe Boraas, *Betrayed, Belittled . . . But Triumphant: Claims of Shareholders in Closely Held Corporations*, 22 WM. MITCHELL L. REV. 1174 (1996) (describing fiduciary duties in closely held Minnesota corporations); Easterbrook & Fischel, *supra* note 138, at 291. For example, Minnesota law requires "each shareholder of a closely held corporation has a duty to each other shareholder to act in a fair, reasonable and honest manner," which should temper any negotiations that may occur. Anthony & Boraas, *supra*, at 1198.

Finally, the union example stands in for the notion that non-shareholder constituencies are protected by mechanisms other than corporate governance. Examining the power dynamic between corporations and the various constituents is beyond the scope of this article. Worthy of note, however, is that the wax and wane of union power in the United States provides a perfect example of relying entirely on external checks instead of internal mechanisms to ensure efficient behavior. More importantly, from an efficiency standpoint, while a legal default may lead to costly litigation, it seems like a cheaper solution to inefficient decisions than requiring a full union (that will also protest decisions with costly litigation).

VII. CONCLUSION

This article has discussed the role that compensation can play in corporate governance policy transitions. Traditional arguments have alternated between full government compensation and no compensation as efficient policies for policy change. This article has shown that neither approach is appropriate for corporate governance policy change: Corporations permit corporate constituencies to externalize the cost of certain decisions and make inefficient decisions in manner not fully appreciated in the compensation literature nor fully mitigated in corporate governance doctrine. Imposing a requirement that decisionmakers redistribute transitional gains can force the internalization of these costs, restoring optimal incentives for decisions. This redistributive norm has appeal for ensuring efficient decisions *ex ante* and reducing opportunism and ensuring equitable distributions of wealth after policy changes.

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