4-1-2015

"Traditional Economics and the Fiduciary Illusion: A Socio-Legal Understanding of Corporate Governance"

Jason Searle

Follow this and additional works at: https://scholarsarchive.byu.edu/byuplr

Part of the Law Commons

BYU ScholarsArchive Citation
Brigham Young University Prelaw Review: Vol. 29 , Article 8.
Available at: https://scholarsarchive.byu.edu/byuplr/vol29/iss1/8

This Article is brought to you for free and open access by the All Journals at BYU ScholarsArchive. It has been accepted for inclusion in Brigham Young University Prelaw Review by an authorized editor of BYU ScholarsArchive. For more information, please contact scholarsarchive@byu.edu, ellen_amatangelo@byu.edu.
Traditional Economics and the Fiduciary Illusion: A Socio-Legal Understanding of Corporate Governance

Jason Searle

Following crises such as Enron and the financial meltdown of 2008, the conversation concerning what went wrong and what needs to be changed is typically dominated by those voices of legal-economic nature, that is, having a basis in traditional economic paradigms. The scholars and policymakers under this banner typically rely on similar theoretical foundations to one another in framing reform. The problem with our singular trust in this purportedly scientific and objective community is identified by the work of emerging socio-legal thought, particularly from new economic sociology. Scholars in this field have recently questioned the neoclassical economic model which serves as a basis for legal-economic scholars’ and policymakers’ reform proposals. Socio-legal thinkers are aware that the solutions created by the legal-economic community materialize in the law. However, as a socially embedded institution, the law more often than not has farther reaching consequences than accounted for by its black-letter intent and neoclassical, rational-actor foundation.

But much socio-legal thought, including new economic sociology, is very recent and has yet to cover much of the territory that has been traversed by legal-economic scholars time and again. One such area will be the focus of this paper: fiduciary duties in corpo-

1 Jason Searle is a senior at Brigham Young University studying Sociology. He will matriculate to law school in the Fall of 2015. A special thanks to Professor Flake for all his help from the first draft, to Professor Jennejohn for taking that first draft and pointing out all the holes in it, and to editors Will Glade and Fran Djoukeng for standing by through thick and thin.
rate governance. The fiduciary set-up of corporate governance has been greatly stressed and invested in by traditional legal scholars and policymakers alike in response to corporate scandals and economic crises. Take Enron, for example—after the allegations that the board of directors engaged in insider trading, new audit, nomination, and compensation committee reforms were designed to make directors independent and better able to comply with fiduciary duties.\(^2\) While such reform sounded good in theory, its practical application was less successful, as directors have been able to serve on these committees without alarming the court of a conflict of interest.\(^3\) This problem arises because the fiduciary model is based on a limited theoretical perspective. Socio-legal thought recognizes this, and thus can contribute to rethinking the issue of corporate governance.\(^4\) This paper will specifically point out the flaws in supposing that the fiduciary set-up creates director accountability.

This article will proceed in Part I by laying out the fundamental differences between the traditional take of legal-economic studies and socio-legal thought, particularly with concern to new economic sociology. After the boundaries are drawn in Part I, Part II will define fiduciary relationships and accompanying principles, and show how they are a product of the traditional approach to law and economics. Part III will point to some major issues created by reliance on the fiduciary model of corporate governance. Part IV will note the potential for socio-legal studies to remedy some of the limitations of the fiduciary model, especially in reference to the duty of care, where it can build upon a more recent trend in legal scholarship. An


example of the support a socio-legal perspective might afford will be
given with the equity trustee. By avoiding oversimplification of the
human actor, socio-legal insight would suggest advantages to the eq-
uity trustee that have not been acknowledged in the more traditional
legal literature. Following this, Part V will conclude.

I. NEOClassICAL ECONOMICS VS. NEW ECONOMIC SOCIOLOGY

In an honest effort to be objective and scientific, the legal-economic
tradition up until the 1980s and 1990s was dominated by
the atomistic, rational human actor model of the neoclassical tra-
dition. At around the same time, scholarly discussion concerning
corporate governance was revitalized, and was fated to be analyzed
under this socially negligent paradigm. This viewpoint, explained
M. Granovetter, an early new economic sociologist, was flawed for
being what he called “undersocialized.” While not totally unfound-
ed, neoclassical accounts rested on faulty assumptions, and failed
to recognize the importance of the law’s and economics’ embedded-
ness in a social world. Granovetter also pointed out the overreaction
of some economists to this situation, which was to “oversocialize”
the human actor, discrediting the actor rationality envisioned by
the undersocialized neoclassical account. The folly in both of these

5 Gerald F. Davis, New Directions in Corporate Governance, 31 ANN REV.
SOC. 143, 144 (2005). (The rational human actor model Davis refers to
consists of human actors primarily motivated to act in their own self-in-
terest. The model assumes that the actor’s decision-making is completely
accounted for by a personal cost-benefit analysis, rendering social factors
inconsequential).

6 Id. at 159.

7 Mark Granovetter, Economic Action and Social Structure: The Problem of

8 Andrew Lang, The Legal Construction of Economic Rationalities?, 40 J.L.
Soc’y 155, 162-163 (2013). (Lang explains how neoclassical economics
relies on two faulty assumptions: 1) Human actors possess perfect infor-
modation, 2) Human actors exercise perfect rationality. We can easily see
how social contingencies undermine both of these assumptions, something
new economic sociology picked up on).
groups was said by Granovetter to be based in oversimplifying the human actor. By this he meant that neither lens alone was sufficient, but a balance between the two was necessary for an accurate portrayal of reality.

Granovetter’s and other emerging new economic sociologists’ middle ground between the oversocialized and undersocialized accounts is explained well by Lang, who identifies the law’s ability not only to regulate the operation of corporations, but also play a constitutive role. This is to say that law is not in a passive role when creating the rules for corporations, but is actively creating a framework within which CEOs, directors, and officers must operate and run their business. Furthermore, what Lang calls “cognitive infrastructure,” the paradigm under which rationality is constructed, is collective within this group because they share in the same corporate governance market. Under this socio-legal perspective, rationality—the crux of neoclassical economics—still exists, but contrary to neoclassical economics, its social embeddedness makes it an imperfect rationality.

While somewhat intuitive, the idea of markets and economic actors as socially embedded had been overlooked, giving new economic sociologists the chance to shed light on numerous matters previously left almost exclusively to the legal-economic camp. However, despite the strides new economic sociology has made, socio-legal perspectives on corporate governance only started to make

11 Michael Useem, The Social Organization of the American Business Elite and Participation of Corporation Directors in the Governance of American Institutions, 44 AM. SOC. REV., 553, (1979). (Useem explored the world of the business elite and discovered an “inner group” of corporate executives who were categorized as such because of their upper-level involvement in numerous corporate, NGO, and other organizations and their power to promote the general interests of the entire capitalist class. Especially common, and applicable to this paper, was Useem’s discovery that high numbers of “inter-locking” directors, or directors serving on boards for multiple corporations, were part of the inner group).
way into the conversation ten to fifteen years ago. One of the scholars making headway in this respect, GF Davis, recognized the work of Granovetter as more than enough reason for socio-legal insight concerning corporate governance to be discovered.

Davis made his case for introducing socio-legal perspectives of corporate governance by tracing the legal-economic approach back to the origins of the corporate governance discussion. Industrialism created a separation of management (executives) and ownership (shareholders). This divide was criticized for years by so-called “managerialist” scholars for the alleged tension it created between management and ownership. Responding critically to these theorists were the nexus-of-contracts (a.k.a. contractarian) theorists, who supposed that, rather than create rivalry, the management-shareholder divide would incentivize management to perform their best.

While bright lines may be difficult to draw today, vestiges of the managerialist and contractarian camps still exist. As Mackerron put it, corporate law scholarship is divided in two: the “traditional hierarchical” side (comparable to managerialist camp) supporting a fiduciary setup for corporations, and the “contractual” side supporting a view of corporate accountability based in contractual obligations for parties involved. The first group, more in support of the fiduciary setup, bears more of a resemblance to the managerialist camp, as their position is more skeptical of corporate management and therefore supportive of legal provisions to keep them in line. The second camp is much more trusting of management and therefore supports more contract-based mechanisms of enforcing accountability.

The focus of this paper is more to address the managerialist camp of Davis’ account, which might seem odd considering they

---

12 G.F. Davis, New Directions In Corporate Governance, 31 Annu. Rev. Sociol. 143, 156 (2005).
13 Id. at 144-146.
14 John A. MacKerron, Shareholder Derivative Litigation and the Nexus of Contracts Corporation, 40 U. Kan. L. Rev. 679 (1991-1992). (While it is outside the concern of this paper, it should be noted that MacKerron also identifies a middle group, who either don’t find the corporate governance setup debate useful, or who fall between the two camps).
seemingly gave greater attention to social factors. But bear in mind that in either camp, we can see places where theorists have either under- or over-socialized the human actors involved. On the one hand, the sternly skeptical attitude of managerialists toward corporate management assumes too much socially fostered deviousness to be inherent in the board setup. On the other hand, a naive trust in the laws of economics and self-interest of management to keep order fails to acknowledge that “boards of directors in practice look little like the antiseptic monitoring devices contemplated by theorists, and are indeed very much social institutions.” So rather than pick one side, I will seek to use socio-legal analysis to highlight the flaws within either camp, and supplement them with insight sensitive to social factors; such insight will acknowledge rationality as embedded in a social structure, but a rationality nonetheless, with room for agency.

Having set new economic sociology and socio-legal studies apart from neoclassical economics and the legal-economic tradition, we may proceed to show how corporate governance fiduciary duties have been handled by the latter, and how the former can offer valuable insight to the fiduciary duty discussion.

II. THE FIDUCIARY RELATIONSHIP AND TRADITIONAL APPROACHES

Corporate governance law assumes the existence of a fiduciary relationship between corporate management/directors and shareholders. By virtue of this relationship, directors on a corporation’s board are said to owe the fiduciary duties of care (e.g. in decision-making) and loyalty (e.g. to the firm/shareholders). These duties make manifest in law through legislation and case-law. Breach of

15 G.F. Davis, New Directions In Corporate Governance, 31 ANNU. REV. SOC. 143, 151 (2005).
16 A fiduciary relationship in a general legal sense is a relationship where one or both the parties involved have some kind of legally binding obligation to one another. In the case of corporate governance, specific duties of directors are enumerated that together are meant to ensure directors act in the best interest of shareholders.
17 STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 197 (2002).
these duties can supposedly lead to liability, though courts have been extremely cautious about holding directors liable, especially for breaches of duty of care. In fact, the existence of the business judgment rule makes finding directors liable for damages or loss very rare.\textsuperscript{18} Even after finding the board of directors was aware of corruption in the Enron scandal, total damages awarded to shareholders from the board only ended up amounting to $13 million, meanwhile an estimated $27 billion in assets had been losing money off the books.\textsuperscript{19}

The importance of and deference to the business judgment rule in the courts reflects the neoclassical concept of specialization—the idea that directors, with their expertise and everyday involvement in the business world, are better suited to make business decisions than courts. Thus, the business judgment rule essentially says that restraint should be exercised in calling director decision-making into question in all cases except where there is evidence of bad faith conduct. This means that directors can make poor decisions, even ones resulting in great firm loss, without being held liable, as long as those decisions were made with the intent to increase firm and/or shareholder value.\textsuperscript{20} Thus, fiduciary duties, in theory, would expectedly be fulfilled by a director acting in good faith, and their existence does not violate the business judgment rule.

From the moment shareholder derivative litigation arises, United Copper Securities Co. v. Amalgamated Copper Co. permits business judgment dismissal of a case before the court will even consider liability.\textsuperscript{21} United Copper extended the power of the business judgment

\textsuperscript{18} Burks v. Lasker, 441 U.S. 471 (1979) See notes 76-101 infra and accompanying text.


\textsuperscript{20} \textsc{Stephen M. Bainbridge, \textit{Corporation Law and Economics} 270 (2002).}

\textsuperscript{21} United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917).
rule from being merely a defensive measure to avoid personal liability to “an offensive weapon permitting directors to terminate shareholder derivative suits.”

To avoid case dismissal, the plaintiff has the burden—in the absence of evidence that the board engaged in fraud, illegality, or self-dealing—to pass the Aronson test. The purpose of this test is to determine whether or not the particularized evidence shareholders bring forward would create doubt as to whether the challenged behavior is business judgment protected.

Walt Disney Co. Derivative Litigation serves as a classic example of the strength of the business judgment rule. After just a year of employment, Michael Ovitz was terminated from his CEO position with the Walt Disney Corporation. Initially, the board saw great promise in Ovitz, and had thus built a generous severance package into his contract amounting to $140 million. While charges were brought against the board for such an apparent blunder, efforts to find any on the board liable failed. The court agreed with the plaintiffs that, especially in light of the brevity of Ovitz’s employment, the severance package seemed a bit excessive. However, the court affirmed a lower court’s decision to dismiss the case on the grounds that the business judgment rule protected the board’s decision in this case just as it would have if they had given out a loan in good faith which was ultimately dishonored.

Caution in holding directors liable through a forgiving business judgment rule is also motivated by a concern to not discourage talented individuals from becoming involved in corporate governance.

---


23 Connolly v. Gasmire, 257 S.W.3d 831, 841 (Tex. App. 2008). (This test says a corporation’s demand [to dismiss] will be excused if a shareholder pleads facts that create reasonable doubt that 1) directors were independent/disinterested, or 2) challenged transaction was result of valid exercise of business judgment. These criteria largely emphasize the director duty of loyalty. If the shareholder fails to create doubt about either one, the case is dismissed).

24 Id.

Leading corporate governance scholar Stephen Bainbridge takes for granted that greater chance of liability for corporate management necessarily reduces efficiency of decision-making. Because of this, he reasons, risk of opportunism and plain carelessness must be accepted as inevitable.\textsuperscript{26} Bainbridge is not alone; great trust of directors is exercised widely in case-law and legal scholarship alike. Glaspy, reviewing Gantler—which gave corporate officers the same protections from liability enjoyed by directors—notes that the court thought it “only rational to insulate officers if we are going to insulate directors, to keep the corporate governance running smoothly and to encourage risk-taking...this seems a more ‘realistic approach’ for corporate America.”\textsuperscript{27} Bainbridge’s and Glaspy’s opinions capture the general consensus among corporate governance scholars concerning directors and fiduciary liability, and this serves to illustrate how strongly neoclassical economic models have influenced corporate governance law.

Such an attitude is also generally taken by legislatures crafting the law. As it has traditionally been seen as corporation friendly, Delaware serves as the capital state in the U.S. for corporations.\textsuperscript{28} The Model Business Corporation Act (MBCA) and the Delaware General Corporation Law (DGCL) both embody important corporate governance standards which were crafted under the influence of the traditional legal-economic paradigm.\textsuperscript{29} The business judgment rule finds its place in the MBCA, which states that a director’s challenged conduct can only be found deserving of liability if in the decision made, “the director was not informed to an extent the director reasonably believed appropriate in the circumstances.”\textsuperscript{30} True to the business judgment presumption, this law gives greater weight

\begin{itemize}
\item \textsuperscript{26} Stephen M. Bainbridge, Corporation Law and Economics 283 (2002).
\item \textsuperscript{27} Meghan Glaspy, Delaware’s Gantler Decision: A Solution to Corporate Corruption, 12 Geo. J.L. & Pub. Pol’y 289, 308 (2014).
\item \textsuperscript{28} Daniel R. Fischel, The Business Judgment Rule and the Trans Union Case, 40 no. 4 The Business Lawyer A.B.A. 1437, 1439 (1985).
\item \textsuperscript{29} Delaware General Corporation Law Ch. 1 S.Ch.IV §141(e) 16; Model Business Corporation Act Ch. 3 §3.02 Pg. 31-32.
\item \textsuperscript{30} Id.
\end{itemize}
to rational, incentivized directors’ business decisions. The DGCL is not much different in its big-picture content. This law relies heavily on fiduciary duties to regulate a corporation’s actions. It assumes corporate actors will be driven by a sense of ethical duty and raw self-interest to do what is best for their company, employees, and shareholders regardless of outside circumstances and pressures.31

Case law also tends to follow the traditional, legal-economic suit, as directors are held liable only very rarely. Those few cases in which a court has given a stricter interpretation of directors duties, and thus been more likely to hold directors personally liable, have been treated by most of the legal scholarship with contempt. The classic case to fit this description, Smith v. Van Gorkom, imposed liability on directors for a breach of duty of care after the court decided they had failed to appropriately inform themselves before a merger.32 From the very year it was decided, Van Gorkom garnered great animosity from the legal-scholarly community, with Fischel making the statement to be cited by hundreds after him—that Van Gorkom was “surely one of the worst decisions in the history of corporate law.”33 Although Fischel regards the court’s facts in this case as inaccurate, his piece accepts them as true for the sake of showing that, even under what he sees as the biased view of the court, the business judgment rule should have protected the directors from liability. Fischel justifies his support for a forgiving business judgment rule on several grounds, including the idea of specialization and directors’ optimal position to make business decisions, and the role of contractual and market mechanisms in rewarding good business decisions and penalizing bad ones.34 These bases of Fischel’s analysis align him with the neoclassical economic tradition, and the popularity of his work in legal scholarship is evidence of the general consensus regarding holding directors liable.

31 The Handbook of Economics Sociology 4, Table 1 (Neil J. Smelser & Richard Swedberg eds. 1994).
34 Id. at 1439-1440.
While there are critics of the business judgment rule and the “insurance” it provides against liability for any action a director can prove was done with a business-advancing motive, the great majority of legal scholarship, policymakers, and Delaware judges deem business judgment protection a worthy and reasonable cause. Their case rests upon neoclassical economic principles and theory. They accept the problems that arise from weak accountability-enforcing mechanisms because they assume directors to be rational actors who are incentivized to perform well due to their relationship to the corporation; if they do well for the corporation, the corporation does well for them.  

III. Critique of Legal Economic Approach to Fiduciary Relationship

Because of the influence of the neoclassical economic paradigm under which corporate governance law is traditionally viewed, the legal community’s perspective on the fiduciary relationship of boards of directors suffers from severe tunnel vision. Case law, legislation, and scholarly work on the fiduciary relationship tend to exhibit one or more of the following five symptoms: 1) A naive trust in the strength of fiduciary duties to encourage accountability of corporate management, 2) Reliance on weak reform of fiduciary duties to create accountability after crisis, 3) Resistance to strong fiduciary duty reform, 4) Ignorance to social considerations, and 5) Ineffective monitoring of board accountability.

In the courts, we see a dominant presence of the third and fourth symptoms, with some significant evidence of the first and fifth symptoms as well. Follet supports this assertion in his commentary on Gantler. Similar to Glaspy (referenced in section II), Follet identifies the general fear that “the specter of liability” is likely to encourage inferior decision-making processes and discourage risk-taking. The light handling of directors in the courts is good evidence of this idea’s primal importance. However, Follet brings up another interesting point which goes against the grain of what traditional
perspectives on corporate governance would predict. Even absent protections from liability, corporate management has been seen to take extreme risks.\textsuperscript{36} Without socio-legal insight, such evidence seems to work against the rational actor model. But from a socio-legal stance, it is acknowledged that directors are no strangers to the rules constraining their behavior. Many are even “repeat players” in the judicial system, which can create a great disparity in power between a corporation’s directors and shareholders when a lawsuit arises.\textsuperscript{37} And when directors cannot cover all their bases to avoid liability, they use special litigation committees, to whom the courts look when considering whether or not to dismiss litigation.\textsuperscript{38} While supposedly comprised of “disinterested outsiders,” these committees are, after all, formed by the firms being sued, thus leading to a conflict of interest.\textsuperscript{39} Thus, the law in courts does not always play out as intended because it is created, enforced, and complied with in a social world.

The ability of directors to work the system through understanding the law and its limitations is epitomized in the case of fiduciary duties. Take for example the duty of care. While in theory this duty is supposed to ensure that directors make informed, sound decisions, even legal-economic scholars have admitted the ruling of Disney practically incapacitates what was already a weak duty of care.\textsuperscript{40} New economic sociologists might identify the disconnect between shareholders and directors. While shareholders expect that a duty

\begin{thebibliography}{9}
\bibitem{40}Kelli A. Alces, Debunking the Corporate Fiduciary Myth, 35 \textit{J. Corp. L.} 239, 250 (2009).
\end{thebibliography}
of care ensures decisions are made on an informed basis with the interest of firm value in mind, the duty as enforced looks very different from what its standard might suggest. But, as long as the duty is there, and as long as scholars and reformists continue to unjustifiably stress the importance of fiduciary duties, shareholders might not consider other ways in which accountability might be achieved.

Still, corporate governance law continues to emphasize fiduciary duties. Especially in the event of market failures, legislators create law assuming that new superficial modifications to directors’ fiduciary duties will have a meaningful impact. This means that most of the time, fiduciary duty tightening and greater regulation implemented have negligible effect or are simply advisory. Where this is not the case, reform tends to be ridiculous and impossible for directors to comply with alone, which leads them to hire committees to account for new compliance measures. Such new requirements in Sarbanes-Oxley may have been tedious, but, as Skinner noted, were not premised upon any new theories of director responsibility.

While failing to create actual accountability, it would be socio-logically naive to believe that fiduciary duty reform makes no difference in corporate governance behavior. This kind of legislation often comes as a knee-jerk response to market failure. Sarbanes-Oxley and Dodd-Frank came about because of such circumstances, and instead of representing effective reform, scholars point out how these acts either did nothing or simply added useless tedium to corporate operations. A socio-legal approach would recognize that as some kind of a response, these acts serve in part as smoke and mirrors to disguise the fact that nothing meaningful is actually being done to bring about change. Furthermore, new stipulations of legislation alter the environment under which directors operate, which reflects

41 Darren C. Skinner, Director Responsibilities And Liability Exposure In The Era Of Sarbanes-Oxley, 52 PRAC. LAW. 29 (2006).
42 Id. at 31.
43 Id. at 34.
44 Id. at 30.
as a change in the definition of rational behavior. But rather than making directors more effective, this modified rationality results in directors taking more time to ensure they can avoid liability, resulting in less efficient performance.\textsuperscript{46}

More impacting legislation than the hasty and poorly construed acts responding to corporate scandals and financial crises are the MBCA and the DGCL, the foundational corporate law statutes referenced previously. The duty of care and the duty of loyalty, as construed in these laws, are heavily based on the ideas of neoclassical economic thought—individuals are assumed to act rationally and are uninfluenced by other economic players.\textsuperscript{47} But the duties these laws are supposed to create and enforce are weak. A socio-legal perspective would recognize that, as experienced players in corporate governance, directors and corporate management are able to play the field—so to speak—to avoid the actual restraint and consequences imposed by these laws.\textsuperscript{48} We saw this empirically proven in the financial crisis and even after, as corporate management was often able to deploy “golden parachutes” while their firms experienced significant loss or even burned to the ground.\textsuperscript{49} This was all done while the MBCA and DGCL were in place. Dodd-Frank’s provision to remedy this situation, establishing a non-binding shareholder vote on executive pay,\textsuperscript{50} was a classic case of an ineffective supplementary reform.

\textsuperscript{46} \textit{Stephen M. Bainbridge, Corporation Law and Economics}, 283 (2002).

\textsuperscript{47} \textit{The Handbook of Economics Sociology} 4, Table 1 (Neil J. Smelser & Richard Swedberg eds. 1994).


\textsuperscript{49} Robert T. Miller, The Wages of Failure, \textit{The Economist} (July 29 2010), \url{http://www.economist.com/node/16693567}.

There may be hope for a change in perspective. Some scholars in the corporate law circle have recently deemed that considering the duty of care a fiduciary duty is dangerous, while others simply think that corporate law has evolved to nullify the potential effects fiduciary duties could have. Once scholar supporting the latter position, Alces, asserts that corporate fiduciary obligation is a myth. Of three traditional scholarly views in support of fiduciary duties, Alces points out that none are compatible with current, real-life application. To Alces, describing the duties of care and loyalty as “fiduciary” is a misnomer that confuses shareholders about how much power of redress they actually have. Overall, there is an emerging movement in the legal scholarship away from the fiduciary relationship.

IV. SOCIO-LEGAL INSIGHT ON FIDUCIARY DUTIES AND DIRECTOR ACCOUNTABILITY

Bringing socio-legal insight into the discussion about fiduciary duties and director accountability could manifest in various ways with various dividends. From introducing qualitative studies to determine how boards become effective, to highlighting the importance of social relationships within the corporate management setting, to creating new models under which director accountability can be studied, socio-legal work has great potential to enrich and inform by itself. However, there is also a great opportunity for socio-legal insight to build upon and add to scholarship emerging from the more traditional legal-economic circles, especially with concern to fiduciary duties and director accountability mechanisms.

Part of the reason we look to build upon work already done by more traditional legal-economic scholarly work is because we recognize, as Davis and colleagues point out, that the more traditional


52 Kelli A. Alces, Debunking the Corporate Fiduciary Myth, 35 J. CORP. L. 239, 241-142 (2009).
models have their place. They write in specific reference to the neoclassically-based agency theory. The premise of self-interested actors combined with the split between management and principals (i.e. shareholders) makes for a theory whose implications resultantly point to regulatory measures to improve firm management performance. These regulatory measures can be either external (e.g. fiduciary obligations) or internal (e.g. board of directors). It is interesting that despite the skeptical view agency theory presumes of management, it still trusts the board, which management typically is a part of, to regulate appropriately. Still, agency theory’s reasoning behind its endorsement of certain regulatory measures is fair, but unsupported by additional theory, it fails to provide insight into how managerial and principal interests can be aligned, a more proactive way of accomplishing the task that regulation sets out to achieve.

Various socio-legal approaches have taken us closer to understanding the alignment of management and principal interests. Ahrens and Khalifa note that, left to agency theory, corporate governance remains a black box, leaving the inner-workings unknown. Therefore, the authors propose socio-legal insight, in the form of qualitative methods capturing the “lived experience” of governance, is in order. Along with this foundational method, the authors note that different models of corporate governance can guide qualitative

---


56 Thomas Ahrens & Rihab Khalifa, Researching the Lived Experience of Corporate Governance, 10 Qualitative Res. Acct. & Mgmt. 4, 4-6 (2013). (When the authors say “lived experience” they are referring to how corporate governance is practiced by directors and executives. This relates back to Granovetter’s idea of socially constructed rationality and Lang’s cognitive infrastructure).
Regardless of the specific model chosen, it becomes apparent after a deeper look into corporate governance that mere compliance with government codes—which is what agency theory would propose to create management accountability—is not a good indicator of good governance practice. A better way to measure good governance comes when directors’ control function is accompanied by an exceptional service function. For instance, under the accountability grounded theory model, the authors pointed out that we can measure success of a board by how “engaged” or “passive” directors are. More engaged directors probe and challenge executives to fulfill their control roles, but they also support executives in decisions, fulfilling a service role.\(^5^8\)

The findings under the accountability model may be expounded upon by referring to stewardship theory, which actually arose in response to agency theory’s alleged “simplistic view of human nature.”\(^5^9\) With a sociological foundation, stewardship theory takes a more forgiving view of corporate management than agency theory. Rather than seeing management as motivated solely by self-interest, the theory envisions management with collectivist values that will motivate them to act in the best interests of the company. This theory would thus suggest that management autonomy should be maximized, or in other words—regulation should be eased.\(^6^0\) Roberts, McNulty and Stiles, who use stewardship theory to study boardroom accountability, are like Davis in the sense that they do not attempt to choose between agency theory and stewardship theory. Rather, they argue that we should be able to recognize when each theory

---

57 Id. 10-11
58 Id.
applies.\textsuperscript{61} For instance, citing a study conducted by Westphal, the authors note how development of closer social ties between the CEO and the board was shown to provide greater mutual trust, space for advice-seeking by executives, less defensive behavior, and more learning.\textsuperscript{62} In this case, an interpretation using stewardship theory would account better for the observed phenomenon than would agency theory. Still, stewardship theory poses the danger of placing too much trust in fostering collaboration, which can result in complacency and group-think, so it is important to have a careful balance of control through appropriate regulation.\textsuperscript{63}

Despite the value of agency theory and stewardship theory in different instances, in the U.S. there is a greater need to realize the insights of stewardship theory than agency theory; just look at our response to the great financial crises of the last decade or so—Sarbanes Oxley and Dodd-Frank. The thousands of pages constituting these acts implemented regulations and rules which law scholars have deemed tedious and unlikely to create a greater level of accountability.\textsuperscript{64} On the other hand, the UK response to their own economic crises has been to explore what could be done more proactively to strengthen effectiveness of non-executive directors.\textsuperscript{65} This is where we see the value in McNulty’s and Stiles’ focus on the connection between non-executive directors and executive management. However, their study does leave the agency theory concern of a management-principal divide unsettled. Just because management and the board of directors get along does not mean minority shareholders are protected. In today’s corporate governance environment,

\begin{itemize}
  \item \textsuperscript{62} Id. S8.
  \item \textsuperscript{63} Id. S10.
  \item \textsuperscript{64} Stephen Bainbridge, Dodd-Frank: Quack Federal Corporate Governance Round II, 25 Minn. L.R. 1779, 1780-1782 (2010-2011).
\end{itemize}
it is obvious that minority shareholders can still be slighted even if executives and directors are on the same page.

This is where a new direction in the mainstream corporate governance literature can be built upon through socio-legal insight. This direction moves toward contract-based corporate governance, rather than a fiduciary set-up. Following this trend, Alces envisions an equity trustee, a person who would replace the current fiduciary duty set-up. Rather than being another director, an equity trustee would be the eyes, ears, and voice of the non-governing minority shareholders.66 Thus, they would be a force for keeping directors accountable.67 What Alces—as a traditional legal-economic scholar—has not stressed as much is the potential for an equity trustee to enhance directors’ service roles.

From a socio-legal standpoint, realizing the value of an equity trustee goes back to the fundamentals and Granovetter. While undersocialized, traditional accounts suppose that a director will be motivated to perform well by having an obligation to n persons, Granovetter would recognize the strength of this relationship would increase were the director required to answer to a person, one who represented shareholders.68 Taking this into consideration accounts for the rationality supposed by traditional legal scholars, but it is shown to be a bounded rationality shaped by many factors, including social relationships. Furthermore, combining this with McNulty’s and Stiles’ findings, it is apparent how an equity trustee could abet the service role of a director. Just as engaged directors were closer to management (and thus able to perform their roles better), so too would an engaged equity trustee put minority shareholders a step closer to directors and management, bringing about similarly positive outcomes.

With concern to more accountability-related factors, there is even greater incentive to introduce the equity trustee. Shareholder

derivative litigation could be avoided, not only because the equity trustee would be actively involved in monitoring and influencing board deliberations, but also because the equity trustee would be in a contractual relationship with the board, which would give them a certain level of latitude in promoting director accountability, proactively averting the need to sue over a breach of fiduciary duties.

V. Conclusion

Legislators, courts, and legal scholars all tend to follow the legal-economic tradition as they respond to financial crises and corporate scandals. This leads to reform based on faulty assumptions that oversimplify the human actor, and in the case of corporate governance accountability mechanisms, this leads to a futile reliance on the fiduciary setup.

New economic sociology and other emerging socio-legal research can supplement the legal-economic tradition’s oversight by identifying important social considerations relevant to corporate governance. Potential socio-legal contributions are many and various, but as a specific example, it was shown how they can lead us to conceptualize directors in a different light than traditional approaches, which helps us appreciate both control and service functions of directors. This new framework supports a recent idea in emerging contract-based legal scholarship—the equity trustee—which could serve as an alternative to the current fiduciary setup that would both create greater accountability and improve director performance.