MARK J. GUAY, P.C.

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Incompletely Theorized Agreements & The Business Judgment Rule

In the introduction to his book entitled ***On The Rule of Law*** the author Brian Z. Tamanaha wrote that "[m]y conviction is that theory is relevant to everyday life, and therefore it should be available to everyone." Companies today operate on various business and financial theories of the most efficient and effective way to do so. So just as it is important to have several key business theories to operate a company, it is equally as important to understand some key legal theories as well. In this article I will review the theory of what is known as Incompletely Theorized Agreements and how it may affect your business. In a Law Review Article entitled "Incompletely Theorized Agreements" by Cass R. Sunstein (108 HLR 1733 -1995), the author states that "Participants in legal controversies try to produce "Incompletely Theorized Agreements" ("ITAs") on particular outcomes as, for example, Delaware case law demonstrates." Judges are people who come from different walks of life and educational backgrounds and beliefs, so there is no "one size fits all" baseball cap perspective on how an entity should be operated within the confines of a legal framework. Simply put, because companies are not boilerplate copies of one another, boilerplate operational and compliance measures are not effective or necessary as well. People are different, and so are the companies they own and operate. Basically, different systems beget different "agreements" to operate them (albeit the Caremark case "red flag" and subsequent line of cases create baseline legal duties).

So what does the author mean by an ITA, and how is it helpful to a company? The author states that decision makers "need not agree on a fundamental principle. . . . but the distinctive feature of this construct to settle disputes is that it emphasizes agreement on (relative) particulars rather than on (relative) abstractions." Ideally, most legal decisions would be based on a "completed theory" that the judges agree upon to justify same but that is usually not possible. Alternatively, judges can perhaps agree on low-level principles that account for the outcome, but not the higher level proposition or abstraction. The beauty of ITAs is that they have the important advantage of allowing large degrees of openness to new facts and perspectives. As Sunstein writes, "There is a large advantage [to ITAs] over more arbitrary methods since ambitious thinkers, in order to reach horizontal and vertical coherence, will probably be forced to disregard many decided cases. . . ." By using an ITA, judges do not have to agree to a high level principle that may not be totally on point, so they agree on a lower level concept based more on the particular facts and circumstances of the case.

So how does this play out today? In the Maryland Law Review Article entitled "A Decision Theory Approach to the Business Judgment Rule: Reflection on Disney, Good Faith, and Judicial Uncertainty" (2007), the author, Andrew S. Gold, writes that "there is no necessary connection between academic theories of the firm (i.e., the purpose of limited liability entities such as corporations, etc.) and judicial theories of the firm. Economists and legal scholars may adopt one theory of the firm, and courts may adopt another. Indeed, judges may reasonably choose to adopt no theory at all". The author then does an overview of academic theories of the firm (e.g., shareholder supremacy) and corporate legal doctrine (e.g., good faith, principal – agent, etc.). One key ITA construct he addresses is the legal doctrine known as the Business Judgment Rule. So how does it work? The author writes that "The business judgment rule ["BJR"] is an example of an incompletely theorized agreement [in that] its presumption produces a doctrinal result in which courts and commentators can roughly agree, even though the higher level theories that support this convergence are in conflict." Simply put, all judges may agree to dismiss a case, but they disagree as to its major premise for doing so.

So what is the BJR, how does it work, and what does it mean to your company? Section 4.01 [a] of the Principles of Corporate Governance [ALI, Vol. 1 - 1994] states a Directors of Officers' duty of care is "to perform [their] functions in good faith in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care of an ordinarily prudent person . . . in a like position and under similar circumstances". So how does such a person comply with this duty? Subpart [c] of same states that "A director or officer who makes a business judgment fulfills the duty under this Section if [he/she];

(1) is not interested in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment . . . and

(3) rationally believes that the business judgment is in the best interests of the corporation.

This rule is considered to be generally consistent with present state law, so it is considered "black letter" law. If a Director or Officer complies with this duty of care according to the BJR rule, it allows a court to dismiss the case. If not, the case is allowed to proceed through the trial process. So why is the BJR considered an ITA? The author concludes that "courts and commentators may differ on theories of the firm, [nevertheless] courts must still reach decisions in concrete cases". The BJR standard of review of a business dispute offers a pragmatic solution to the many types of facts and circumstances courts are faced with each day. "Courts do not need a fully developed theory of the firm in order to adopt the business judgment rule."

Looking back, how did corporate law ever get to this point? As far back as the beginning of the 1900s, courts were addressing the relationship between economics and the law. In the case of Lochner v. New York, 198 U.S. (1905) the U.S Supreme Court addressed the issue of whether the State of New York lawfully convicted a baker (Joseph Lochner) for violating the 10 hours a day, 60 days a week maximum time permitted under the New York Bakeshop Act of 1895. The court overturned the law stating that it "necessarily interferes with the right of contract between the employer and employees, concerning the number of hours which the latter may labor in the bakery of the employer." It did so using the 14th Amendment of the U.S. Constitution. In his well-known book entitled ***Freedom from the Market*** by Mike Konczal [2012], he writes that "it is the saddest irony that the Supreme Court used these Reconstruction amendments to attack labor legislation which they were never designed to do, while they also abandoned using them to preserve civil rights for blacks in the South." [p.50]

Notwithstanding the courts majority holding, what is most important from this opinion is the Dissenting Opinion written by Justice Oliver Wendell Holmes, Jr. who stated as follows:

> I regret sincerely that I am unable to agree with the judgment in this case (invalidating a statute limiting the hours of work in bakeries], and that I think it my duty to express my dissent.
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> This case is decided upon an economic theory which a large part of the country does not entertain. If it were a question whether I agreed with that theory, I should desire to study it further and long before making up my mind. But I do not conceive that to me my duty, because I strongly believe that my agreement or disagreement has nothing to do with the right of a majority to embody their opinions in law. It is settled by various decisions of this Court that state constitutions and state laws may regulate life in many ways which we as legislators might think as injudicious or if you like as tyrannical as this, and which equally with this interfere with the liberty to contract . . . . The liberty of the citizen to do as he likes so long as he does not interfere with the liberty of others to do the same, which has been a shibboleth for some well-known writers, is interfered with by school laws, by the Post Office, by every state or municipal institution which takes his money for purposes thought desirable, whether he likes it or not. The Fourteenth Amendment does not enact Mr. Herbert Spencer's Social Statics. [At that time well known British sociologist known for his "Social Darwinism" theory, and who coined the expression "survival of the fittest".] The other day we sustained the Massachusetts vaccination law. United States and state statutes and decisions cutting down the liberty to contract by way of combination are familiar to this Court. Two years ago we upheld the prohibition of sales of stock on margins or for future delivery in the constitution of California. The decision sustaining an eight-hour law for miners is still recent. Some of these laws embody convictions or prejudices which judges are likely to share. Some may not. But a constitution is not intended to embody a particular economic theory, whether of paternalism and the organic relation of the citizen to the state or of laissez faire. It is made for people of fundamentally differing views, and the accident of our finding certain opinions natural and familiar or novel and even shocking ought not to conclude our judgment upon the question whether statutes embodying them conflict with the Constitution of the United States.

The majority opinion of the Lochner case, and dissenting opinion by Holmes above, laid the groundwork for the tension between the law, and its relationship to business and economics, for the next hundred plus years. Holmes rightly called out the court when they had adopted an overly broad "liberty of contract" economic theory to justify their conclusion. Fast forward a century later, to the year 2000, and the author Mike Konczal summarizes so-called "financial capitalism" today, as follows:

> The consensus among academics [today] is so tight that in the year 2000, one pair of legal scholars described the "End of History for Corporate Law", where all modern nations agreed on a "widespread consensus that corporate managers should act exclusively in the common interests of shareholders".
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> This shareholder revolution, just like all revolutions, was based on an affirmative vision of freedom. This new ideal was not the freedom of managers to determine what is best for their business, or the freedom of the public and workers to make demands on how corporations exercise these actions; it was the freedom of shareholders to exercise their property rights according to their private wishes.
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> You see it in the economist Milton Friedman's influential 1970 New York Times Magazine essay "The Social Responsibility of Business Is to Increase Its Profits," which called for reestablishing the corporation as simply the property of its shareholders. He also had a very clear vision of what the modern corporation was: it was shareholders as "the owners of the business" with bosses as people directly hired by them to carry out their will. "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers."
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> Friedman's idea that shareholders own corporations as their own property, and that corporate executives are employees of shareholders, has so won out in popular arguments that it's worth reflecting on why it is wrong. The CEO is an employee of the firm itself. The CEO's paycheck is paid out by the corporation, not a long list of widely dispersed shareholders, each having to sign the check themselves. CEOs don't interview with shareholders for their jobs. Shareholders hire the board, which in turn hires the CEO, but the board can consider any number of factors in that role. The CEO, through the business judgment rule and the legal framework of the mid-century period, had to take into account the interest of shareholders, but would also take into account many other obligations and responsibilities as needed by the firm.

> Moreover, while shareholders have some legal powers and obligations, they lack most of what we would conceive of as real ownership rights. Shareholders don't control assets. Shareholders can't walk into the firms where they invest and start taking things off the shelf. They don't manage. They can't fire or hire everyday employees and bosses or to tell workers how to do their jobs. The can't force the firm to do anything in their daily operations, be it buy or sell property, or open and close various business lines, or take on debts and other obligations. They also don't control funds. . . . The whole point of limiting the liability shareholders face is because they have none of these rights that we associate with ownership. What Friedman needed was an intellectual framework that obligated executives to understand themselves as mere agents of shareholders. This framework was being hammered out in the seminar rooms of the newly insurgent "law and economics" movement. The first step was to weaken the notion that because shareholders were dispersed meant that they had only a tenuous connection to the firms themselves. In 1965, law professor Henry Manne introduced the idea of a "market for corporate control." By selling and buying shares in firms, especially in the form of taking over firms and changing managements, shareholders could create a market for the control of corporations. This market was reflected in the share price. Management indifferent to shareholders would be punished by lower share prices.
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> This new wave of thinking continued through the 1970s, and perhaps reached its apex in 1976, when the economists Michael Jensen and William Meckling published their paper "Theory of the Firm," which remains one of the most cited papers in the study of business. Jensen and Meckling describe the firm as simply a marketplace in its own right. Like any market, in the view of the law and economics movement, it is efficient and based on maximizing behavior. For Jensen and Meckling, firms weren't social creations, or active entities in the economy and their communities. They were instead an abstraction that intersected numerous individual contracts, all of them efficient in their own right. In their view, "it makes little or no sense to try to distinguish those things that are 'inside' the firm (or any other organization) from those things that are 'outside' of it." That corporations were sites of private government for workers, or had any kind of obligation or relationship to their broader communities, all dissolved in this acidic market thinking.

It also presupposes that shareholders own the firm, and that they have hired managers to execute the firm for them. Using the increasingly dominant language of economics, the shareholders are principals, and the managers are their agents. The question becomes how to align the incentives of the agents with those of the principals. For Jensen and Meckling, the question was one of agency cost. Shareholders had to cover the costs of monitoring and directing their principals and their central problem, as Jensen would later describe it, was "how to motivate managers to disgorge the cash" rather than "wasting it on organization" priorities. What if the law was deployed to minimize these costs and motivate managers to strictly serve shareholders? Instead of managers trying to run an enterprise, balancing the needs of labor, suppliers, and others, the power of law would force firms to become the mere property of their shareholders.

These ideas were firmly in place in time to take advantage of the economic malaise of the 1970. Not at all afraid of using the state to carry out a new notion of property, economists rebuilt the entire legal framework surrounding corporations and the power of shareholders. Courts overturned state-level laws that slowed down hostile takeovers, chilling the ability of any new laws to try to address worries about abuses. The Reagan administration significantly stopped antitrust scrutiny of mergers, allowing for a greater concentration of corporations. The legal framework was rapidly overturned to set the stage for a revolution.

The revolution was successful in changing who the economy works for. It now works better for owners, the CEOs who are now aligned with them, and the financial sector that executes it, rather than workers and everyday people. CEO pay was relatively flat from the 1930s through the 1970s. Beginning with the shareholder revolution, CEO pay has skyrocketed, largely because they are paid in large stock options that encourage them to boost share prices and serve shareholders. Finance has also been handsomely rewarded for ensuring the freedom of shareholders and owners. Finance professionals have doubled their presence in the top 1 percent since the early 1980s, earning large premiums compared with other educated workers. But the economy mostly works for shareholders. Before 1980, money from profits and loans would largely go to investments. Now there is no such relationship. Instead the cash goes to shareholders – this is just the world that theorists of shareholder freedom wanted to create." [Excerpts from pp. 144 -149]

So how can companies pivot from these so-called older "black box" business models, to more stakeholder centric models? The BJR does allow courts to pivot from a "shareholder supremacy" or "freedom of contract" theory over the past century, to a more nuanced theory of a company. Remember, courts are not locked into any particular economic model when they decide the fiduciary performance of corporate directors and officers using the BJR rule. Stakeholder governance may be too non-specific at this time to some viewers, but to others its time has come. Engaging in an ITA decision process avoids being locked into one type of corporate model. As Professor Gold writes in his Article above, that ". . . [T]heories may be treated as search lights that illuminate particular judgments and show them for what they really are. . . . Theories are simply the (human constructed) means by which people make sense of their ethical and political worlds." Economic trends in the theory of the firm today suggest that you ratchet up your compliance measures and company purposes to address a change in corporate economic models, and how courts may treat them going forward. (See for example the book ***The Value of Everything*** by Mariana Mazzucato [2018]).

Putting this all in context, over the course of more than 100 years, there has always been much debate, and ink spilled, on the duties and rights of a corporation. With respect to corporate duties, the duty of care and the duty of loyalty have played a preeminent role in shaping the relationship between a director, an officer and a shareholder. The doctrine of "good faith" has always been the legal doctrine behind these fiduciaries duties, and the business judgment rule the legal standard of review. With respect to corporate rights, the legal construct of corporate "personhood" has resulted in both property rights beginning around the early 1900s, with the Lochner case, and later on liberty rights recently culminating in the Citizens United and Hobby Lobby case that expanded corporate rights and also diminished the governments right to regulate same.

So where are we today? The contraction of corporation duties, and the expansion of corporate rights, has resulted in the free market economic approach to corporations we have had for years - until recently. Why do we need change? The cost of such a system has raised the question of who pays for so-called corporate "externalities"? The solution proposed recently is to enforce a system of ESG metrics for all entities in order to level the playing field. ESG reporting provides the courts with a new economic model that provides accessibility to data, and accountability for results derived therefrom. The business judgment rule allows courts the flexibility to look behind free market economic models, with a more nuanced approach to corporate governance. A major litigator tool is to ask the court to pierce the corporate veil (i.e., "PCV") for rogue corporate behavior to go after the "persons" behind the corporate "personhood" and "intentional ignorance" is not an excuse. The big pivot has arrived, so corporations need to pay close attention to what they do, how they do it, and the impact on their stakeholders. The privilege of being in business has both duties and rights. Ignoring either is to do so at your own peril. In the seminal book entitled ***The Metaphysical Club***, the author Louis Menand writes that;

> [I]n societies bent on transforming the past, and on treating nature itself as a process of ceaseless transformation, how do we trust the claim that a particular state of affairs is

> legitimate? The solution has been to shift the totem of legitimacy from premises to procedures. We know an outcome is right not because it was derived from immutable principles, but because it was reached by following the correct procedures. Science became modern when it was conceived not as an empirical confirmation of truths derived from an independent source, divine revelation, but as simply whatever followed from the pursuit of scientific methods of inquiry. If those methods are scientific, the result must be science. The modern conception of law is similar; if the legal process was adhered to, the outcome is just. Justice does not preexist the case at hand; justice is whatever result just procedures have led to. [p. 432]

So ready or not, ESG is here. Depending on the size of your company, you need to look at how you plan to address these issues to all your stakeholders. Hoping for a favorable BJR ruling may be a PLAN B, but it is definitely not a good PLAN A. So don't wait until your theories are completed. Decide to move forward with your ITAs to create a strategy to achieve sustainable goals.

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