

Is Corporate Law ‘Private’ (and Why Does it Matter)?

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1. THE IMPORTANCE OF ACADEMIC CHARACTERISATIONS OF LAW

The way in which scholars and students characterise a phenomenon academically is of enormous – and often underappreciated – significance, especially when it comes to aspects of the law. How we characterise an area of law – or, in other words, what the dominant academic *paradigm* of that subject is – affects how we customarily think about it, write about it and teach it. Crucially, it also affects our *normative* perspective on that subject. That is to say, it determines what we regard to be its strengths and weaknesses, its ‘rights’ and ‘wrongs’, and the appropriate course of its future development. The opinions and attitudes that are shaped in legal monographs, law review articles and law school classrooms don’t just echo around the proverbial ivory towers of elite academic institutions. Ultimately – albeit often very gradually – they trickle down into the so-called ‘real world’ either when former students of the law later become influential practitioners of it, or when leading academic texts are used by judicial or policy-making figures to help shape their critical understanding of challenging legal issues.

Within the Anglo-American environment, the dominant academic characterisation of corporate law is as an aspect of ‘private’ or facilitative law. As such, corporate (or company¹) law is conventionally bracketed alongside other traditional private law subjects such as contract, property,² equity, agency and trusts law. Accordingly, the efficacy of the various

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¹ Whereas the term ‘corporate law’ is ordinarily used in the US, in the UK it is still customary to refer to the law of incorporated business entities as ‘company law’. For purposes of authorial convenience, I will tend to use the former of these terms in this paper.

² Although property law is unquestionably part of private law, whether it is a ‘facilitative’ area of law in the sense of the other topics in this list is open to question. Arguably, property law is more correctly understood as a *market-constitutive* (and thus *pre-facilitative*) area of law insofar as it delineates the set of social relations that are conventionally understood to constitute ownership, on which basis productive exchange becomes possible. However, for purposes of argumentative convenience, I will regard this function of property as being facilitative in itself, thereby justifying property law being viewed on the same plane as these other notionally private law subjects. In any event, one may make a similar claim about contract law, on the basis that modern social exchange relations are arguably not inert or pre-ordained in a proverbial state of nature, but rather are artificially constituted by judicial doctrines that define the essential features of an enforceable promise. As important as these concerns are for lawyers, though, they lie outside of the scope of the present study. For an authoritative

laws and regulations concerning corporate law in the US and UK is ordinarily judged by reference to how responsive those rules are to the supposed private preferences of key corporate participants or ‘contractors’. For the most part, this category is normally restricted to include – in the last place – the common or ordinary shareholders who supply the corporation’s equity or risk capital; and, by necessary implication, the managerial officers (including directors) who are appointed to make executive policy decisions on shareholders’ collective behalf. It follows from this premise that the core and motivating purpose of corporate law should be to reflect or ‘mimic’ the ‘terms’ that shareholders and managers would be inclined to agree upon with one another privately, in the hypothetical scenario where no antecedent laws exist and therefore all norms stand to be determined by private negotiation alone.³ This is what is commonly known as the ‘contractarian’ or ‘nexus of contracts’ theory of corporate law.

Correspondingly, corporate law is ordinarily *not* characterised as an aspect of ‘public’⁴ or regulatory law, in the way that subjects like tort,⁵ criminal, environmental, antitrust (or competition) and securities law⁶ are. That is to say, unlike the above areas of law, corporate law is typically not perceived as being designed to coerce social-behavioural change, or to bring about direct distributional outcomes within society whether in terms of risk, power or wealth. Therefore academic characterisations of corporate law normally do not

exposition of the concept of property as an artificial and juridically constituted ‘bundle of rights’, see WN Hohfeld, ‘Some Fundamental Legal Conceptions as Applied in Judicial Reasoning’ (1913) 23 *Yale Law Journal* 16; WN Hohfeld, ‘Fundamental Legal Conceptions as Applied in Judicial Reasoning’ (1917) 26 *Yale Law Journal* 710. For an excellent critical perspective on these issues, drawing on the work of the American legal realist Robert Lee Hale, see P Ireland, *Property and Contract in Contemporary Corporate Theory* (2003) 23 *Legal Studies* 453, 486-91.

³ The most comprehensive and influential statement of this conception of corporate law is provided by Easterbrook and Fischel’s now classic work, *The Economic Structure of Corporate Law* (Cambridge, MA, Harvard University Press, 1991).

⁴ To clear up any potential confusion amongst readers, I am not using the term ‘public law’ here in its conventional doctrinal sense, which tends to denote areas of law that govern the relationship between individual citizens and the state including constitutional and administrative law. Rather, I use the term here essentially to refer to ‘non-private’ or regulatory areas of the law that affect the activities of business corporations, and for want of a better word for this purpose.

⁵ No doubt many English private lawyers will dispute my inclusion of tort law within the ‘non-private’ category of legal topics. However, insofar as tort law is designed to regulate the *ex post facto* risk-distributive outcomes of economic activity, and thus only indirectly affects the *ex ante* prudential motivations therefor, it is in my opinion more appropriately situated within this latter list. In view of the fact that the vast majority of tort claims (especially concerning large businesses) are settled on a negotiated ‘out of court’ basis, there is an argument to say that tort law is best understood as a market-facilitative area of law designed to provide a framework for the retrospective ‘purchase’ by a tortfeasor of the victim’s right not to be wrongfully harmed. On this, see PS Atiyah, *The Rise and Fall of Freedom of Contract* (Oxford, Clarendon Press, 1979), 750. Accordingly, in categorising tort law in the above way, I do not deny being guilty of a degree of deliberate conceptual over-simplification.

⁶ On the (somewhat arbitrary) substantive distinction that is customarily drawn between corporate law and securities (or, in Europe, capital markets) law, see below ch 6, pt IIC-E.

seek to portray the laws and norms in this field as exhibiting such characteristics, which would run counter to their purportedly facilitative – and thus fundamentally *non*-socially-determinative – nature.

Just as the purpose of an artistic caricature is to accentuate the most distinctive or noteworthy features of a person rather than portray her every literal detail, the objective of an academic characterisation is to emphasise and draw on the key distinguishing features of a subject rather than to document that phenomenon in all of its complexity. Inevitably, therefore, the process of academic characterisation – in law as elsewhere – involves some marginal degree of papering over the empirical cracks. That is to say, the occasional outlying or idiosyncratic feature is conveniently (and quite acceptably) elided so as not to detract from the essential qualities of the subject that the writer is seeking to accentuate.

Therefore an academic characterisation of an area of law, like an artistic caricature, need not be one hundred per cent comprehensive in documenting a subject, nor sensitive to its every empirical nuance. As a minimum requirement, however, the characterisation must be capable of incorporating *all* materially significant features of its subject matter, or else the ensuing model will lose its essential representational quality.

Moreover, the process of academically characterising a subject – and especially an area of law – involves not just an empirical but also a normative dimension. These two elements necessarily overlap and reinforce one other. Inevitably, the answer to the empirical question – that is, what essentially *is* a given phenomenon – affects our answer to the ensuing normative question – that is, what essential form or qualities *should* that phenomenon embody? Thus in any field of social science, constructive academic debate involves scholars providing competing characterisations of the essential (empirical) nature of a thing on a definitional level, in order to establish (or change) the points of references in accordance with which the efficacy or desirability of that phenomenon can subsequently be judged from a more critical perspective.

In short – in law as in elsewhere – *ought* judgements are ultimately dependent to a large extent on *is* judgements, because in order to be able to critically evaluate a subject we must first of all understand its key attributes and qualities.⁷ It follows that, where a particular

⁷ At the same time, it may conversely be said that ‘is’ judgements are to a large extent dependent on preceding ‘ought’ judgements, insofar as it is impossible to make sense of any social phenomenon without first having a preordained sense of its perceived purpose or objective. On the ‘is-ought’ distinction in legal discourse generally, and also the distinction between (i) sheer physical facts and (ii) institutional facts as interpreted – and thus given meaning – through the lens of a given normative order, see N MacCormick, *Institutions of Law: An Essay in Legal Theory* (Oxford, OUP, 2007), chs 1 and 2; N MacCormick, *Questioning Sovereignty: Law, State, and Nation in the European Commonwealth* (Oxford, Oxford University Press, 1999), ch 1.

characterisation of an area of law lacks adequate empirical foundations (in the sense of failing to represent any materially significant features of the relevant subject matter), any normative conclusions that are drawn on that basis are either void – or, at the very least – become subject to further questioning as a precondition to their continuing acceptance by others.

2. THE PURPORTED ‘PRIVITY’⁸ OF ANGLO-AMERICAN CORPORATE LAW

In the field of corporate law, the main ‘is’ dispute concerns the alleged ‘private’ v ‘public’ nature of the laws in this field – that is, to what extent can corporate law properly be regarded as the outcome of decentralised market or civil society bargaining, in contrast to centralised regulatory state imposition? Or, to put the issue another way: is corporate law at its core an organic (‘bottom-up’) or synthetic (‘top-down’) creation? Where one adopts the former view as regards the fundamental nature of corporate law, they are ordinarily led to the ensuing normative position that the relevant laws in future *should* rightfully be developed along the same basic path: that is, lawmaking in this field should be *responsive to* private preferences, rather than determinative of such.⁹

Vice versa, proponents of the latter (synthetic) view of corporate law tend consequently to arrive at the contrary normative position. That is, that the laws in this field should be coercive and socially-determinative, aimed at eliciting direct change in the behavioural patterns and relative resources of key corporate participants in line with general democratic opinion in society; and irrespective of whether or not such regulatory outcomes are consistent with the affected participants’ (especially shareholders’) private preferences.¹⁰

For much of the past century, corporate law scholars in the United States and United Kingdom have developed the academic contours of their subject as an essentially private, functional and politically ‘colourless’ field of enquiry.¹¹ The precise jurisprudential

⁸ I fully acknowledge that, to English private lawyers of an orthodox slant, my (mis)use of the word ‘privity’ in this context may be perceived as a serious terminological error. I am well-aware that, in ordinary legal usage, the term is used to denote the traditional ‘privateness’ (in the sense of non-effect on third party rights) of individual contractual agreements, rather than the privateness (in the sense of non-regulatory nature) of an overall area of law. Notwithstanding, I use the term in this different and broader sense merely for want of a more appropriate word to describe the essential nature of the phenomenon that I will be discussing in this part.

⁹ On this, see JE Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford, Oxford University Press, 1993), 25-32.

¹⁰ On the distinction between socially-determinative and non-socially-determinative conceptions of the purpose of corporate law, see D Millon, ‘New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law’ (1993) 50 *Washington and Lee Law Review* 1373.

¹¹ On the tendency of legal-formalist thought (particularly in the United States) more generally to portray private law as being apolitical and thus purely instrumental in nature, see MJ Horwitz, ‘The Rise of Legal Formalism’ (1975) 19 *The American Journal of Legal History* 251; MJ Horwitz, ‘The Emergence of an Instrumental

trajectories along which these developments have occurred on each side of the Atlantic bear their own unique characteristics.¹² Nonetheless, a common and fundamental feature of the so-called ‘Anglo-American’ corporate law system is the dominant scholarly perception of the subject as a dynamic and self-determinative aspect of *private* law lying beyond the meddling reach of the ‘public’ or interventionist regulatory state. Thus, as mentioned above,¹³ corporate law is still conventionally rationalised and taught within the English-speaking world as an offshoot of ‘building blocks’ private law subjects such as contract, agency, equity and trusts. A uniting feature of all these areas of law, and the root of their purportedly ‘private’ nature, is their common focus on giving legal effect (or, vice versa, non-effect) to the terms and essential substance of arrangements constituted by decentralised persons acting on their own behalf, whether in an individual or private-organisational capacity.

Hence, in commercial environments, legal rules are commonly regarded as providing little more than a structural vessel – whether in the form of a legally-binding agreement or legally-recognised relationship or business entity – into which the participating parties remain free to pour their own substantive content as reflected in the (literal or notional) bargains that they autonomously strike with one another. Even those aspects of private law doctrine that could be said to exhibit a normative or value-laden quality, such as the notions of good faith, implied terms or fiduciary capacity, tend in general to denote principally procedural standards of fair dealing in any given bargaining context. As such, private law (including corporate law) logic is characteristically averse to concepts of substantive justice or fairness that seek directly to effect distributional outcomes between the participants in a freely (ie honestly and non-coercively) constituted agreement or organisation.¹⁴

In contrast – and as likewise mentioned earlier¹⁵ – those subjects which are usually placed within the ambit of ‘public’ or regulatory law, including tort, criminal, antitrust and tax law, are inherently interventionist and redistributive (whether monetarily or in terms of distribution of risk or market power) in nature. In commercial environments, these areas of

Conception of American Law, 1780-20’ (1971) 5 *Perspectives in American History* 287; N Duxbury, ‘The Origins of Modern American Jurisprudence, Part I: The Birth of Legal Formalism’, University of Manchester Faculty of Law Working Paper No 6 (January 1991).

¹² On this, see below chs 4 and 5 respectively.

¹³ See above ch 1, nn 1-7 and accompanying text.

¹⁴ Rawls refers to this concept as “pure procedural justice”, whereby “there is no independent criteria for the right result”, but rather “a correct or fair procedure such that the outcome is likewise correct or fair, whatever it is, provided that the procedure has been properly followed.” See J Rawls, *A Theory of Justice*, revised edn (Oxford, Oxford University Press, 1999) (first published 1971), 75. It follows from this logic that in any transaction “the outcome is just, whatever it is, in virtue of the contract that produced it.” See M Sandel, *Liberalism and the Limits of Justice*, 2nd edn (Cambridge, Cambridge University Press, 1999) (first published 1982), 108.

¹⁵ Above n 4.

law seek in differing ways from one another to regulate directly the social outcomes of business activity via the super-imposition of externally-determined standards or norms, over and above the actual or imputed preferences of contractors or business associates.

From an orthodox legal formalist¹⁶ perspective, the functional disparity between the private (contractual) and public (regulatory) spheres of business law is unproblematic so long as each dimension respects the other's legitimate regulatory space. Accordingly, it is asserted that the 'public' aspects of business law should be restricted to setting and enforcing the external 'rules of the game' within which commercial actors or organisations operate. This is with a view, *inter alia*, to preserving proximately competitive market conditions and also mitigating the uncompensated infliction of social costs on third parties (especially environmental interests) who are incapable of seeking *a priori* contractual protection or compensation.¹⁷ Ultimately, though, the internal content or structure of each agreement, association or entity that is privately formed – including the motivating goals and objectives of business activity itself – should be left to the realm of spontaneous and decentralised contractual order as governed exclusively by private law doctrine.¹⁸

In the specific context of corporate law, the influence of neo-classical legal formalism weighs very heavily within the Anglo-American environment under the guise of what is variously termed the 'contractarian', 'nexus of contracts', or 'private ordering' theory of the firm. Originally an invention of US-based financial economists in the 1970s,¹⁹ contractarianism has expanded in depth and influence over recent decades to become the dominant conceptual and normative lens through which the corporation and its constituent laws are conventionally studied across the English-speaking world.

On a jurisprudential level, contractarianism in effect instils the logic of private law into the internal structure and functioning of modern business corporations, by asserting that 'public' or widely-held corporate entities – in spite of their typically enormous organisational scale, extensive social impact and peculiar ownership/control dynamic (including the lack of any distinct proprietary or entrepreneurial presence) – should nonetheless be regarded as essentially private and quasi-contractual institutions, which are subject to qualitatively similar market dynamics and pressures to those affecting orthodox (ie closely-held) business

¹⁶ On the influence of this important jurisprudential tradition more generally, see above n 2.

¹⁷ See M Friedman, *Capitalism and Freedom* (Chicago, The University of Chicago Press, 1962), ch 2.

¹⁸ In this regard, Bowman explains that regulation "is not simply a coercive tool" but "is also a method of achieving a desired result by defining the boundaries of self-regulation", in that by "prohibiting specific forms of behaviour [it] implicitly sanctions other behaviour." See S. Bowman, *The Modern Corporate and American Political Thought: Law, Power and Ideology* (PA, Penn University State Press, 1996), 139.

¹⁹ On the seminal works underpinning this school of thought, see below n 22.

entities.²⁰ In particular, contractarian scholars emphatically refuse to afford any conceptual significance to the corporation's formal legal autonomy or 'personhood', instead regarding the incorporated firm as a mere structural convenience that serves the collective, contractually communicated interests of its various human participants at any given point in time.²¹

Moreover, since the aforementioned public-private law dichotomy attempts to put purportedly 'internal' corporate affairs beyond the reach of deliberate state determination, it follows that questions concerning the inherent goals of the corporation are both an unnecessary and inappropriate question for governments directly to concern themselves with.²² Rather, the social desirability of any corporate objective that emanates from existing legal and market mechanisms – in particular, the widely-accepted Anglo-American managerial norm of shareholder wealth (or 'value') maximization²³ – can be inferred a priori from its very pervasiveness and continuing widespread acceptance both by investors and other corporate participants today.²⁴

In respect of any adverse social outcomes that follow from the systematic pursuit by corporations of this objective, the proper remedy is said to lie in the bounds of *non*-corporate (regulatory) law rules – especially tort, criminal and tax law – that use punitive and disincentive measures to reduce or render negative the ultimate monetary 'payoffs' to corporations of engaging in certain harmful or socially undesirable kinds of activity.²⁵ The

²⁰ On this, see generally P Ireland, *Property and Contract in Contemporary Corporate Theory* (2003) 23 *Legal Studies* 453; P Ireland, 'Defending the Rentier: Corporate Theory and the Reprivatisation of the Public Company' in J Parkinson, A Gamble and G Kelly, *The Political Economy of the Company* (Oxford, Hart Publishing, 2000), ch 7.

²¹ See, eg BR Cheffins, *Company Law: Theory, Structure and Operation* (Oxford University Press, Oxford, 1997), 31-41. According to Cheffins:

the history of [the joint stock company] indicates that even without laws providing for incorporation, business enterprises can be organized along much the same lines as the modern corporation. It follows that companies legislation has had in and of itself only a modest impact on the bargaining dynamics which account for the nature and form of business enterprises. Thus, *analytically an incorporated company is, like other types of firms, fundamentally a nexus of contracts.*"

See *ibid*, 41 (emphasis added). See also FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA, Harvard University Press, 1991), 8 -15. Easterbrook and Fischel claim (at 12) that "[t]he 'personhood' of a corporation is a matter of convenience rather than reality".

²² See M Friedman, 'The Social Responsibility of Business is to Increase its Profits' in T Beauchamp and N Bowie (eds), *Ethical Theory and Business* (Upper Saddle River, Pearson, 2004) (first published 1979); article originally published in *The New York Times Magazine* (1970).

²³ On this phenomenon generally, see SM Bainbridge, 'In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50 *Washington & Lee Law Review* 1423; MJ Roe, 'The Shareholder Wealth Maximization Norm and Industrial Organization' (2001) 149 *University of Pennsylvania Law Review* 2063.

²⁴ For an argument to this effect, see Easterbrook and Fischel, *The Economic Structure of Corporate Law*, above n 12, 35-39.

²⁵ For further discussion and analysis of this so-called 'negative externalities' argument for (limited) regulatory state interventionism in private ordering, see below ch 7, pt II. The academic progenitor of this argument is the

resultant norm is one of ‘shareholder wealth maximisation within the (extraneous) law’.²⁶ This approach could be said to respect the internal organisational autonomy of corporations by treating incorporated entities as akin to human individuals, entitled to form their own life plans and objectives subject only to compliance with the universal laws to which *all* (corporate and non-corporate) behaviour in a liberal society is subject.²⁷

The principal normative achievement of the contractarian paradigm has been its remarkable success in *alleviating* formerly widespread academic discontent²⁸ about the continuing relevance and legitimacy of corporate law’s privity: that is to say, the traditional treatment of corporate law as an essentially *pre*-political and market-instrumental facet of private law, rather than a publicly infused dimension of regulatory law concerned with the objectives and substantive outcomes of corporate organisations within the wider fabric of economy and society. It is therefore unsurprising that the contractarian theory of the firm tends like traditional legal formalism to exhibit a strong anti-regulatory hue.²⁹

3. MANDATORY RULES: A DIFFICULT EMPIRICAL PILL TO SWALLOW

To a significant extent the contractarian characterisation is supported – albeit it in different ways – by the actual form and substance of corporate law as it exists in both the United States and United Kingdom.³⁰ However, a comparably significant body of existing Anglo-American corporate governance rules and principles would – at first sight anyhow – appear to undermine or at least challenge the dominant contractarian portrayal of the law in this area as being purely facilitative, by suggesting that corporate governance law is in fact imbued with a heavily ‘public’ or regulatory impetus.³¹ In particular, the fact that many fundamental norms

English economist Arthur Cecil Pigou. See AC Pigou, *The Economics of Welfare*, 4th edn (London, Macmillan, 1932) (first published 1920), pt II.

²⁶ In using this term I am indebted to John Parkinson, who – in his classic work *Corporate Power and Responsibility* – identified and criticised what he regarded to be the orthodox normative formula in corporate law scholarship of “profit maximization within the law”. See J Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford, Oxford University Press, 1993), 42-43.

²⁷ This can be regarded as the standard neo-liberal position with respect to the proper responsibilities of both corporations and corporate law within wider society. For a fuller exposition of this argument, see Friedman, ‘The Social Responsibility of Business’, above n 13; FA Hayek, ‘The Corporation in a Democratic Society: In Whose Interest Ought It and Will It Be Run?’ in HI Ansoff (ed), *Business Strategy* (Harmondsworth, Penguin, 1969), 266.

²⁸ On this, see below pt II.

²⁹ On the prevalence of this characteristic within legal-formalist jurisprudence more generally, see the sources cited above n 2.

³⁰ On the principal manifestations of the contractarian paradigm within the doctrinal frameworks of US and UK corporate governance law, see below chs 4 and 5 respectively.

³¹ On the principal ‘public’ or regulatory dimensions of Anglo-American corporate governance law, see below ch 6.

of Anglo-American corporate governance are determined on a mandatory (and thus contractually irreversible) basis – either directly or indirectly at the behest of the regulatory state – sits uneasily alongside the dominant contractarian portrayal of corporate laws as being the flexible, instrumental and *non*-socially-determinative outcome of private selection methods based on rational (shareholder and managerial) choice.

The most problematic feature of mandatory rules from a contractarian perspective is the fact that they are necessarily subject to universalistic or ‘across the board’ application, and hence by definition *cannot* be responsive to individual preferences or firm-specific circumstances that might merit the occasional exception from the regulatory norm. Accordingly, consideration for collective conformity on a macro (i.e. system-wide) basis effectively trumps any conflicting concern for respecting private ordering at the micro (i.e. individual firm) level. Insofar as the permissible ambit of private ordering in corporate governance is in this way restricted by externally-imposed regulatory boundaries, it can consequently be said that the process of legal-institutional evolution in corporate governance is one which – although in many respects organic and quasi-contractual in nature – nonetheless operates substantially in the shadow of the interventionist regulatory state.

Against this background, if the contractarian position is to retain its normative argumentative force, it must be capable of providing a convincing explanation for the significant presence of *prima facie* regulatory laws within the corporate governance field. In fairness, defenders of the contractarian paradigm of corporate governance have been acutely cognisant of the conceptual difficulties which mandatory rules pose for the continuing validity of their empirical and, in turn, normative claims. Indeed, contractarian theorists, far from ignoring or seeking to cover up the difficulties that mandatory rules pose for their conceptual model of corporate governance, have contrarily opted to recognise and subsequently tackle this empirical phenomenon head on. Hence, over recent decades, an important element of contractarian scholarship on corporate governance has comprised attempts to explain the presence of the *prima facie* mandatory or regulatory aspects of corporate law in a manner that actually *supports*, rather than detracts from, the basic private ordering rationality behind the contractarian position.

Although this sub-school of ‘interventionist-contractarians’ deserve praise for undertaking such a seemingly intractable intellectual challenge, the main arguments that they have advanced in support of their position are, in my opinion, ultimately of limited effectiveness in seeking to sustain the validity of private ordering rationality in its application to the regulatory features of corporate governance law. In particular, the interventionist-

contractarian position encounters serious difficulties when it attempts to rationalise mandatory corporate governance rules on the basis of hypothetical bargaining rationality. That is, in the absence of *actual* contracts or private arrangements (whether expressly or implicitly) between corporate participants with respect to internal corporate governance norms, interventionist-contractarians have sought to preserve the contractual metaphor by seeking to explain prevailing features of the law essentially as a representation of ‘what contracting parties (ie shareholders and managers) *would have* bargained for’, had they been able to put their minds directly to the task.

The role of the regulatory state, accordingly, is in effect to ‘step into the shoes’ of the contracting parties (principally shareholders) by providing the terms that they would have been inclined to negotiate for within the idealised hypothetical bargaining scenario. Furthermore, insofar as a number of such terms are perceived to be so important in nature that no (or, at least, *almost no*) rational shareholders would be inclined voluntarily to dispense with them, their constitution in concretised and irreversible legal form can be regarded as necessary for the purpose of honouring notional contractor expectations. For this reason, many corporate law rules – even those that are mandatory in form – are frequently viewed to be merely *market-mimicking* in effect. As such, the mandatory regulatory imposition of these norms is largely uncontroversial on a normative level. This is because the state – in promulgating and enforcing the relevant rules – is *not* seeking to compel outcomes different from those that shareholders would ideally prefer but, for whatever reason, are unable to insist on directly under ‘real world’ bargaining conditions.

Before analysing this argument in further depth, though, it is necessary first to examine what I believe to be two *defensible* concessions that contractarian theorists commonly make to regulatory state interventionism – both in corporate law and private law doctrine more generally. These are the arguments for limited regulatory usurpation of private ordering in the interests of: first, mitigating negative third party effects of private contractual activity; and, second, providing structurally essential public goods.

4. THE ACCEPTABLE AMBIT OF STATE INTERVENTIONISM IN PRIVATE ORDERING: NEGATIVE EXTERNALITIES AND PUBLIC GOODS

I explained above how, within the contractarian paradigm, the problem of negative externalities – that is, the uncompensated infliction by firms of costs on third parties (especially environmental interests) situated outside of a firm’s notional contractual nexus –

is appropriately dealt with via mandatory regulation extraneous to ‘core’ corporate law. The purported aim of such regulation is to ensure, via the imposition of appropriate civil and – where necessary – criminal liability, that the adverse social costs to a firm of its productive activities are fully (or, at least, substantially) reflected in the private cost calculus underpinning its a prioridecision as to whether or not to engage in such activities. In this way, the law theoretically mitigates the scope for divergence between the private (firm) and public (third party) payoffs of a given course of entrepreneurial action, without obfuscating the firm’s fundamental prudential motivation.³²

I further explained above how the contractarian paradigm, by conceptually distinguishing such ‘externalities-internalising’ regulation from the scope of corporate law as conventionally defined, succeeds in preserving the essential privity of corporate governance within its conceptual model.³³ At the same time, though, by permitting (limited) recourse to regulatory state interventionism in the above situations, the externalities argument equips the contractarian paradigm for dealing with any negative public effects of business activities (such as harm to the physical or ecological environment) that by nature are incapable of being incorporated within its underpinning private bargaining dynamic.³⁴

A similar basic argumentative logic supports the other common concession that contractarians typically make to regulatory state interventionism in private ordering. This is the well-known ‘public goods’ argument. In essence, a ‘public good’ is – by its very nature – both *non-excludable* and *non-divisible*. The former quality denotes that those who expend the costs involved in providing the good cannot exclude those who have not paid for it from benefiting from it. The latter quality indicates that the relevant good – unlike most commodities – is not exhausted or diminished in utility by being used, with the effect that those who pay to provide it will continue to derive significant use value from it even in the presence of a number of ‘free riders’ who also stand to benefit from it indirectly.³⁵

It follows that, where the relevant good is provided by private actors alone, those paying for it will – due to the inevitability of free riders – be incapable of appropriating all of the benefits of it.³⁶ As a result, such persons will be disinclined to provide such a good – at

³² On this, see above ch 3, nn 8-9, 16-18 and accompanying text. However, for an influential counter-perspective highlighting the potentially wealth-reducing effect of ‘externalities-internalising’ regulation when applied in respect of productive economic activities, see RH Coase, ‘The Problem of Social Cost’ (1960) 3 *Journal of Law and Economics* 1.

³³ On this, see above ch 3, nn 8-9 and 13-18.

³⁴ See above ch 3, nn 16-17 and accompanying text.

³⁵ See FH Easterbrook and DR Fischel, ‘Mandatory Disclosure and the Protection of Investors’ (1984) 70 *Virginia Law Review* 669, 681.

³⁶ See Coffee, ‘Market Failure’, above n 107, 726-27.

least to the extent that they would if they could exclusively exploit the full benefits thereof. This is one of the classic economic scenarios where the pursuit (by investors) of individual rationality en masse leads not to overall allocative efficiency, but rather to the ‘collective folly’ of a socially sub-optimal outcome – that is, systematic underproduction of the relevant good.

For these reasons, even scholars of a strongly contractarian or neo-liberal disposition are in general agreement that, at the most basic level of civil society, the fundamental structural preconditions of a market system are dependent on extra-contractual governmental design. Thus the state is vested with inalienable residual responsibility for establishing a reliable judicial and legislative system for the constitution, formation and enforcement of contractual and proprietary interests between private parties, together with the prohibition of fraud, monopoly, and other practices averse to the market’s underlying structural and ethical ‘rules-of-the-game’.³⁷

More generally, the provision of effective policing, national defence and basic communicative infrastructure (eg a national or interstate road network) from public taxation revenues are regarded as similarly essential to any functioning and sustainable market-based system of production and exchange.³⁸ This stands as a near-universal truth, moreover, regardless of one’s particular political opinion about the social benefits or dangers of state interventionism beyond this base minimum level.³⁹ Finally, the preservation of macro-economic conditions conducive to continuing market stability – if only by the most basic governmental means of producing monetary instruments and determining the national base rate of interest – are likewise almost unanimously accepted as legitimate state functions, irrespective of one’s view about the appropriate extent of governmental economic policy-making additional to this threshold.⁴⁰

³⁷ See, eg M Friedman, *Capitalism and Freedom* (Chicago, University of Chicago Press, 1962), 27: the organization of economic activity through voluntary exchange presumes that we have provided, through government, for the maintenance of law and order to prevent coercion of one individual by another, the enforcement of contracts voluntarily entered into, the definition of the meaning of property rights, the interpretation and enforcement of such rights, and the provision of a monetary framework.

³⁸ See Friedman, *ibid*, ch 2 (‘The Role of Government in a Free Society’).

³⁹ At a reasonable stretch, the public goods argument can be further extended to require that social-institutional arrangements protect or embody certain intrinsic liberal values that private bargaining dynamics are incapable of reflecting, for instance race and gender equality, and non-discrimination on grounds of religion, disability or sexuality.

⁴⁰ Despite providing one of the most influential expositions of the political dangers of unnecessary governmental interference in a ‘free’ economy, Friedman nevertheless remarked in reference to “the monetary system” that “[t]here is probably no other area of economic activity with respect to which government action has been so uniformly accepted.” See Friedman, *Capitalism and Freedom*, *supra* n 21, 27.

A common feature of all the above institutional phenomena is their exhibiting the aforementioned defining characteristics of a public good, namely non-excludability and non-rivalry, which will inevitably result in their systematic underproduction (and, in the most extreme case, *non*-production altogether) by private market providers.⁴¹ However, insofar as the regulatory mitigation of negative externalities, and corresponding provision of public goods, are structurally essential for the effective functioning of a voluntary market-based system for allocating goods and services, then they are undeniably antecedent to the neo-liberal contractarian paradigm – both of corporate law in particular, and of socio-economic arrangements more generally.

Against this background, it could be surmised that contractarians (and, indeed, neo-liberal scholars more generally), in seeking at once to admit the necessity of – but also significantly limit the permissible ambit of – regulatory state interventionism in private ordering, are proverbially ‘trying to have their cake and eat it’. That is to say, acknowledging that the purportedly self-regulatory domain of private ordering (both in corporate governance matters and in citizens’ socio-economic affairs more generally) is necessarily dependent on an irreducible minimum of governmentally-mandated institutional infrastructure, opens an awkward regulatory ‘can of worms’ for contractarians that could be said to discredit their argument against state interventionism in other – less structurally fundamental – respects.

Indeed, it may be asserted that the fundamental dependence of market-based selection processes upon an antecedent ‘floor’ of public interventionism (whether via regulatory or administrative means) *in itself* renders the whole notion of private ordering inherently *artificial*, and hence indefensible against further state interventionism. In other words, the fact that the state creates the structural preconditions for private ordering arguably entitles it – *quid pro quo* – to set regulatory boundaries to the appropriate scope of such where this is seemingly justified by public interest considerations, and *irrespective of* whether the resulting constraints align with the collective private preferences of contractors.⁴²

Notwithstanding the normative appeal of the above claim to who are intuitively sympathetic to case for greater public-regulatory interventionism in corporate governance affairs (and indeed private ordering practices more generally), it is imperative to note a compelling counter-argument that can be raised by contractarians in defence of the

⁴¹ On this, see above ch 6, nn 111-13 and accompanying text.

⁴² It should be noted that this argument is not just specific to corporate law, but rather could also be used as a normative basis for regulatory state interventionism in contract law, property law, and other reputedly ‘private’ or facilitative areas of law.

deregulatory / non-interventionist position. This counter-argument proceeds from the premise that, in a liberal-democratic political economy, the collective preference of citizens to permit economic exchanges and/or private social-institutional arrangements (including corporate governance norms) to be ordered on a decentralised basis via voluntary market processes necessitates that the state – in reflection of this general public will – effectively cedes allocative and/or regulatory sovereignty over such matters to civil society actors and groups situated outside of government.

However, in a certain range of situations – such as where ‘pure’ (ie non-regulatorily-underpinned) private ordering is conducive to negative externalities or macro-instabilities, or where state provision of public goods is essential to the continuing effective functioning of the market exchange system in any respect – a policy of *outright* state non-interventionism in contractual affairs will likely be rendered either self-defeating (as in the case of non-provision of an essential public good), or otherwise contrary to the central values of individual autonomy and private utility-enhancement that governmental deference to private ordering is intended to promote (as in the case of imposition by a firm of an ‘uncorrected’ externality on a third party). In such instances, targeted regulatory interventions in the above regards are likely to be conducive to *safeguarding* – rather than undermining – these important contractarian values. Moreover, insofar as the centralised and systematic correction of negative externalities and provision of public goods by the state are essential preconditions of decentralised and private methods of institutional ordering in other respects, the occasional targeted deployment of such regulatory techniques can reasonably be regarded as consistent with – and, indeed, *part and parcel of* – a more general state policy of non-interventionism in citizens’ (and, indirectly, firms’) voluntary contractual affairs.

There remains, however, an outstanding issue of concern for contractarians. While the deliberate regulatory intervention of the state in the above regards may ultimately be supportive of the continuing feasibility of private ordering in other respects, it may still be remarked by critics of the contractarian position that ‘regulation, at the end of the day, is regulation’; and that, regardless of the specific end that a particular regulatory or administrative intervention by the state seeks to achieve, the fact still stands that private ordering has in some way been superseded by public policy (albeit in this case, a public policy designed to advanced private ordering practices in the longer run). Accordingly, it may be said that any institutional outcomes that follow from such ‘interference’ are entirely arbitrary and artificial, with the implication that the state is no less entitled in future to regulate with a view to constraining or superseding private ordering, as it is entitled to

regulate in order to enable the private ordering process to function in the first place. That is, now that the regulatory floodgates have been opened, for the interventionist state ‘everything is up for grabs’ regardless of the consequences for the individual autonomy or collective utility of contractors.

However, the above ‘artificiality’ criticism of externalities and public goods regulation is ultimately misplaced, insofar as it elides the crucial asserted fact that such state interventions *themselves* stem ultimately from quasi-contractual agreement, albeit at the macro (ie economy-wide) rather than micro (individual firm) level. The logic is that, due to the inherent incapacity of contractors to capture the full benefits of such institutional developments privately were they to be introduced by contract, contractors instead make the collective decision – in their a priori capacity as citizens – to submit voluntarily to the universal and coercive authority of the state with respect to these matters. In this way, contractors (qua citizens) are together able to make a reliable collective commitment to contribute to the maintenance of externalities-mitigation and public goods provision on an ongoing basis, notwithstanding that their individual self-interest quaeconomic actors (at least in the short term) would be better served by a strategy of *non-cooperation* with these overall schemes. The role of mandatory regulation, accordingly, is in effect to ‘bond’ the expectation of each market participant to the effect that all other participants will contribute towards maintaining the relevant institutions. This enables the participants as a group – via submission to a regulatorily-compelled system of externalities-mitigation and public goods provision – collectively to transcend the inevitable ‘prisoner’s game dilemma’ that would otherwise preclude the voluntary formation of such a scheme (in spite of the overall benefits to the group of doing so).⁴³

The above discussion thus establishes that – contrary to first appearances – regulatory or administrative state interventions in private ordering geared to the reduction of negative externalities or provision of public goods do not represent independent or self-standing public policies in their own right. Rather, they ultimately derive from – and are thus inextricably linked to – the initial macro-agreement between citizens under which they collectively assent to a sustainable institutional framework to govern their future economic relations with each

⁴³ For a fuller exposition of this argument, see J Rawls, *A Theory of Justice*, revised ed (Oxford, Oxford University Press, 1999) (first published 1971), 236-37. In particular, Rawls posits that “even among just men, once goods are indivisible over large numbers of individuals, their actions decided upon in isolation from one another will not lead to the general good.” It follows that “[s]ome collective arrangement is necessary and everyone wants assurance that it will be adhered to if he is willingly to do his part”, with the result that “the use of [regulatory] coercion is perfectly rational from each man’s point of view.” See *ibid*.

another.⁴⁴ It follows that state interventionism – albeit as understood exclusively in the limited forms discussed above – is structurally inseparable from the initial (negative) policy decision of the state to refrain from directly regulating a given field of economic activity, instead delegating self-regulatory capacity to the relevant contracting individuals or firms.

Such methods of regulatory state interventionism are thus fundamentally *consistent* with private ordering rationality from a conceptual standpoint. Accordingly, acceptance of a limited role for state interventionism in the above ways, far from providing a normative license for wholesale state ‘over-ride’ of private ordering outcomes, contrarily *reinforces* the normative case for a (negative) state policy of regulatory non-interventionism in micro-level market affairs more generally. This pertains not only to fundamental questions of economic resource allocation amongst competing uses, but also to contingent matters of market-institutional (including corporate governance) norm design.

5. THE ‘MARKET MIMICKING’ RATIONALISATION OF REGULATORY STATE INTERVENTIONISM IN PRIVATE ORDERING

Acceptance of a limited licence for state interventionism in corporate governance, at least for the overtly public-regarding objectives described above, is relatively uncontroversial. This is so even within the otherwise-deregulatory confines of the contractarian paradigm. Where the permissible ambit of public regulatory initiative is restricted to the purportedly ‘external’ (ie extra-contractual) concerns of externalities-mitigation and public goods provision, it cannot be said to interfere with the substantive ‘core’ of corporate governance as it is conventionally understood.

I explained above how the contractarian paradigm seeks normatively to establish something of an ‘inside/outside’ dichotomy with respect to supposedly ‘corporate’ and ‘non-corporate’ concerns – the former being the proper preserve of the private law of corporate *governance*, and the latter rightfully subject to the public (or regulatory) law of corporate *effects*. And, whilst contractarians typically do not dispute the state’s entitlement to wield determinative regulatory influence on the latter ‘external’ side of this notional divide, the former ‘internal’ side is – by contrast – deemed to be regulatorily ‘out of bounds’ except for

⁴⁴ I am grateful to Andreas Kokkinis for helping me to identify this important point in personal conversation.

purely facilitative measures that are designed to reflect investors' pre-existing private preferences.⁴⁵

However, this dichotomous understanding of the various laws pertaining to corporate control matters is – to a significant extent – empirically unsubstantiated within the Anglo-American environment today. Rather, it is manifestly the case that many of the most central aspects of the reputedly 'internal' side of corporate governance in the US and UK are constituted in mandatory regulatory form, and thus would appear to be determined *at least as much* by determinative state decree as by prudential market-driven initiative. The effect of this finding is to render the aforementioned dichotomy somewhat over-simplistic as a method of conceptually categorising its subject matter, at least in the absence of some further convincing explanation as to why the supposedly 'internal' dimension of corporate law should continue to be understood in principally facilitative and quasi-contractual terms.

To this end, a contractarian explanation for the widespread presence of regulatory laws pertaining to corporate governance's theoretically contractual core has been developed in the guise of the so-called 'market mimicking' rationalisation of mandatory rules.⁴⁶ Like the 'public' grounds for regulatory interventionism discussed above, the market mimicking argument is designed in recognition of – and also as a response to – the inevitable existence of market failures in voluntary private ordering mechanisms. However, there is a notable distinction between the two types of argument, by virtue of which the latter case for state interventionism sits rather less comfortably alongside the other aspects of the contractarian paradigm of law.

As illustrated above, the negative externalities and public goods arguments for state interventionism are premised on what is best referred to as *public* market failures. The notion of public market failure denotes situations where unregulated private ordering is structurally incapable of eliciting contractual outcomes that reflect the prudential interests of third parties. The term 'third parties', as used in this context, denotes those who are situated outside of the relevant bargaining nexus (eg the firm) and thus are incapable of protecting their interests directly via contractual provision. Involuntary (ie tort) creditors and local communities stand out as conspicuous examples in this regard.

By contrast, the market mimicking case for state interventionism is predicated on the existence of *private* market failures: that is, instances where unregulated private ordering fails

⁴⁵ See above nn 18-19.

⁴⁶ On the concept of market mimicking rules in corporate law generally, see Black, 'Is Corporate Law Trivial?', above n 2, 552-55.

to produce outcomes reflective of the prudential interests of *the contracting parties themselves*. The essential logic is that, while voluntary contracting is a fundamentally efficient and desirable mechanism through which to order the bulk of society's economic arrangements (at least relative to the available alternatives), the functionality of such cannot always be taken as given under 'real world' bargaining conditions. If, however, regulation is deployed in such a way as to 'tease out' the purportedly 'optimal' bargaining outcomes that are liable to ensue in the absence of transaction costs and other impediments to efficient contracting, then contracts can 'be made to work'.⁴⁷ That is to say, the regulatory state – via appropriately targeted interventions in private ordering – can succeed in providing 'what the parties would ideally have wanted' as the outcome to their mutual bargain, but for whatever reason were unable to arrive at – or perhaps even recognise as optimal – under the given circumstances. In other words, the purpose of regulation is in effect to 'mimic' the operation of an efficiently functioning market, whereby contracting parties are impulsively inclined towards those agreements that are best calculated to advance their respective material interests.⁴⁸

For this purpose, the market mimicking rationalisation makes reference to the concept of a hypothetical bargaining scenario, the conditions of which are calibrated in such a way that any practical obstacles to the reaching of optimal (or, at the very least, mutually advantageous) voluntary arrangements are 'factored out' of the picture.⁴⁹ Whereas some variants of hypothetical bargaining rationality work on the basis of a notionally 'ideal' contractual forum conducive to economically optimal results,⁵⁰ others merely seek to envisage circumstances where the parties are able to direct their minds specifically to the issue (or 'term') in question.⁵¹ Under either approach, though, the essential purpose of

⁴⁷ For instance, Jeffrey Gordon claims that:

it is a mistake to assume that full contractual freedom in corporate law would necessarily lead to private wealth maximization. The existence of some mandatory rules may lead to *better contracts*. In other words, the mixed system of optional and mandatory legal rules that we observe may be best *even from an essentially contractarian perspective*.

Accordingly, "any efficiency losses from the rigidity of mandatory rules may be outweighed by the gains such rules generate *by addressing defects in the contractual process*." See JN Gordon, 'The Mandatory Structure of Corporate Law' (1989) 89 *Columbia Law Review* 1549 at 1554, 1549 (my emphases added). For a similar defence of mandatory corporate governance rules on fundamentally contractarian grounds, see LA Bechuk, 'The Debate on Contractual Freedom in Corporate Law' (1989) 89 *Columbia Law Review* 1395.

⁴⁸ For example, Bernard Black argues that "[s]ome mandatory rules [in corporate law] may survive because they mimic the market", and thus "would be universally adopted by contract, assuming the parties about them." Black claims that such rules are consequently "trivial", in the sense that they "have no bite" (that is, no socially-determinative effect in their own right). See Black, 'Is Corporate Law Trivial?', above n 2, 552, 551.

⁴⁹ On this, see Bechuk, 'The Debate on Contractual Freedom in Corporate Law', above n 31, 1410-11.

⁵⁰ See, eg Easterbrook and Fischel, 'The Corporate Contract', above n 4, 1433.

⁵¹ According to Charny, hypothetical bargaining standards deployed by different scholars vary from one another in accordance with the following two main 'sliding scale' criteria: (i) *generality* (ie how specifically geared is

regulation is the same: that is, to provide for what the parties *would have* stipulated were they both able and inclined to negotiate explicitly over a given matter.⁵² For this reason, the market mimicking rationalisation of state interventionism can be understood as an avowedly *counter-factual* phenomenon.

The market mimicking rationalisation is a much more controversial - and, as I will demonstrate below, logically problematic - line of argument than the publicly-oriented justifications for market failure regulation documented above. This is for two main reasons. First, there is the aforementioned fact that, in distinction from the negative externalities and public goods arguments, the market mimicking rationalisation goes straight to the heart of the core contractual dynamics of corporate governance, rather than just the indirect social impacts thereof. Secondly, and more fundamentally, at the very heart of the market mimicking rationalisation there is a *prima facie* contradiction. This is the apparent tendency of the argument simultaneously to both proclaim *and* deny the capacity of private contracts to produce distributive outcomes that are optimal - or, at least, broadly desirable - from the perspective of the contracting parties themselves. Indeed, of particular noteworthiness in this regard is the fact that the market mimicking rationalisation supports a relatively extensive (for contractarian standards) role for regulation - not just for the orthodox facilitative purpose of 'filling gaps' in (otherwise independently constituted) agreements, but - moreover - with a view to effecting *outright displacement* of actual contractual outcomes, and their substitution with a regulatory embodiment of those outcomes that allegedly would have ensued within some sort of fictional alternatively reality. For this reason, the market mimicking rationalisation of mandatory corporate law rules - and, indeed, of state interventionism in private ordering generally - raises a number of significant problems for contractarians, both methodologically and logically.

the deployed standard to the circumstances of the actual 'agreement' in question?); and (ii) *idealization* (how abstracted from reality are the conditions under which the hypothetical contractors are assumed to be bargaining?). See D Charny, 'Hypothetical Bargains: The Normative Structure of Contract Interpretation' (1991) 89 *Michigan Law Review* 1815, 1820-21.

⁵² See Charny, *ibid*, 1815-16.

6. THE LIMITATIONS OF THE ‘MARKET MIMICKING’ RATIONALISATION

A. The Inherent Arbitrariness of Hypothetical Bargaining Rationality

The first problem with the market mimicking argument for regulatory state interventionism concerns the methodology of its underpinning hypothetical bargaining construct. As useful as this conceptual device is, a hypothetical bargain is ultimately what it purports to be – that is, *hypothetical*. As such, it has no inert empirical content but – rather – begins life as nothing more than a theoretical ‘empty vessel’ that requires subsequent ‘filling’ by scholars on an artificial and counter-factual basis. However, far from being an inert weakness of hypothetical bargaining rationality, the theory’s characteristic counter-factuality is its most powerful feature, in that it establishes a normative case for social or regulatory outcomes different to those prevailing under (inferior) real world bargaining conditions.⁵³

But given that the point of deploying the hypothetical bargaining construct is to justify desirable outcomes from purported ‘first principles’, everything depends on *how* – exactly – the identity of the contractors is constructed within the theory’s notional ‘original position’ of the fictional bargaining table.⁵⁴ Absent convincing and generally acceptable reasons to justify *why* the hypothetical contractors were constructed in a given way, any conclusions that result from the deployment of such logic are prone to be rejected as invalid on grounds of their perceived arbitrariness or political partiality.⁵⁵

The defensibility of the answers given to methodological questions such as the following are hence crucial to the validity of any particular application of hypothetical bargaining rationality: *How rational should the notional contractors be presumed to be as economic actors? How much awareness should they be deemed to have of their specific circumstances? And what should their presumed risk appetite be?* It is my contention that none of these points of uncertainty have been satisfactorily settled by those who – consciously or subconsciously – deploy hypothetical bargaining rationality in attempting to justify regulatory interventionism in corporate governance affairs on market mimicking grounds.

⁵³ On the counter-factuality of the hypothetical bargaining construct, and the conceptual problems that this poses, see R Dworkin, ‘Why Efficiency?’ (1980) 8 *Hofstra Law Review* 563.

⁵⁴ On this, see V Brudney, ‘Corporate Governance, Agency Costs, and the Rhetoric of Contract’ (1985) 85 *Columbia Law Review* 1403, 1415-16.

⁵⁵ On this difficulty generally, see Charny, ‘Hypothetical Bargains’, above n 35.

With respect first to the issue of what degree of economic rationality hypothetical investors should be taken to possess, the contractarian paradigm of corporate governance is both ambivalent and somewhat contradictory. In this regard, a number of alternative constructions are possible. One approach, which could be termed the ‘weak’ bargaining hypothesis, queries merely what arrangement *the actual parties* (ie investors and managers) in question would have bargained for in regard to a specific aspect of their future relationship, had they been directly afforded the opportunity to do so *ex ante*. A second potential approach – constituted at a slightly higher level of theoretical abstraction (the ‘semi-strong’ bargaining hypothesis) – seeks to determine what arrangement hypothetical contractors of *the relevant type* (eg ordinary shareholders, or professional institutional shareholders) would generally favour in respect of any particular matter, irrespective of the specific characteristics, preferences or competencies of the parties in question. A final possible approach – which operates at the most abstract level of analysis (the ‘strong’ bargaining hypothesis) – attempts to surmise what arrangements perfectly rational contractors, exhibiting the characteristics of classical ‘economic man’, would tend to bargain for absent any limitations in information and foresight, or other inhibiting transaction costs.⁵⁶

The advantage of the weak bargaining hypothesis is its more immediate relevance to the circumstances of the parties in question, which increases the likelihood of its purported ‘outcomes’ being accepted as valid in respect of the situation at hand. Correspondingly, the disadvantage of the strong bargaining hypothesis is its extreme counter-factuality in relation to the circumstances at hand, which renders its normative conclusions difficult to accept in the absence of convincing and generally acceptable reasons for doing so. At the same time, though, the strong bargaining hypothesis – in being positioned at a level of analysis relatively far removed from reality – is generally equipped to elicit more universally-applicable recommendations (whether for preservation or reform of existing norms or laws) in respect of a particular matter than circumstantially-sensitive approaches to the same issue.

All social-scientific analyses based at root on contractarian logic tend as a general rule to fall into one of the above three categories of abstraction, whether intentionally or by accident. However, which of these three categories the *corporate* contractarian rationalisation of state interventionism falls into it is not readily apparent. Nor is it apparently spelled out in either a clear or consistent way across the principal theoretical literature, with both the ‘pure’

⁵⁶ On these alternative possible constructions of the notional hypothetical bargain, see Charny, *ibid*, 1817.

and more transaction-costs-focussed variants of corporate contractarianism making notably different presumptions from one another in relation to such matters.⁵⁷

In addition to creating uncertainty about the degree of economic rationality to be attributed to contracting parties in the hypothetical bargaining scenario, the market mimicking rationalisation of regulation throws up a further unresolved question concerning how much awareness corporate contractors (ie investors and managers) should be deemed to have of their specific circumstances when negotiating with one another in the notional original position? Two potential theoretical methodologies stand out in this regard. In the first alternative, the negotiating parties are deemed to have knowledge of their relative starting positions, and accordingly bargain for protective governance terms with those considerations in mind. In the second alternative, the parties are regarded as negotiating for protective terms behind a fictional ‘veil of ignorance’, by virtue of which they are presumed to be unaware of their particular starting point relative to other contractors. At the same time, though, all parties are deemed to be in possession of general knowledge and understanding of the overall endeavour that they each form part of.⁵⁸

In the corporate governance context, it is clearly of material relevance to the likely outcome of hypothetical bargains which of the above two theoretical approaches is deployed. In particular, a priori awareness of one’s status as a manager or shareholder will undoubtedly impact on what one sees as an individually advantageous outcome of the original bargain over relative governance entitlements. This is especially so in widely-held ownership environments where there exists an inevitable scarcity of opportunities for ex post facto ‘settling-up’ of parties’ initial contractual entitlements in the event that they prove to be insufficient.

Notwithstanding these points of concern, corporate contractarianism is in general somewhat ambivalent on this particular issue. Most leading expositions of the contractarian paradigm would appear to stop short of deploying full veil of ignorance methodology, with parties to implicit corporate contracts at least presumed to know who they are in a broad generic sense (e.g. managers, shareholders, creditors or employees). But the same theory

⁵⁷ Whilst the orthodox or ‘pure’ variants of contractarianism (such as those developed by Easterbrook & Fischel, and Bainbridge) apparently seek to attribute proximately rational economic characteristics to corporate participants, the more transaction-costs-focussed versions of the theory (such as those developed by Williamson and Hart) are premised on what the relevant authors perceive to be inherent limitations in the rationality of corporate participants as human agents. For a comparison of these two approaches, see G Kelly and J Parkinson, ‘The Conceptual Foundations of the Company: A Pluralist Approach’ in J Parkinson, A Gamble and G Kelly, *The Political Economy of the Company* (Oxford, Hart Publishing, 2000), ch 6, 116-21.

⁵⁸ The latter ‘veil of ignorance’ methodology is based on the influential work of the rationalist political philosopher John Rawls. See Rawls, *A Theory of Justice*, above n 27, 118-23.

would appear to attribute little-to-no awareness on the part of contractors of their relative position *within* each relevant participant ‘grouping’ (eg whether one is an informed institutional shareholder or uninformed retail investor), which might otherwise lead parties of the same broad identity to form significantly different contractual preferences from one another.⁵⁹

Furthermore, corporate contractarians have shown scant appreciation of the need either to articulate or justify their particular theoretical methodology of choice when resorting (expressly or implicitly) to hypothetical bargaining rationality. In particular, the theory’s exponents have failed to explain why recourse to the orthodox veil of ignorance construct is apparently not merited when determining what constitutes an efficacious a prioriallocation of governance entitlements between managers and shareholders. This issue is of particular concern given the general prominence of this particular method of deductive reasoning within contractarian analyses of social arrangements more generally, in both legal theory and rationalist political philosophy.

A final aspect of arbitrariness inherent in the hypothetical bargaining model deployed by corporate contractarians is the inbuilt and undefended assumptions that it seems to make about the risk appetite of contracting parties. It goes almost without saying in corporate-contractarian literature, with its heavy emphasis on orthodox law and economics reasoning, that the common guiding objective of contractors is purportedly to arrive at whichever distribution of governance entitlements is most likely to advance their overall wealth as a group – the assumption being that the bigger the resulting ‘pie’, the bigger the particular slice that each individual contractor will ultimately be entitled to. However, far from being an indisputably ‘neutral’ objective to attribute to contractors in the original position, the goal of overall wealth-maximisation implies that contractors have a predisposition towards risk that impels them to accept the possibility of adverse distributional outcomes in the sharing of the notional pie. That is to say, contractors will focus their energies in seeking an overall wealth-maximising outcome, on the assumption that this will indirectly prove beneficial to them on an individual level.⁶⁰

⁵⁹ For instance, whereas the informed institutional shareholder with relatively informal access to management may perceive detailed corporate disclosure or proxy regulation as little more than costly and unnecessary bureaucracy, the uninformed retail investor may view the same laws as a necessary and inalienable proprietary ‘life line’ in the absence of alternative means of access to firm-specific information or governance influence.

⁶⁰ Surveying the basic normative thrust of corporate-contractarian scholarship generally, Victor Brudney has observed that “[i]f the contract (under which the stockholder is said to offer his investment in exchange for managerial services) is ‘knowingly’ and ‘freely’ made by the parties, then on conventional assumptions, *its*

In short, then, corporate contractarianism envisages a firm's participants negotiating with the best (or, at least, proximately best) possible individual distributional outcome in mind, thus imbuing them with the notional psychological characteristic of 'pathological optimism'.⁶¹ In making this significant assumption, contractarian theorists foreclose consideration of the reasonable possibility that many corporate contractors negotiate with an alternative risk appetite that impels them to forego potential further increases in overall group wealth beyond a given level, in order to ensure at least a minimal guaranteed level of sharing in the ultimate collective output. In the corporate governance context, an investor with the latter psychological make-up might consequently be prone to favour a regulatory scheme that guarantees shareholders a minimum level of guaranteed rights of intervention in corporate decision-making. Moreover, the investor's preference in this regard would likely remain the same even where it is demonstrated that the firm's overall wealth-creating capacity will likely be greater in the event that shareholders forego such rights in favour of vesting unqualified executive authority in the board of directors.

It should be emphasised that the hypothetical investor in the above scenario is no less rational than the investor who shows a disregard for such distributional concerns in the original position. The only difference is their relative degree of risk tolerance, whereby one is led to favour the 'pure' wealth-maximising outcome, and the other is drawn towards the outcome that favours a 'satisficing'⁶² degree of group wealth-creation tempered by an offsetting level of concern for individually adverse social-distributional outcomes. But the

performance makes each of the parties better off and creates a larger pie for society – assuming no externalities, public goods, or market failures.” See Brudney, ‘Corporate Governance’, above n 50, 1404 (emphasis added).

⁶¹ Indeed, this attribution would appear to be a basic characteristic of orthodox law and economics methodology more generally, from which the corporate-contractarian school of thought is ultimately derived. For instance, Richard Posner – arguably the principal progenitor of the modern law and economics movement in the US – has been a consistent critic of John Rawls' argument that individuals in the notional 'original' bargaining position would choose a set of institutional arrangements whereby inequalities in resources inter se are only generally acceptable to the extent that they improve the utility of those least well-off within the relevant group (see Rawls, *A Theory of Justice*, above n 27, 65-70). Posner has argued that Rawls attributes an excessive degree of risk aversion to his hypothetical contractors, and also that the original position – as formulated by Rawls – results in “the choices of the unproductive” being “weighted equally with those of the productive.” See RA Posner, ‘The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication’ (1980) 8 *Hofstra Law Review* 487, 499. On this basis, Posner argues that the “efficiency” of a given contractual outcome – understood as denoting its propensity to maximise the wealth of the parties as a general group (irrespective of relative distributional outcomes) – is the criterion that “actual” (as opposed to hypothetical) contractors would therefore tend to favour as the principal determinant of social arrangements. According to Posner, “[s]ince efficiency is a widely regarded value in our world of limited resources, a persuasive showing that one course of action is more efficient than the alternatives may be an important factor in shaping public choice.” See RA Posner, *Economic Analysis of Law* (Boston, Little, Brown, 1972), 6.

⁶² On the concept of ‘satisficing’ outcomes as a motivating goal of economic activity generally, see HA Simon, ‘Theories of Decision-Making in Economics and Behavioral Science’ (1959) 49 *American Economic Review* 253.

contractarian position, in automatically attributing the former risk appetite to contractors without further explanation, ultimately tars its normative conclusions with the charge of arbitrariness by failing to justify the underpinning factual assumptions of its approach. For this reason, any normative argument that is advanced for greater or lesser public regulation of corporate governance affairs on market mimicking grounds should be regarded as *prima facie* invalid. That is, at least in the absence of a rigorous accompanying defence of the various factual assumptions and imputations on which this claim is based.

B. Are Hypothetical Contracts Really ‘Contractarian’ at All?

A second and more fundamental weakness in the market-mimicking rationalisation of mandatory corporate governance rules is its unintended normative effect in undermining the conceptual validity of the contractarian account of regulation in its entirety. Above all, it may legitimately be queried whether the hypothetical contracts that are forwarded in support of purportedly ‘market mimicking’ regulatory outcomes are really ‘contractarian’ in nature at all, at least in the ordinary sense of the word. There are two principal reasons to doubt the ‘contractualness’ of the contractarian argument in this regard: one of which concerns the basic theoretical logic of the argument, whereas the other derives from a crucial (and, I will argue, inherently self-defeating) concession that proponents of this claim have frequently made.

With respect to the former (logical) concern, David Charny has observed that “[i]t is by no means clear that individuals should be bound to hypothetical – as opposed to actual – contracts, or even that it is appropriate to call such hypothetical contracts ‘contracts’ at all.”⁶³ On this basis, Charny doubts the relevance to hypothetical contracts (whether as embodied statutorily or judicially) of traditional arguments for contractual obligation based on the individual autonomy of voluntary parties to an agreement, given that no actual or explicit assent has ever been signalled by the notionally ‘contracting’ parties to the terms thereof.⁶⁴ Moreover, the fact that in such cases no actual agreement has been either promulgated or assented to means that there are no specific terms – whether express or even implied – that can be used as a working basis for constructing the hypothetical contract. This means that the

⁶³ See Charny, ‘Hypothetical Bargains’, above n 35, 1817. Likewise, Ronald Dworkin asserts that “a counterfactual consent provides no reason *in itself* for enforcing against me that to which I would have (but did not) consent”, and indeed “is *no consent at all*.” See Dworkin, ‘Why Efficiency?’, above n 49, 578 (emphases added).

⁶⁴ *Ibid.*

relevant rule-maker (whether legislative, judicial or administrative) must in effect pluck a hypothetical agreement out of thin air by seeking to determine what the contracting parties *would have* bargained for in respect of the situation at hand.⁶⁵

But in the absence of any concrete evidence as to what the parties themselves would have been inclined to bargain for in the circumstances at hand, the only available proxy for such are what Charny calls “socially extant expectations of fairness or reasonableness.”⁶⁶ These expectations are inevitably derived from the rule-maker’s perception of the “general social consensus about how various types of transactions should be structured”, so that there is “little need for inquiry into variations of perceptions or preferences among individual transactors.”⁶⁷ Accordingly, in cases where individual contractors exhibit differing private preferences from one another, those individual preferences that do not align with the perceived general social consensus with respect to a particular matter can be rejected by the rule-maker a priori as examples of erroneous adverse selection.⁶⁸

Thus by means of the above course of logic, substantive concepts of fairness or welfarism in social arrangements are effectively brought into contractarian argumentation via the proverbial ‘back door’. This demonstrates the methodological inescapability of using substantive outcomes as the *starting point* – rather than end point – of hypothetical bargaining rationality. As Kronman highlights, “[t]he inference in all hypothetical bargains must...be *from mutual benefit to consent*, rather than the other way around, as in the case of actual agreements.”⁶⁹ In other words, the fact that a given regulatory arrangement is objectively judged to be mutually welfare-enhancing is *in itself* a reason for treating it as a substantive outcome of some hypothetical bargain, even though no underpinning contractual agreement to this effect has ever occurred between the parties who are subject to the rule in question.⁷⁰

⁶⁵ See JC Coffee, ‘The Mandatory/Enabling Balance in Corporate Law’ (1989) 89 *Columbia Law Review* 1618, 1628. Coffee claims that the “greatest defect” of hypothetical bargaining rationality is its focus on seeking artificially to provide “what parties would have wanted”, rather than attempting to compel them to bargain “for what they do want” (ibid).

⁶⁶ Charny, ‘Hypothetical Bargains’, above n 35, 1838.

⁶⁷ Ibid.

⁶⁸ Ibid.

⁶⁹ See AT Kronman, ‘A Comment on Dean Clark’ (1989) 89 *Columbia Law Review* 1748, 1750 (emphasis added).

⁷⁰ Atiyah has made essentially the same point in the following succinct terms:

If one starts by assuming that all men are rational, if one then assumes that they desire certain goals, if one can demonstrate that these goals are best reached by a certain path, and if one then finds man on that path, it is a natural conclusion that man finds himself there as a result of a deliberate act of free choice.

Kronman explains how, on this basis, “the assertion that ...[the parties] would themselves hypothetically agree to...adoption [of a relevant term] *adds no justificatory force of its own*, for this last claim follows automatically from – it is entailed by – the rule’s welfare enhancing character.”⁷¹ It follows that “[h]ypothetical contract arguments are not really contractualist at all”, given that “[t]hey explain and justify their conclusion by an appeal to considerations of welfare alone, the latter providing their necessary and sufficient conditions.”⁷² For this reason, the market mimicking rationalisation of mandatory rules – to the extent that it is premised on hypothetical bargaining outcomes – is more appropriately understood as a *welfarist*, rather than contractualist, line of argument.

Insofar, therefore, as the market mimicking rationalisation of state interventionism in private ordering does not even fit the necessary characteristics of a ‘contractarian’ argument at all in the accepted sense, it can justifiably be concluded that private ordering rationality is on its own incapable of accounting for the significant regulatory dimensions of Anglo-American corporate governance law as a system. With the effective breakdown of the contractual metaphor as a means of giving normative force to prevailing distributions of corporate governance rights, it arguably follows that such outcomes stand to be determined on the basis of democratic public policy debate, just like any other avowedly welfarist social outcome. In this context, continual recourse to the fictional rhetoric of hypothetical private bargain could thus be said to obfuscate the fundamentally *public-regarding* nature of the necessary institutional enquiry at hand.

Notwithstanding the seriousness of the above revelation for the logical defensibility of the market mimicking rationalisation of regulation, there remains to be added one further nail to the proverbial coffin of this argument. This concerns a significant – indeed, *self-defeating* – concession that interventionist contractarians have made in providing an explanation for why mandatory rules are purportedly an acceptable and, moreover, essential complement to private ordering dynamics in corporate governance. In short, proponents of the market mimicking argument make the logically fatal error of arguing for (limited) regulatory state interventionism in corporate governance on grounds of systematic irrationality in private rule selection methods.

See PS Atiyah, *The Rise and Fall of Freedom of Contract* (Oxford, Clarendon Press, 1979), 51 (emphases in original text). Writing as far back as 1979, Atiyah claimed that “[t]oday this form of reasoning is often treated as highly fictitious” (ibid).

⁷¹ See Kronman, ‘A Comment’, above n 65, 1750.

⁷² Ibid.

Although contractarian theorists are generally prepared to concede the inevitable existence of some ‘real world’ imperfections in shareholder rationality and market-based pricing mechanisms,⁷³ the market mimicking argument goes above and beyond this by advocating the widespread invocation of mandatory rules as a structural response to the *systematic* mispricing of corporate governance norms by the capital markets.⁷⁴ In making this sizeable allowance for widespread investor irrationality, the market mimicking argument arguably gives away too much by inadvertently invalidating the very assumption on which the validity of its private ordering hypothesis rests: that is, the basic (albeit imperfect) capacity of capital markets to reflect the requisite degree of relevant information about a firm, including its internal rule structure, to make possible the proximately rational selection and pricing of its securities by investors.⁷⁵

As an unfortunate consequence of adopting this awkward starting position, the market mimicking rationalisation of mandatory rules is inevitably inclined towards contradictory normative claims. On the one hand, proponents of this view assert that corporate law rules should do no more than mimic the institutional choices that corporate participants (particularly investors) would be inclined to make themselves under idealised bargaining conditions. On the other hand, though, the same school of thought accepts that corporate participants are in reality very often incapable of making purportedly rational or efficient rule selection choices unaided.

The inevitable implication is that the interventionist regulatory state must ultimately make these calls instead by trying to ascertain what rules hypothetically rational contractors would be inclined to favour in respect of any given corporate governance problem, and also which of these rules the same hypothetical agents would deem so important and/or complex as to be rendered incapable of removal or variation under any possible conditions. But for the state to do any more than this – for instance, to promulgate rules on the basis of public policy considerations rather than majoritarian private preferences – would arguably be to overstep its legitimate remit as a purportedly passive-facilitative rule-maker. Thus contractarianism at

⁷³ Indeed, as I explained in chapter three, the economic rationale for the principle of shareholder exclusivity in corporate governance law is premised on the (assumed) *incapacity* of corporate equity investors to draft ‘complete’ contracts that provide protection against all conceivable contingencies. If information were costless to acquire, enabling shareholders to make rational investment choices based on full foresight of the consequences thereof, then this purported ‘incomplete contract’ problem would not exist. See above ch 3, pt IIIB1.

⁷⁴ See, eg Easterbrook and Fischel, ‘The Corporate Contract’, above n 4, 1436.

⁷⁵ In finance theory, this assumption is known popularly as the Efficient Capital Markets Hypothesis (or ECMH), on which see EF Fama, ‘Efficient Capital Markets: A Review of Theory and Empirical Work’ (1970) 25 *Journal of Finance* 383. For a critical perspective on the ECMH, see LA Stout, ‘The Mechanisms of Market Inefficiency’ (2003) 28 *Journal of Corporation Law* 635.

the same time both asserts and denies the deliberate policy-making remit of the regulatory state in corporate governance. In the case of mandatory rules, moreover, this conceptual double-bind is exacerbated by the inescapability (for corporate participants) of the institutional outcomes that result from state interventionism, especially when it comes to fundamental governance issues such as the distribution of decision-making power and influence at the heart of the corporate structure.

Accordingly, by accepting the case for state-promulgated mandatory rules on the basis of systematic investor irrationality, the market mimicking argument could be said to tread a very fine line between advocating: on the one hand, the essentially quasi-*private* state function of market correction by means of contractual ‘gap-filling’; and, on the other, the manifestly *public* state function of ‘regulatory paternalism’. In this sense, regulatory paternalism entails the interventionist state substituting its own (publicly-constituted) conception of what makes a purportedly effective or desirable corporate governance framework in place of those (sub-optimal) structural outcomes that are likely to result from privately-driven, market-based rule selections.

The unavoidably paternalistic slant of the market mimicking rationalisation of mandatory corporate governance rules has significant normative consequences, insofar as it calls into question the purportedly endogenous dynamic underpinning the development of Anglo-American corporate governance norms. In particular, it infers that mandatory corporate governance rules rest on a fundamentally *anti*-contractual basis insofar as they represent a largely wholesale *substitute to*, rather than supplementary facilitator of, the market-driven private ordering process. On this basis, one can justifiably draw the conclusion that contractarianism is ultimately incapable of rationalising the significant, fundamental and perpetual presence of mandatory rules at the heart of Anglo-American corporate governance, at least without accepting an intrinsic public-policy-making role for the interventionist regulatory state.

7. CONCLUSION: CORPORATE LAW *ISN'T* REALLY ‘PRIVATE’ AFTER ALL!

I began this paper by querying the fundamental nature of Anglo-American corporate law. In particular, I questioned where exactly this area of law should be positioned in relation to the notional normative fault line between facilitative ‘private’ law and regulatory ‘public’ law subjects. Although I have sought to answer this question in detail over the course of this paper, I feel that it is only appropriate to end by providing a direct response thereto.

On its exterior, Anglo-American corporate law is undoubtedly a private law subject. Like other areas of private law, it exhibits a range of expressly flexible and facilitative formal features, rendering its substantive content contingent to a significant extent on the prudential preferences of corporate contractors (principally investors and managers) at the ‘micro’ or individual firm level. Such features of the law, moreover, are entirely consistent with the idealised model of corporate law that is presented within the contractarian theoretical paradigm, whereby laws are designed to *reflect*, rather than determine, the pre-existing contractual choices of private parties.

On closer inspection of the legal architecture, though, a more complicated picture emerges. In spite of their *prima facie* endogenous and privately-determined character, the rich contractual dimensions of corporate law in the US and UK are ultimately dependent for their effective functioning on an underpinning body of laws that, in the last place, are both *irremovable* and - in large part - *inadaptable* in nature. It can therefore reasonably be concluded that Anglo-American corporate governance law is, at root, an undeniably ‘public’ or regulatory phenomenon. To adopt a metaphorical analogy with the natural world, corporate governance law is thus best depicted as ‘a garden’ rather than ‘a wilderness’. That is to say, whilst by nature organic and evolutionary, it can only be made to develop in a manner that is desirable to its progenitors if its evolution is allowed to proceed within parameters that are strictly controlled in advance via artificial or synthetic means.

But where, one might ask, does this ultimately take us in practical terms? In other words, what are the implications of the above understanding of corporate governance ‘as artificial design’ for the appropriate future development of the subject matter?

Above all, the critique of corporate law presented in this paper calls for a more tolerant and progressive attitude towards regulatory state action in this field. Increasingly over recent decades, ‘regulation’ has come to be understood in a highly pejorative sense by many private (and especially corporate) lawyers, as a mechanism that is liable to deprive individuals of their economic freedom of action in the service of (frequently misguided) governmental ‘grand plans’. However, if the above discussion has established anything, it is that in the field of corporate governance, ‘regulation’ is not the dirty word that it is frequently made out to be. It is my belief that, rather than being seen as something that is liable to deprive individuals of their liberty as economic actors, regulation should rather be viewed – in the corporate governance context especially – as a phenomenon that can ultimately *contribute to* securing individual contractual freedom. Above all, regulatory state interventionism is structurally necessary in this environment for counteracting inherent

economic-organisational power disparities, which would otherwise constrain the capacity of corporate contractors (particularly investors) to bargain directly for protection of their interests via decentralised ‘self-help’ practices.

Moreover, on the understanding that corporate law is – at root – an artificial and regulatorily founded phenomenon, there would appear to be no obvious normative impediment to this body of laws being designed to achieve manifestly *public*-regarding objectives as established *democratically*, rather than contractually. This position stands irrespective of continuing attempts by orthodox corporate law scholars to assert the purported privity of their subject matter, and its consequent immunity from extraneous regulatory ‘interference’.