Implications of Sen’s Concept of Commitment for the Economic Understanding of the Corporation

Ian B. Lee

Introduction

In a classic paper, Amartya Sen proposed that reasons for action be conceptualized in terms of three distinct forms of motivation: self-interest, sympathy and commitment. This paper explores the implications of Sen’s conceptualization for the economic understanding of the corporation. My thesis is that commitment can help to explain certain “deliberative” features of corporate governance, features that the traditional economic approach inadequately explains or passes over entirely.

At first glance one might assume that the point of Sen’s trichotomous conceptualization of rational motivation is to permit ethically motivated conduct to be understood within rationality, given that Sen placed ethical motivations under the rubric of commitment. In other words, one may understand Sen’s proposal as a challenge to the traditional assumption that Rational Man must be selfishly motivated. Many welfarists, however, no longer hold such a narrow view of individual motivations, and acknowledge that Rational Man maximizes a “utility function” that may well include care for (at least some) other people, as well as sensitivity to moral and social norms. Some might be tempted to conclude in light of this development that the usefulness of Sen’s trichotomy has been exhausted.

However, such a conclusion would neglect an important feature of Sen’s trichotomy and, in particular, of his distinction between self-interest and sympathy, on the one hand, and commitment on the other hand. In Sen’s trichotomy, commitment is distinguished from self-interest and sympathy in being conceptualized as a “meta-ranking,” that is, a preference ranking over preference rankings. In other words, commitment is a way of understanding the preferences that an individual would like to have or wishes that he or she had. It is, accordingly, a way of conceptualizing a distinction between a person’s welfare and his or her choices.

The author thanks Richard Bronaugh, Bruce Chapman, Alon Harel, Heidi Libesman, Eric Orts and participants in the 2006 annual meeting of the European Association for Law and Economics for their comments, and Brian Stabenberg and Charlene Jones for research assistance.


The conceptual wedge between choice and welfare continues to distinguish Sen’s approach from that of conventional theorists, most of whom retain the assumption that Rational Man seeks to maximize a function that represents his welfare, even if it is an inclusive function in light of his caring and ethical nature. For Sen, by contrast, an individual’s choices, or revealed preferences, are only one datum about his or her welfare, rather than being ex post facto synonymous with it, and if we care about welfare we should not neglect the additional information about an individual’s welfare—specifically, about his or her commitments—that might be provided by other means, such as introspection and discussion or, more generally, deliberation.

What might commitment contribute to an understanding of the corporation? I shall argue that the prevailing economic understanding of the corporation emphasizes the role of the market mechanism and conceptualizes the non-market aspect of corporate governance as fiat. However, some features of corporate governance are not adequately accounted for either as instantiations of the market mechanism or as fiat. They are, in fact, “deliberative” in character. The concept of commitment can be part of an interpretation that accommodates the deliberative features of corporate governance: whereas the market mechanism operates as a clearinghouse for the preferences revealed by the participants’ choices, the deliberative features permit the ascertainment and consideration of non-choice welfare information of the participants, for example, information about commitments relevant to cooperative and moral action.

The paper consists of two parts. In Part I, I discuss the concept of commitment, focusing on the distinction between choice and welfare and the implications of this distinction for normative economics. In Part II, I discuss the conventional economic understanding of the corporation and explain how the concept of commitment can be part of an interpretation of the corporation which accommodates, more adequately than the conventional approach, the deliberative features found in corporate governance.

I. Commitment, choice and welfare

In this Part, I explore Sen’s concept of commitment. I argue that just as self-interest has a behavioural and a definitional role in economics (Section 1), so too did Sen’s commitment-based critique of self-interest have a behavioural and a definitional aspect (Section 2). This paper emphasizes the implications of the definitional challenge, which essentially posits a conceptual gap between welfare and choice. In light of the widespread acceptance within the law-and-economics community of the notion of revealed preference, I shall elaborate on the reasons for treating welfare and choice as distinct concepts (Section 3).

I. Self-interest: a behavioural proposition or a definition?

In “Rational Fools,” Sen explains that he is concerned with questioning what is, notoriously, the “first principle of Economics,” namely the principle that “every
agent is actuated only by self-interest."
Although the discipline of economics is seemingly defined by this principle (combined with the notion of scarcity), economists are not unanimous as to the meaning of the principle. In particular, one can distinguish between two understandings which, following Sen, I shall label behavioural and definitional, respectively.4

As a behavioural proposition, the self-interest principle serves as a simplifying assumption that facilitates the generation of testable predictive hypotheses. The notion that individuals pursue their own welfare is taken to mean that individuals do not consider the interests of others, nor do they act upon ethical principles the pursuit of which is not warranted on own-welfare grounds. Often, as required for specific applications, the behavioural assumption is tightened further, for instance by assuming that individuals have "tastes" only for certain things, such as consumption and leisure, and that their welfare, or utility, depends on the satisfaction of these tastes alone. The justification for these assumptions rests, for some, on their empirical plausibility. Defending (or at least asserting) the empirical plausibility of behavioural self-interest was, for example, a recurring theme of George Stigler's Tanner Lectures.5 For others, the behavioural assumptions used in economics are justified, whether or not plausible a priori, because they permit the derivation of predictive hypotheses that are testable by reference to social science evidence.6

By the time of Sen's writing, some economists had already moved beyond behavioural self-interest. Buchanan and Tullock, for example, were emphatic that their economic analysis of politics "does not depend . . . upon any narrowly hedonistic or self-interest motivation of individuals in their behavior . . . . The representative individual in our models may be egoist or altruist or any combination thereof."7 Arrow had formulated hypotheses that an individual's welfare might be sensitive to the "satisfactions obtained by others" and that welfare might even attach to acts, as opposed to outcomes, to the extent that it is sensitive to the individual's "contributions to the utilities of others."8 For these theorists, self-interest remains a pillar of the "economic way of looking at life,"9 but it does not represent a falsifiable empirical claim or an assumption about behaviour. Instead, it is a conceptual conflation of an individual's welfare (or utility or preferences) with his or her choices. As Sen observed:

5. Ibid. at 318-23.
9. Kenneth Arrow, "Gifts and Exchanges" (1972) 1 Phil. & Pub. Affairs 343 at 348. Arrow nevertheless warned against oversimplifying non-egoistic behavioural hypotheses, which he thought had limited application (343-55).
It is possible to define a person's interests in such a way that no matter what he does he can be seen to be furthering his own interests in every isolated act of choice. The reduction of man to a self-seeking animal in this approach depends on careful definition. If you are observed to choose x rejecting y you are declared to have 'revealed' a preference for x over y. . . . With this set of definitions, you can hardly escape maximizing your own utility, except through inconsistency.11

Relaxing the behavioural assumption that individuals care only for themselves (i.e., that they attach no weight to principles or to the welfare of others), while retaining the "definitional egoist" conception of individuals as consistent utility maximizers, has enabled economists to explore and make predictions about individuals' behaviour in fields such as politics and the family, where other motivations in addition to self-love are at work.12 As Posner puts it, "[a] preference can be taken as a given, and economic analysis proceed as usual. . . . '"13

In addition, the definitional conflation of welfare and choice has important ramifications for normative economics. When combined with the Pareto principle, it accounts for the neoclassical economist's "predilection for private ordering."14 As Trebilcock argued, "if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it."15

2. Behavioural and definitional aspects of commitment

Sen argued that the economist's "conception of man" might be enriched by taking into account, in addition to self-interest, two additional forms of motivation: sympathy and commitment.14 Sympathy refers to the effect of someone else's welfare on one's own "sense of well-being,"17 whereas commitment refers to motivations apart from one's welfare (defining the latter to include sympathy). Sen provided several examples of the distinction between sympathy and commitment, including the following:

[1.] If the knowledge of torture of others makes you sick, it is a case of sympathy; if it does not make you feel personally worse off, but you think it is wrong and you are ready to do something to stop it, it is a case of commitment. . . .

[2. Consider] two boys who find two apples, one large, one small. Boy A tells boy

---

15. Ibid. Trebilcock adds that "the presumption is rebuttable by reference to a fairly conventional list of forms of market failure or . . . contracting failure," such as transaction costs or externalities (Trebilcock, ibid. at 7).
17. Ibid. at 327.
B. ‘You choose.’ B immediately picks the larger apple. A is upset and permits himself the remark that this was grossly unfair. ‘Why?’ asks B. ‘Which one would you have chosen, if you were to choose rather than me?’ ‘The smaller one, of course,’ A replies. B is now triumphant: ‘Then what are you complaining about? That’s the one you’ve got!’ … A would [indeed] have lost nothing from B’s choice had his own hypothetical choice of the smaller apple been based on sympathy as opposed to commitment. A’s anger indicates that this was probably not the case."

There is some ambiguity in the first example, as illustrated by the question whether it is an instance of sympathy or commitment, or something else, if knowledge of torture makes you sick because you think it is wrong rather than because you feel for the victims. Nevertheless, Sen can be understood to be making two essential points. First, one’s welfare may be affected by what happens to and is experienced by other people (“sympathy”). Second, it is possible to distinguish conceptually between motivations for choice that do, and do not, relate to the impact of the choice on one’s sense of well-being (e.g., whether one is “made sick”), as, for example, when a person acts on principle despite the harm to her sense of well-being and despite her indifference to the well-being of the beneficiaries of the principle in the circumstances (“commitment”).

Sen proposed that commitment be understood in terms of a preference ranking over rankings of actions. A particular ranking of actions is reflected in the individual’s choices, while other rankings might reflect various conceptions of the individual’s preferences—for instance, one ranking of actions might reflect the agent’s “isolated” personal interests ignoring sympathy.” Another might be the ranking most consistent with a particular commitment. Since commitment is conceptualized as a meta-ranking, the other rankings might also be ranked according to their degree of consistency with that commitment. This meta-ranking technique, according to Sen, is useful in formalizing many types of preference about rankings, including morality (I may view a particular ranking of actions as the “most moral ranking” even if it is not the ranking reflected in my choices), as well as political allegiances, class interests, and other like considerations. In less elaborate terms, commitment is a way of speaking of the preferences that an individual would like to have or wishes that he or she had, whether or not they are revealed in his or her choices.

Sen’s defence of the analytical usefulness of commitment has proceeded, for the main part, along three lines. First, Sen has argued for the importance of commitment in explaining and predicting behaviour. For example, in “Rational Fools” Sen argued that commitment may help to explain the behaviour of voters, each of whom turns out to vote despite there being virtually no likelihood of his or her affecting the outcome, and of workers, who may have sources of motivation not captured by the “economics of rewards and punishments.” In a more recent treat-

---

18. Ibid. at 326, 328-29.
19. Ibid. at 338.
20. Ibid. at 339.
21. Ibid. at 333.
22. Ibid. at 333-34.
ment, Sen is even more explicit in arguing that commitment is necessary in order to explain and predict certain “patterns of behavior.”

Second, Sen has argued that commitment is valuable in understanding the nature of rationality. “Rational Fools” began to explore this aspect of commitment, although the discussion was brief and tentative. Subsequently, Sen has argued that if we do not recognize that an individual sometimes pursues commitments at the expense of the individual’s “own goals, and in particular [his or her] welfare (no matter how broadly it is characterized),” then we “impair” the “reasoning” that contributes to our acts of choice, thus adopting an unduly narrow understanding of rationality. This aspect of Sen’s argument has been the most controversial.

A third way in which commitment is important for economic analysis has received less attention; Sen himself has neglected it in his more recent writing on commitment, although it is the aspect of commitment with which Sen claimed he was principally concerned in “Rational Fools.” Specifically, commitment has implications for normative economics because, in challenging definitional egoism, it drives a wedge between choice and welfare and thereby challenges the revealed preference theory on which normative economics has traditionally relied. In other words, choices become one source of information about the chooser’s welfare, instead of being the very definition of welfare. “Once we give up the assumption that observing choices is the only source of data on welfare, a whole new world opens up, liberating us from the informational shackles of the traditional approach.” In particular, Sen wrote, there may be a role for “introspection and communication.”

It is this third contribution of commitment which, in my view, has implications for the economic understanding of the corporation.

3. Choice versus welfare

The widespread acceptance of revealed preference theory among practitioners of economic analysis of law prevents me from taking for granted that Sen is justified

29. While this aspect of Sen’s concept of commitment has received less attention, it has not gone unnoticed. See, e.g., Brennan, supra note 3; Pettit, supra note 3; Daniel Hausman & M.S. Macpherson, Economic Analysis and Moral Philosophy (Cambridge: Cambridge University Press, 1996); Philippa Mongin, “A Concept of Progress for Normative Economics” (2006) 22 Econ. & Phil. 19.
31. Ibid. at 339-40.
32. Ibid. at 339.
in proposing a conceptual distinction between choice and welfare. Moreover, because of Sen’s emphasis in later writing on the behavioural aspect of commitment and on its implications for rationality, there is a risk that the nature of his challenge to revealed preference theory may be misunderstood. In the remainder of this Part, therefore, I aim to clarify the nature of the dispute about revealed preference and offer arguments in support of regarding welfare and choice as distinct concepts.

The conceptual unity of choice and welfare is a definitional assertion about welfare, rather than an empirical proposition about the behaviour of choosers. More specifically, it is a definition of welfare in terms of that which is chosen. Some criticisms of revealed preference are formulated in such a manner that they appear to be based on empirical grounds—for example, one might object that we routinely observe people choosing things that do not advance their welfare, such as when they overeat. However, such criticisms are in my view better understood as reflecting a disagreement about the definition of welfare. Whereas the revealed preference theorist defines the overeater’s welfare as that which is maximized by his choices (and hypothesizes that in the circumstances he more highly values gustatory pleasure than after-dinner comfort and overall health), the critic of revealed preference considers that additional information might potentially be pertinent in ascertaining the overeater’s welfare, for example, information as to whether the overeater later experiences regret, or has in conversation described himself as wishing he had greater willpower to resist edible temptations. The critic of revealed preference wonders whether it is adequate to define the overeater’s welfare as that which his choice maximized rather than, for instance, that which the overeater wishes he could achieve. Their disagreement is a conceptual dispute about welfare, or perhaps a methodological dispute about welfare economics, rather than an empirical dispute about choice.

It is very easy to lose sight of the conceptual and normative, rather than empirical and behavioural, character of the dispute about revealed preference. For instance, it is common to suppose that, if there is a gap between choice and welfare, it arises as a consequence of certain tendencies of human choice behaviour—that is, because of “bounded rationality.”33 Kaplow and Shavell, for example, acknowledge the plausibility of an argument that “imperfect information” and human “shortcomings,” such as an “inability to process available information,” may “prevent individuals from promoting their well-being.”34 I am not convinced that this is the best line of attack against revealed preference. Information and the ability to process it are things that people can choose to acquire (typically at a cost), and the amount of information and information-processing ability that an individual possesses at a given moment of choice can therefore be understood as revealing his or her relative preferences for those things. Moreover, at a moment of choice, available information and cognitive capacity can be conceptualized as part of the individual’s choice.

constraint; the individual’s welfare remains that which the individual maximizes within the constraint. The route to establishing a conceptual distinction between welfare and choice is to show that the foregoing is not the best way of thinking about welfare, not an argument that people are constrained choosers.

Another frequently invoked ground for interfering with choices has to do with endogeneity of preferences—the notion that a person’s own acts and those of third parties can affect his or her preferences. This phenomenon, too, is comprehensible within the framework of revealed preference. We might anticipate that a person would be better off at time T+1 if at time T she cultivated a taste for beer rather than champagne (because she would be able to satisfy the former taste more cheaply), but if we do not observe her making the choices that would lead to the development of a taste for beer, is it not because, at each moment for choice, she values the consumption of champagne more highly than the future prospect of enhanced enjoyment of beer? At each moment, she can be understood to be maximizing her welfare.

I have indicated that the gap between choice and welfare must rest on a normative and conceptual argument about welfare, rather than an empirical and behavioural argument about choice. Let me briefly outline two ways in which such an argument might be expressed. A first manner of expressing the argument emphasizes its normative aspect: a definition of welfare in terms of choice results in conduct being labeled “welfare-improving” that normative economics should not view as such. Consider an alternate ending to the familiar story of Ulysses. Suppose that, upon hearing the Sirens’ song, Ulysses somehow succeeds in freeing himself (the bonds having been tied too loosely), resuming control of the ship, and steering it onto the rocks, where he perishes. Leaving aside the fate of the innocent crew (arguably an externality), we should reject for purposes of normative economics a definition of welfare according to which Ulysses’ actions would be deemed to have improved his welfare. But this is precisely the interpretation that revealed preference entails: in defining welfare as that which is chosen, we must characterize Ulysses’ actions as welfare-maximizing, all things considered, within the constraints he faced. If a revealed preference theorist were asked to evaluate the welfare implications of a proposed intervention to override Ulysses’ choice, for example by tightening his bonds, he or she would counsel against doing so, reasoning that we must take Ulysses’ welfare to be maximized by whatever Ulysses chooses to do.

Can the revealed preference theorist avoid this embarrassing result? For example, can the revealed preference theorist, by describing Ulysses’ actions in terms of a pathology of choice (e.g., under the Sirens’ influence he lacked the “ability to process available information”), disavow Ulysses’ choices while retaining a definition of welfare as identical to choice in non-pathological situations? Such a strategy avoids the embarrassing result, but it rests on the questionable assumption that a

36. Kaplow & Shavell, supra note 2 at 1334; Sunstein, supra note 34 at 1158.
37. See Becker, Accounting for Tastes, supra note 12.
bright line separates individuals who are not under a cognitive disability, from those who are. The safer assumption is that we all operate under cognitive limitations (we all have a bounded ability to process available information). If revealed preference is to have any domain at all, it must define a person's welfare as that which is revealed by choices made under the constraints—material and cognitive—under which he or she operates at the time.38

The argument against revealed preference can also be expressed in a different way, by emphasizing its conceptual aspect. Specifically, abandoning the definitional conflation of choice and welfare makes possible a more appealing conceptualization of hands-tying.

To see how, let us return to the example of the overeater, whom I shall now call Fred. Imagine that Fred decides (at time T) to put a time-activated lock on his refrigerator, to prevent himself from snacking (at time T+1). This is an instance of "hands-tying," analogous to Ulysses' instruction to his crew to fasten him to the mast. There are two different ways of conceptualizing Fred's act at time T. The conventional analysis—treating choice and welfare as synonymous—proceeds as follows. At time T, Fred maximizes his welfare. Fred's welfare at time T takes into account how he feels today about things that he will experience in the future. In particular, he considers that in the long run (time T+2) he will be better off for having reduced his food intake, although he knows that at time T+1, he will be frustrated at being unable to gain access to the refrigerator. Indeed, Fred knows that his periodic cravings for snacks are of such intensity that, at time T+1, relieving them will outweigh even the long run benefit of good health. This is why, all things considered, Fred decides at time T to "tie his hands," although he thereby reduces his welfare at time T+1.39 At time T, Fred takes an action that reduces his welfare at time T+1; he does so because this strategy maximizes his welfare at time T.40

---

38. Moreover, the constraints are themselves the outcome of the person's previous choices, for example, in Ulysses' case, the choice not to have someone double-check the strength of the bonds fastening him to the mast. Presumably in forgoing this added precaution Ulysses was revealing his preferences, as well.

39. Let U(x) be Fred's welfare at T+1 from choosing action x. That Fred anticipates he will give in to his craving means that U(x) is maximized over {snack, not snack} when x = snack. This implies that U(not snack) < U(snack). If Fred locks the refrigerator at time T, his choice set at T+1 will be {not snack}, and his welfare at T+1 will be U(not snack) < U(snack). If Fred locks the refrigerator at T, he will reduce his welfare at time T+1.

40. The concept of time-inconsistent preferences seems to reflect this interpretation (Jon Elster, *Ulysses and the Sirens: Studies in Rationality and Irrationality* (Cambridge: Cambridge University Press, 1979) 69-70). Elster models the individual as possessing a single utility function u over allocations of consumption x1, x2, and x3 (representing consumption at three time periods) subject to the constraint that x1+x2+x3 is constant. If we let (x1, x2, x3) represent the allocation that maximizes u(x1, x2, x3), then an individual's utility function is time-inconsistent if (x1, x2, x3) is different from the allocation that maximizes u(x1, x2, x3) | x1 = x1. The model assumes, of course, that individuals' choices at each moment maximize their "utility" (i.e., welfare) subject to the then-prevailing constraints. Hands-tying strategies undertaken at the initial period are intended to cause the individual to choose (x1, x2, x3) during the second period, even if this is not the allocation that maximizes u(x1, x2, x3) | x1 = x1—i.e., in other words, even if it is not the allocation that, under the constraints prevailing in the second period, maximizes the individual's utility. See also Jon Elster, *Ulysses Unbound* (Cambridge: Cambridge University Press,
The other way of conceptualizing Fred's act of hands-tying at time $T$ views it as **constraining his choices at time $T+1$**, in the belief that his **constrained choices will be more consistent with his welfare at time $T+1$**. In order to have this conceptualization available to us, we must be willing to treat welfare and choice as distinct concepts. What is at stake between the two conceptualizations is that if we insist upon the definitional unity of welfare and choice, then a person who ties his hands must be understood to be reducing the ability of his future self to maximize his welfare, whereas a more natural understanding of what we do when we move the cookie jar to the highest shelf, keep the pantry stocked with rice cakes rather than potato chips, or give away our collection of addictive video games, is that we protect our future selves from disserving our own welfare.

I have explained that the unity of choice and welfare under revealed preference theory is a definitional assertion with normative implications, and that the objections to it must be normative and conceptual, rather than empirical. In particular, I have suggested that defining welfare as synonymous with choice can lead us to designate as welfare-improving actions that normative economics should view as welfare-destroying, and entails an awkward conceptualization of the act of tying one's hands.

Thus far I have been concerned with constructing an affirmative argument for a conceptual distinction between welfare and choice. Before moving on, it is appropriate to consider what arguments can be offered in support of the contrary proposition, that is, in support of the unity of welfare and choice. The familiar claim that revealed preference is true by definition is beside the point. That revealed preference is a truism does not speak to its normative adequacy as a conception of welfare.

The claim that normative economics ought to treat people's welfare as that which is revealed by their choices is a normative or conceptual claim about the nature of welfare, or a methodological claim about normative economics. Such claims need to be defended.

An example of a conceptual claim about the nature of welfare is the following argument made by Dowding:

> Could we make sense of someone who claimed that they 'really' preferred $x$ to $y$ even though there are no conditions under which they would choose it? Rather would we not think the person had not grasped the meaning of the term 'prefers'? The person might claim they had some 'mental representation' of the 'preferring of $x$ to $y$' but this mental representation never led them when making choices. Externalism in the

---

2000) 24; A. Cukierman, *Central Bank Strategy, Credibility and Independence* (Cambridge, MA: MIT Press, 1992). Quoting Cukierman, Elster describes time-inconsistency as occurring when, without any change in exogenous circumstances, "the best policy currently planned for some future period is no longer the best when that period arrives." Accordingly, hands-tying is an act that I undertake today so as to ensure that in the future period I will choose the policy that maximizes my welfare (the "best policy") as I see it today, although I anticipate that it is not the policy that will maximize my welfare as I will then perceive it.

41. We cannot (A) take the position that Fred's welfare at $T+1$ is improved by eliminating the option that he would have chosen, at time $T+1$, while (B) defining welfare as that which is maximized by one's choices, all things considered. (A) implies that $U(\text{not snack}) > U(\text{snack})$, whereas (B), combined with what we know Fred would do if the refrigerator were not locked, implies that $U(\text{snack}) > U(\text{not snack})$. 

Implications of Sen's Concept of Commitment...

philosophy of mind denies that we can make any sense of this. What kind of phenomenon would this 'mental representation' be? Why should we think it a preference?

I do not think that Dowding's argument undermines the arguments against the conceptual unity of choice and welfare, for I am not suggesting that individuals' unfulfilled desires about their own behaviour "never le[a]d them." It may be the case, however, that they sometimes do not prevail, and that in certain foreseeable circumstances they consistently do not prevail—as in the examples of Ulysses and Fred, absent hands-tying. Under such circumstances, do we distort the meaning of "preference," or welfare, if we fail to equate it with that which is consistently chosen? I have suggested, above, that the contrary is true. It does less violence to the concept of welfare to say that if Ulysses were to break free of his bonds and sail to his doom he would reduce, rather than maximize, his welfare, and to characterize the person who deprives himself of future choices he believes will be irresistible, yet harmful, as acting to prevent himself in the future from reducing his welfare, rather than as maximizing his present welfare at the expense of his future welfare.

A conventional methodological argument for the revealed preference approach justifies the economist's exclusive reliance on the observation of choices on the basis that non-choice welfare data is inherently unreliable. Revealed preference might on this view be analogized to an absolute exclusionary rule against hearsay evidence, which typically is also premised on the inherent unreliability of second-hand testimony. Since the 1990s, the hearsay rules have been relaxed in many jurisdictions, including Canada and the United Kingdom, in the belief that an absolute exclusionary rule sacrifices too much that might be of value in the search for the truth on the basis of a crude, binary judgment about reliability. In place of the absolute exclusionary rule courts now apply a more flexible approach that takes into account the informational value of particular items of hearsay evidence as well as degrees of reliability in light of, for example, the circumstances in which the hearsay

43. It has also been argued that revealed preference is indispensable for empirical social science research (see Dowding, ibid.). However, one can acknowledge the utility of revealed preference for conducting empirical research, and still question whether for the purposes of normative economics welfare and choice must be treated as synonymous.
statement was made. The exclusionary rule implicit in the revealed preference approach is open to attack on similar grounds. Based as it is on an all-or-nothing judgment about reliability, it is too sweeping.

As Sen writes:

That behaviour is a major source of information on preference can hardly be doubted, but the belief that it is the only basis of surmising about people's preferences seems extremely questionable. While this makes a great deal of sense for studying preferences of animals, since direct communication is ruled out (unless one is Dr. Dolittle), for human beings surely information need not be restricted to distant observations of choices made. There is, of course, something of a problem in interpreting answers to questions as correct and in taking the stated preference to be the actual preference. . . . But then there are problems, as we have seen, with the interpretation of behaviour as well. . . . The thrust of the revealed preference approach has been to undermine thinking as a method of self-knowledge and talking as a method of knowing about others. In this, I think, we have been prone, on the one hand, to overstate the difficulties of introspection and communication, and on the other, to underestimate the problems of studying preferences revealed by observed behaviour.

In short, even granting that circumvention is warranted in evaluating evidence of welfare gleaned from introspection and communication, it is neither inevitable nor advisable that such evidence be excluded from consideration altogether.

My aim on this Part has been to explain that an important, yet little-discussed aspect of Sen's writing about commitment concerns its implications for normative economic analysis and, in particular, the conceptual wedge it drives between welfare and choice. I have argued that the conceptual unity of welfare and choice must be attacked or defended on the basis of normative or conceptual arguments about the nature of welfare or methodological arguments about normative economics, rather than empirical or behavioural arguments—which invariably beg the question. I have also suggested arguments of the former kind that might be advanced in support of Sen's position. In the second Part of this paper, I shall address the implications of the conceptual distinction between welfare and choice for the economic analysis of corporate law.

II. Commitment and the economic understanding of the corporation

In this Part, I suggest that the concept of commitment can be of assistance in making sense of features of corporate governance that the conventional approach struggles to explain. I begin by describing the conventional economic understanding of the corporation (Section 1). This understanding emphasizes the role of markets and conceptualizes the non-market aspect of corporate governance as a residual zone of absolute discretion. I argue that some features of corporate governance are not adequately accounted for either as instantiations of the market mechanism

or in terms of discretion. They are, in fact, "deliberative" in character (Section 2). I argue that the concept of commitment can contribute to an understanding of the corporation that accommodates its deliberative features: these features permit the ascertainment and consideration of non-choice welfare information of the participants, for example, as to commitments relevant to cooperative and moral action (Section 3).

I should explain at the outset what I mean by "understanding" the corporation. I want to distinguish between two senses of the term. First, an understanding can be an economic model, a simplified representation of reality that serves as a basis for the generation of testable hypotheses. Simplification involves making restrictive assumptions about the behaviour of relevant individuals; economic models of the corporation typically assume that investors have preferences for wealth and the avoidance of risk, while managers and employees have preferences for wealth, leisure and perquisites. Second, one can approach understanding the corporation as a process of interpretation. The corporation is, after all, a legal act, much like a statute, a contract or a will. The interpreter's task is to ascertain the meaning of this act, which entails attempting to determine from permissible evidence (e.g., text, structure) what its authors have purposefully achieved.

When I refer to the contribution of commitment to an understanding of the corporation, I have in mind the second sense of "understanding." My argument, in other words, is that commitment is useful to the interpreter of the legal provisions that make up the corporation. The interpretation made possible by commitment complicates what I shall call the conventional economic interpretation of the corporation, that is, the approach to the interpretation of corporate law that is prevalent among practitioners of law and economics.

1. Conventional economic understanding of the corporation

Most economic analysis of corporate law can be gathered under the banner of contractarianism. However, contractarianism can mean different things. At its least restrictive, it describes the notion that the corporation should be regarded as a vehicle for a voluntary interaction among its participants. It holds that in interpreting corporate law we are interpreting the terms of a multilateral bargain rather than, for example, an instrument of state economic regulation or a concession conferred upon shareholders by the state. Typically, however, economic analysts view contractarianism as a methodology that speaks not only to the voluntary character of corporate arrangements, but also to the beliefs and purposes that we should attribute to the contracting parties. In other words, contractarianism does not simply tell us

---

48. In this paper, "corporation" refers to a business corporation organized in the U.S. or Canada. In addition, readers should not think that the term "legal provisions" refers only to the provisions of the corporations statute. I intend the term broadly, so as to include as well the terms of the instruments adopted by the participants in the corporation against the backdrop of corporate law. Examples of such terms are the provisions of the articles of incorporation and of any issued securities, and the terms under which other voluntary participants, such as employees, become associated within the corporation. In this sense, my perspective on the corporation is, as I explain below, contractarian.
that the corporation is a set of contractual relationships; it also tells us how we
should interpret these contracts. Indeed, there is a conventional interpretation of
the corporate bargain in the law and economics literature, and it is this interpretation
which I call the “conventional economic understanding” of the corporation.

Theoretical foundation of the conventional economic understanding

The theoretical foundation of this conventional understanding is the economic lit-
erature on the theory of the firm and, in particular, seminal works by Coase, Alchian
and Demsetz and Jensen and Meckling.49 These authors were concerned with
explaining why firms exist, or, more precisely, why organizations exist that have
the characteristics typically identified with firms.50 What they sought was an expla-
nation that connects the existence and characteristics of firms with standard eco-
nomic assumptions about the behaviour of key participants, especially investors,
managers and employees. The inferred explanation serves as the basis for testable
predictive hypotheses about, for example, how the characteristics of organizations
differ depending on the characteristics of their members or the nature of the organi-
zation’s activities.51 The economic literature on the firm was, accordingly, an exer-
cise in “understanding” the corporation in the first sense.

Two types of explanation may be distinguished within this literature. According
to one explanation, identified with Coase, the corporation is a device for econom-
izing on transaction costs by centralizing control over factors of production within
the hands of an entrepreneur, who exercises fiat. The invisible hand guides wealth-
seeking actors (entrepreneurs and suppliers of factors of production) to an equi-
librium in which the costs associated with allocating production within a firm are
just equal to the costs associated with allocating production within another firm,
or to the costs that would be incurred if the allocation of production were left to
markets.52 This understanding finds echoes more recently in the “transaction costs”
approach of Williamson,53 and in the “mediating hierarchy” conception articulated
by Blair and Stout.54 As pictured by these authors, the firm has the aspect of a com-
mand structure resulting from a Hobbesian bargain in which for the avoidance of
chaos55 the participants submit to the sovereignty of an absolute ruler.

49. Ronald Coase, “The Nature of the Firm” (1937) 4 Economica 386 [Coase]; Armen A. Alchian
& Harold Demsetz, “Production, Information Costs, and Economic Organization” (1972) 62
Am. Econ. Rev. 777 [Alchian & Demsetz]; Jensen & Meckling, supra note 35.
50. Ibid.
51. See, e.g., Alchian & Demsetz, supra note 49; Jensen & Meckling, supra note 35.
52. Coase, supra note 49 at 395.
53. See Williamson, supra note 33.
54. See Margaret Blair & Lynn Stout, “A Team Production Theory of Corporate Law” (1999) 85
55. Some may think “chaos” an excessively colourful term in the context of the corporation. In fact,
Coase was concerned about “transaction costs,” specifically the costs of pricing transactions
in the marketplace. But both Williamson and Blair and Stout describe the alternative to fiat
in less abstract and anodyne terms than Coase: Williamson describes fiat as necessary in a world
where contracting parties do not merely pursue their own interest, but are ready to deceive and
cheat in their dealings with others, whereas Blair and Stout portray the alternative to the firm
According to the other explanation, identified with Alchian and Demsetz and Jensen and Meckling, the firm is modeled as a market rather than a vehicle for the exercise of fiat. Alchian and Demsetz disputed Coase’s suggestion that firms are characterized by the exercise of fiat, in a famous passage:

The firm . . . has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people. . . . I can ‘punish’ you only by withholding future business. This is exactly all that any employer can do. He can fire . . . Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread. I have no contract to continue to purchase from the grocer and neither the employer nor the employee is bound by any contractual obligations to continue their relationship. 57

In Alchian and Demsetz’s model, the firm is conceptualized as a “privately owned market” in which a wealth-seeking central contracting agent (the shareholder-entrepreneur) monitors the performance of, and accordingly hires and fires, workers and others who contribute to the firm’s production.

Jensen and Meckling similarly analogize the firm to a market (“the ‘behavior’ of the firm is like the behavior of a market”). 58 In their model, the observed terms of cooperation within the corporation are an equilibrium in which managers, acting upon their preferences for wealth, leisure and perquisites and wishing to attract capital from investors who both want to maximize their wealth and are aware of the managers’ preferences, offer monitoring and bonding devices against their own shirking and excessive consumption of perquisites. As examples of monitoring and bonding devices, Jensen and Meckling mention periodic financial disclosure and independent audits. However, subsequent writers have identified many other such devices, including, most notably, a fiduciary duty enforceable by a civil action for damages, and what many consider to be the most powerful bonding device of all—the market for corporate control. 59

From explanation to interpretation

At the outset of this Part, I sought to distinguish the generation of explanatory hypotheses for predictive use, on the one hand, from the interpretation of a legal

---

56. See Alchian & Demsetz, supra note 49; Jensen & Meckling, supra note 35.
57. Alchian & Demsetz, supra note 49 at 777.
58. Jensen & Meckling, supra note 35 at 311.
59. The market for corporate control refers to the protection of the shareholders’ interests afforded by the fact that managers’ desire to keep their jobs leads them to abstain from activities (such as shirking and self-dealing) that will depress the stock price and make the corporation a potential hostile takeover target. The utility of the market for corporate control as a bonding device is, accordingly, an explanation for those features of the corporation that make that market possible, namely the free transferability of shares and the right of the majority shareholders to replace the directors. See Henry G. Manne, “Mergers and the Market for Corporate Control” (1965) 73 J. Pol. Economy 110 [Manne, “Mergers”].
act, on the other hand. The theorists whose work I have just canvassed were engaged in the former activity rather than the latter. However, the conceptual gap between explanation and interpretation is narrow. The economist offers an explanation as to why individuals form organizations with the characteristics that the law bestows upon corporations; the interpreter of corporate law seeks to understand what purpose is embodied in the law's creation of organizations with those characteristics. The economist's explanation of the firm comes virtually ready to serve as a guide to the interpretation of corporate law.

Two methodological choices are implied, however, by the application of the economist's explanation of the firm to the task of interpreting corporate law. I alluded to these choices at the beginning of this section. First, the interpreter must accept that when reading the corporations statute one should not think of it as an instrument of economic regulation on the part of the state, but as representing the terms of a bargain among the individuals who voluntarily participate in the corporation. According to this view, the purposes reflected in the corporations statute are those of the participants; the state has no purpose of its own in enacting the statute beyond facilitating the participants' advancement of their own ends. For purposes of this paper, I do not take issue with this first methodological assumption.

A second methodological choice is in my view more questionable. In adopting the economist's explanation of the firm as an interpretive guide to corporate law, the interpreter adopts by implication the economist's behavioural assumptions. The interpreter assumes, in other words, that the participants in the corporation are interested only in wealth (and, in the case of managers, leisure and perquisites), and reads the corporations statute in accordance with the terms that individuals so motivated would devise. For instance, the assumption underlying Easterbrook and Fischel's classic exposition of the contractarian interpretation of corporate law is that "self-interested entrepreneurs and managers, just like other investors, are driven to find the devices most likely to maximize net profits." 60

Upon these premises, the law-and-economics scholar interprets corporate law, where possible, in accordance with what economic theorists of the firm hypothesize is the basic scheme of the corporation. This scheme may be described as one whereby the board of directors, its delegates (the managers) and all other participants in the corporation make decisions maximally satisfying their preferences for wealth and other sources of enjoyment, within the bounds established by market forces and bargained-for contractual constraints. In the case of the board and managers, the constraints that loom largest are the market for corporate control and the directors' fiduciary duty.

60. See Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law (Cambridge, MA: Harvard University Press, 1991) at 6 [Easterbrook & Fischel]. When I say that this methodological choice is questionable, I do not dispute, of course, the practice of making simplifying assumptions as a necessary part of the exercise of modeling behaviour and generating testable predictive hypotheses. What I question is the advisability of interpreting a legal act as if it had been adopted by the simplified actors of the economic model, instead of by real people.
Market primacy

The conventional economic understanding of the corporation emphasizes the role of markets. By this I mean two things: first, that an influential view holds that as an empirical matter markets are a more important constraint on the board and managers than legal duties and, in fact, that market forces reduce directorial and managerial power to practical insignificance; and, second, that even where the latter empirical proposition is doubted, directorial and managerial power is conceptualized as a residual and in-principle undesirable zone of absolute discretion.

Concerning the first point, recall Alchian and Demsetz and Jensen and Meckling's conceptualization of the firm as a market. By this they mean that in understanding the "behaviour of firms" it is less helpful to think of individuals exercising power over or on behalf of others within an institution (this was Coase's conception), than to think of individuals interacting voluntarily with one another, each with view to his or her own advantage. Market forces, rather than fiat, determine the outcomes of these interactions. This was the upshot of Alchian and Demsetz's greengrocer analogy.

The notion that, in light of market forces, managerial power is illusory has been extremely influential within the legal academy. In the legal literature, the role of the market for corporate control receives particular emphasis. The argument may be traced back to Henry Manne's article "Mergers and the Market for Corporate Control," which argued that managers are kept in line by the possibility of a hostile takeover, whereby a third party acquires majority voting control of an underperforming firm and replaces its management. Manne asserted that the market for corporate control is a potent disciplinary force, next to which "the efforts of the SEC and the courts to protect shareholders through the development of a fiduciary duty concept and the shareholder's derivative suit seem small indeed." 

The effectiveness of market constraints has been invoked, for example, in the debate about whether established firms reincorporate in Delaware because of the pro-management bias of its rules or, rather, because of the rules' high quality. The current near-consensus in favour of the latter position rests in part on the premise that the market for corporate control would punish managers if they reincorporated in a lax jurisdiction. The premise of strong market constraints also surfaces in

61. Manne, "Mergers," supra note 59. Some might dispute the characterization of Manne's article as "legal" scholarship, since it appeared in the Journal of Political Economy rather than a law review. It is beyond dispute, however, that Manne's article has had enormous influence in the legal academy. According to one study of citations in law journals, it was the most-cited article of all time: see William J. Carney, "The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm" (1999) 50 Case W. Res. L. Rev. 215 at 225.


64. See Winter and Romano, ibid. For a well-argued dissenting view, see Lucian A. Bebchuk & Allen Ferrell, "Federalism and Corporate Law: The Race to Protect Managers from Takeovers" (1999) 99 Colum. L. Rev. 1168.
the debate about corporate social responsibility ("CSR"), with Posner arguing, for example, that firms engaging in unprofitable CSR could be expected to shrink, "quite possibly to nothing,"65 on the theory that in competitive product markets there is no margin for firms to make expenditures uncompelled by consumer demand.66

Concerning the second point, to the extent that law and economics scholars have recognized that market forces are blunted by transaction costs and other imperfections, they have typically conceptualized the board as exercising a power that is residual and discretionary. It is residual in that, as transaction costs approach zero, so too does the practical domain of the board's power. It is discretionary in that, within the zone bounded by market forces and legal constraints, such as the fiduciary duty, the board's freedom of action is absolute.

Authority is, accordingly, an imperfection; it is a measure of the degree to which markets in the real world fall short of the ideal. It is undesirable in principle, a "second-best" alternative to the market mechanism,67 since individuals would not willingly place themselves (or their wealth) in others' hands, were it not for the transaction costs associated with the market. An ideal world would instead resemble Manne's vision of a "free-market model of a large corporation system."68 Advocating the complete deregulation of corporate and securities law, Manne argued that the result would be to leave corporate officials with "only the margin of rents provided by the cost of takeovers to give them any breathing room from powerful market forces that would keep compensation at a purely competitive level, and even these rents will be small if the transaction costs of takeovers are allowed to be minimized by market forces."69

2. Discretion versus deliberation

In this section of the paper, I want to question the completeness of the conventional understanding of corporate governance as involving a balance between the costs associated with discretion and the transaction costs associated with the market. I should emphasize that I question only the completeness of this understanding; I do not deny the usefulness of the economic model of the firm, in particular its usefulness in making predictions about patterns of organization.68 Nevertheless, I want to suggest that there are aspects of corporate governance which it may not be useful in illuminating. In particular, I wish to question whether the task of interpreting the powers of the board of directors is well served by the conventional economic

69. Ibid. at 1391.
70. For instance, a conventional economic model of the firm enables us to predict that the more friction exists in markets for factors of production in a given economic sector, the greater the extent to which we can expect that firms in that sector will be vertically integrated (Coase, supra note 49).
understanding of these powers in terms of discretion, and whether the conventional model is adequate to the task of understanding the role of shareholder voice in corporate governance.

The board of directors as a deliberative decision-maker

Corporate law vests the board of directors with the power to manage, or supervise the management of the business and affairs of the corporation. Boards are permitted to delegate their powers to corporate officers, who in turn assign responsibilities to lower managers, and so on. When a human resources manager decides to reassign or terminate an employee, or a drug company executive decides to withdraw a medication from the market, he or she is exercising power that can be traced back to the board, and ultimately to the board's own plenary powers under corporate law. What is the nature of these powers?

I have already mentioned that in the mainstream economic and law-and-economics literature, to the extent that the board's power is not viewed as inconsequential in light of the unremitting pressure of market forces, it is understood as a zone of absolute discretion bounded by market forces and legal-contractual constraints. Bainbridge's discussion of the board's powers provides an illustration of this Coase-inspired interpretation:

[The] defining characteristic of a firm is the existence of a central decisionmaker vested with the power of fiat. . . . Organizing economic activity within a firm is more efficient than doing so across markets when the costs of bargaining are higher than the costs associated with command-and-control. . . . Obviously, fiat within a firm has limits. Some choices are barred by contract, such as negative pledge covenants in bond indentures. Other choices may be barred by regulation or statute. Still other choices may be unattractive for business reasons, such as those with potentially adverse reputational consequences. Within such bounds, however, adaptation effected through fiat is the distinguishing characteristic of the firm in Coasean theory. 71

I do not dispute the merits of using fiat as an element of an economic model. However, jurists would be mistaken to view it as a satisfactory interpretation of the powers conferred upon the board under corporate law. Two central characteristics of the board seem to point to a different interpretation: its structure and its mandate. I shall discuss each characteristic in turn.

The board is structured as a collective body and, at least in principle, acts only by deliberating. 72 Individual directors have no power as such, but can exercise power only as part of a properly constituted meeting of the board. A meeting can be dispensed with only if the members of the board are unanimous as to the action to

71. Stephen Bainbridge, "Director Primacy: Means and Ends of Corporate Governance" (2003) 97 Nw. U. L. Rev. 547 at 555-57 [Bainbridge, "Director Primacy"].

72. I recognize that, in practice, the quality of the deliberations may be wanting. In some circumstances, chief executive officers may wield overwhelming influence over boards; in others, directors may fail to exercise diligence and independent judgment in carrying out their duties. I regard these situations as pathological, rather than as definitive of directors' role within corporate governance.
be taken. Moreover, corporate law contains provisions designed to ensure the integrity of the meeting; for example, boards may meet by telephone, but only if all participants are able to communicate adequately with one another during the meeting. The utility of fat can explain the existence of a sovereign, but it cannot explain why that sovereign is a group rather than an individual, let alone why that group, in principle, exercises power only by deliberating.

I acknowledge that it is also possible to explain these structural characteristics of the board as bonding devices. Self-interested managers might agree to be supervised by a multi-person board that acts in accordance with prescribed procedures, on the theory that outside investors will recognize that it is more difficult for managers to self-deal if they are supervised by a board, and that the multi-person composition of the board and the procedural requirements for board action make it more difficult for a corrupt board member to collude with self-dealing managers. 73

However, in addition to structuring the board and requiring it to act by meeting or by consensus, corporate law further obligates the board to pursue the "best interests of the corporation." The legal definition of the board's mandate is difficult to square with the conventional understanding of the board's powers. The conventional view holds that the purpose of the board's fiduciary duty—the duty which requires it to pursue the best interests of the corporation—is to control agency costs by attaching a price (in the form of liability risk) to the unilateral taking of opportunities or other property belonging to the firm. For example, Easterbrook and Fischel write that "the fiduciary principle ... replaces prior supervision with deterrence, much as criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks." 74

Two things are puzzling about this explanation. First, it does not explain why the duty is formulated in affirmative terms, rather than as a prohibition against misappropriation. For some, this might not be a significant problem. Perhaps what the fiduciary duty seeks to deter is a failure to carry out the affirmative mandate.

But there is another, more serious problem. The conventional theory predicts that the participants in the corporation would wish to assign a crisp mandate to management—one that would be easy for managers to follow, should they be so inclined, and easy for a court to determine compliance with. 75 An example of such a mandate would be an instruction to maximize the stock price. In reality, however, management's mandate is much more open-ended. Eighty-six years after Dodge v. Ford, 76 it is an open legal question in Delaware whether the "best interests of the corporation" means only the shareholders' interests, or whether the interests of other

73. See, e.g., Stephen Bainbridge, "Why a Board? Group Decisionmaking in Corporate Governance" (2002) 55 Vand. L. Rev. 1. Bainbridge discusses the advantages multi-person boards offer as a solution to the problem of "who will watch the watchers," and offers an additional explanation for the multi-person board. Given bounded rationality, and on the basis of experimental literature suggesting that groups are more competent decision-makers than their average member, Bainbridge suggests that the use of group decision-making may be a rational adaptation to individual cognitive limitations. His argument recalls the saying, "two heads are better than one."

74. Easterbrook & Fischel, supra note 60 at 92.

75. Bainbridge, "Director Primacy," supra note 71 at 581.

participants in the corporation, such as employees, may also receive independent consideration. And even if it were limited to the shareholders’ interests, many possible conceptions of their interests would remain possible, including their interest in the corporation’s socially responsible conduct. Only in certain takeover situations does Delaware law impose a narrow and precise mandate on the board.

The effect of the open-texturedness of the standard is to leave the meaning of the standard up for grabs in the corporate decision-making process. In other words, the board is not obliged to attend only to the operational question of how to maximize earnings, but in deliberating on what would advance the interests of the corporation it may, by implication, include in its deliberations the question how those interests should be understood.

Why would the fiduciary duty be so open-textured, if its sole purpose were to provide corporate officials as homines economici with an incentive to refrain from theft? Why, in a mechanism intended to reduce discretion, does the formulation appear calculated to create discretion?

As a mandate for a deliberative decision-maker, the “best interests of the corporation” is much more easily understood. It serves as a discursive focal point for the justification of choices by the board and others deliberating about corporate policy. It is evidently not a formula that can be applied mechanically so as to yield a unique, incontestably correct decisional outcome, any more than the expression “public interest” in the governmental context. Rather, it serves to place some justifications off-limits (such as reasons that invoke a raw preference for the interests of a section of the collectivity), and to indicate that the board and other corporate decision-makers do not simply exercise fiat: they are not simply free to pursue whatever ends they wish provided that they do not steal, but must justify their decisions with reasons articulated in terms of the interests of the corporation.

The shareholders as a locus of decision-making authority

Aside from the board, the other locus of decision-making power within the corporation is the general meeting of shareholders. The shareholders have no power to manage the corporation: this power is vested exclusively in the board. However, the shareholders as a general body have the power to elect and remove the board of directors; to approve or withhold approval of fundamental changes, such as

78. See, for example, Medical Committee for Human Rights v. Securities and Exchange Commission, 432 F.2d 659 at 662 (D.C. Cir. 1970). In this case, although admittedly not a state corporate law decision, the D.C. Circuit Court of Appeals recognized the legitimacy of the shareholders’ concerning themselves with the responsible conduct of the corporation’s business, even if profits were thereby not maximized.
79. See, e.g., Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994) (where a change of control or sale of the business has become inevitable, the directors must be guided exclusively by the goal of maximizing the value received by the shareholders). In many states, the board’s mandate remains broad even in the situation of a takeover, in light of so-called “constituency statutes.”
mergers; and to propose and adopt resolutions containing (non-binding) recommendations to the board on matters concerning the corporation's business ("shareholder proposals"). As with the board of directors, the paradigmatic modality of shareholder decision-making is a meeting, at which resolutions are tabled for discussion and voted upon, and corporate law contains provisions designed to ensure the integrity of the meeting.

These features of corporate governance, which we may group under the rubric of "shareholder voice," are perplexing for economic theorists of the corporation. There is a conventional economic explanation for the shareholders' control rights, namely that shareholders are the residual claimants and therefore have the strongest incentive to maximize the overall value of the firm, at least when it is solvent. 80 This seems an adequate negative explanation as to why creditors and employees do not, as a general rule, wield control rights. However, it is unsatisfying as an affirmative explanation for shareholder voice because the latter jars with two principles that many of the same theorists also defend: first, that the governance of corporations should ideally be determined by the interplay of markets and not by power, by the invisible hand of the stock market rather than the visible hand of the stockholders' meeting, and second, that shareholders are uninterested in voice because the point of being a stockholder in a widely held corporation is that one does not have to take an active part in the oversight of management, that one can be a passive investor rather than an active monitor. The first principle is another way of expressing the economist's conventional belief in the normative ideality of markets, described earlier; the second is, in part, a corollary of an understanding of fiat as the "defining characteristic" of the firm. 81 If the goal is to achieve efficient coordination by assigning the power of fiat to a centralized actor, it makes little sense to designate an unwieldy collectivity—the shareholders—as the repository of ultimate power. 82

The conventional solution to this paradox involves recharacterizing the shareholders' voting rights so that they are not an instrument of collective decision-making, or voice, but are instead an instrument of the market. On this view, the principal function of voting rights is to make possible the market for corporate control. For example, Bainbridge writes:

Granted, collective action problems preclude the shareholders from exercising meaningful day-to-day or even year-to-year control over managerial decisions. However, the shareholders' claim on the corporation is freely transferable. As such, if management fails to maximize the shareholders' residual claim, an outsider can profit by purchasing a majority of the shares and voting out the incumbent board of directors. Accordingly, vesting the right to vote solely in the hands of the firm's shareholders is what makes possible the market for corporate control. . . . 83

81. Bainbridge, "Director Primacy," supra note 71.
82. The shareholders' power is ultimate since, as even Easterbrook and Fischel acknowledge, "managers exercise authority at the sufferance of investors" (Easterbrook & Fischel, supra note 62 at 67).
Although I do not discount the importance of the market for corporate control as a disciplinary tool, the conventional recharacterization leaves much about the shareholders' voting rights unexplained. For example, why do corporations hold annual meetings, and take votes on directorial elections and other matters, even when there has been no change of control? Moreover, shareholders have the right to advance notice of a meeting and to consult, in advance, a list of the other shareholders. The purpose of all of these provisions, and of the universal practice in widely-held corporations of holding an annual shareholders' meeting, eludes the conventional economic theorist for whom voting rights exist only to make possible the market for corporate control.

Whatever the other merits of the conventional economic understanding of the corporation, certain features of corporate governance—its deliberative features—are not adequately explained within that understanding. In particular, neither in regarding the firm as a market nor in viewing it as a zone of absolute discretion hemmed in by market forces and legal sanctions can one make sense of the legal provisions that govern the exercise of power by the corporation's principal decision-making organ (the board of directors) and of the body to which the board is accountable (the shareholders). These provisions are suggestive instead of an organization in which decisions are made on a collective basis (by bodies authorized to act on behalf of the whole) and in which the decision-making bodies do not simply exercise fiat but, ideally at least, engage in a process of deliberation before acting. The collective aspect is inconsistent with the firm-as-market thesis, whereas the deliberative aspect seems to call for some qualification of the thesis according to which participants vest absolute discretion in a ruler solely as a way of avoiding transaction costs.

3. Commitment and deliberation within the corporation

So far, I have suggested that corporate governance contains deliberative elements that are not well explained within the conventional economic understanding of the corporation. Why do the deliberative elements exist? Are there reasons for thinking that the participants in the corporation would provide for a deliberative space within the corporation? In this section, I suggest that Sen's concept of commitment can provide answers to these questions, and that it consequently contributes to the theoretical foundation of an interpretation capable of accommodating the corporation's deliberative elements.

I shall proceed in the following manner. I begin by making explicit certain assumptions on which my interpretation relies. Then, I explain how, according to the conventional line of reasoning, one would suppose that individuals at the stage

84. See Del. G.C.L. §§ 211(a), 219(a), 222; C.B.C.A. ss. 132(5), 138.
of determining the structure of their venture would choose to have their subsequent dealings governed exclusively by the market mechanism. Finally, I argue that commitment complicates the analysis; specifically, it supplies a reason why the participants might not wish to structure their ongoing dealings exclusively around markets.

The constitutional stage

In developing an account of the role of deliberation within the corporation, I assume two stages, a constitutional stage and an operational stage. At the constitutional stage (T), the participants in the corporation make their decision to participate, and settle on the terms of their participation. At the operational stage (T+1), business is carried on in accordance with the terms agreed to at the constitutional stage. I assume that the participants are, as described by Sen, individuals who are motivated both by the pursuit of their own interests and by commitments. Thus, individuals’ behaviour departs sometimes from that which would be expected of a purely selfish actor, or of an actor who in addition to self-love exhibits sympathy, but their welfare is nevertheless not fully represented in their choices, since—like the overeater of my example in Part I—they evaluate the “preferences” represented by their choices and sometimes experience regret.

I suppose that the participants in the corporation, like the individuals in Rawls’ original position, are deciding upon terms of association under a condition of uncertainty as to what the future holds for them. They cannot anticipate all of the decisions that will be encountered or the degree of success that the business will achieve. Unlike Rawls, I do not assume that the participants are behind a veil of ignorance as to the roles they will play within the corporation. Since the association is voluntary, the terms of association can be fair even if the roles of each are known during the negotiations.

The market mechanism

What terms might we expect the individuals at the constitutional stage to settle upon to govern their venture? Would they wish their subsequent dealings to be governed exclusively by the market mechanism? To use Alchian and Demsetz’s expression, would they establish a “contractual structure subject to continuous renegotiation”? In the absence of transaction costs, a conventional line of reasoning might well lead to the conclusion that such a structure would be wealth-maximizing for the participants, as it would ensure that factors of production are

---

86. A two-stage approach is common in contractarian analyses of the corporation. It is, for instance, employed by: Coase, supra note 49; Williamson, supra note 33; Easterbrook & Fischel, supra note 60; and Blair & Stout, “Team Production,” supra note 54.
88. The necessity for universal consent obliges participants to adopt an impartial perspective in practice, without the need for the device of the veil of ignorance.
89. Alchian & Demsetz, supra note 49.
deployed at the operational stage only to the extent that their value added exceeds the opportunity cost of their use.

Transaction costs are not zero, of course, and this is one reason why the participants might not at the constitutional stage decide to rely exclusively on the market mechanism to govern their subsequent interaction. To avoid the costs, they might—so the conventional reasoning goes—institute fiat.\footnote{Coase, supra note 49. Bainbridge, “Director Primacy,” supra note 71.}

\textit{Commitment}

However, I want to suggest that the parties have an additional reason, aside from transaction costs, for not structuring their ongoing dealings exclusively around markets. In particular, because the participants have commitments, they might establish a system for decision-making that permits the ascertainment and reconciliation of non-choice welfare information, that is, information about their commitments. I wish to mention two scenarios in which the participants might anticipate that, in light of their commitments, their welfare will not be fully reflected in the choices they make during the operational stage.

A first scenario involves cooperation in prisoner’s dilemmas. Prisoner’s dilemmas are pervasive in business. For example, Blair and Stout have theorized that organized productive activity involves the making of irrevocable contributions of resources to a venture by the owners of the resources. Blair and Stout further argue that these investments expose the contributors to the risk of opportunistic exploitation by the other participants. In the absence of some protective mechanism, contributions will not be forthcoming, or transaction costs will be incurred as contributors attempt to close every contractual loophole. This problem has the structure of a prisoner’s dilemma: there is a cooperative outcome (all contribute; no one takes advantage) that is not an equilibrium since some participants have an opportunity and incentive to take advantage of others who have become vulnerable through their irrevocable contributions; and the equilibrium outcome (no one contributes) leaves everyone worse off than the cooperative outcome.

Can the inclusion of deliberative features within the corporate constitution be understood as a response to the expectation that prisoner’s dilemmas will arise at the operational stage? An affirmative answer proceeds in three steps. First, in light of commitment, a prisoner’s dilemma can be understood as a confrontation between two types of rationality: the pursuit of individual goals, on the one hand, and action in accordance with collectively rational principles, on the other hand. Second, from the standpoint of welfare, commitment suggests viewing the prisoner’s dilemma as presenting a conflict, not between the chooser’s welfare and the welfare of the group, but between two components of the individual’s welfare: the individual’s interest in the pursuit of his or her own goals, and his or her commitments. The structure of commitment is such that the latter are not fully reflected in the individual’s choices. Third and finally, deliberative mechanisms help to elicit non-choice

\footnote{Blair & Stout, “Team Production,” supra note 54.}
information about the participants’ commitments. Let me elaborate briefly on each of the three steps in the argument.

Concerning the first point, Sen argued that the concept of rationality should be broadened so as to accommodate commitment—behaviour departing from one’s own goals or welfare—and that this might be an avenue to comprehending the rationality of cooperation in prisoner’s dilemmas. Sen did not fully explain in what way committed behaviour is rational, although he alluded to a connection between commitment and group membership.92 Anderson93 built upon this connection by suggesting that committed action should be understood as action on principles that it is rational for the group, regarded as a collective agent, to adopt, and thus that it is rational for any individual who identifies as a member of that group to act on. I shall refer to these as “collectively rational principles.” While not every group of individuals is a collective agent, “any group of people whose members refer to one another as ‘we’ and, who... see themselves as ready to be jointly committed to acting together, will properly regard the object of their choice to be a single joint strategy. They will thereby constitute themselves as members of a single collective agent.”94 Identification as part of the collective agent—one might use the term “we-identification”—makes cooperative action rational.

Prisoner’s dilemmas may, accordingly, be viewed as presenting a confrontation between two types of rationality: the pursuit of one’s own goals (the traditional concept of rationality) and action in accordance with collectively rational principles of a group with which one identifies (the rationality of committed action). It is rational to pursue one’s goals but, Anderson argues, it should also be viewed as rational to suspend the pursuit of one’s goals in deference to collectively rational principles, where one regards oneself as part of the group.93 Anderson emphasizes that it is important not to assume that identity groups can only be formed around social characteristics such as religion, national origin, and class. A shared intention (e.g., “seeing ourselves as solving a problem by joining forces”) is all that is needed “to constitute individuals as a social group with a common practical identity,”95 making it rational for each to act in accordance with collectively rational principles—to act, in other words, upon a cooperative commitment.

The second step of my argument involves drawing the conclusions for welfare that follow from the first step. Whereas the conventional understanding of a prisoner’s dilemma is that it presents a conflict between the chooser’s welfare and the aggregate welfare of the members of the group (a conflict in which the former necessarily prevails if the chooser is rational), the concept of commitment invites us to view it instead as presenting a tension between two aspects of the individual’s welfare: the individual’s interest in the pursuit of his or her own goals, on the one hand, and his or her commitment to principles collectively rational for the group, on the other hand. An individual’s choice within a prisoner’s dilemma is a datum

93. Elizabeth Anderson, “Unstrapping the straitjacket of ‘preference’: a comment on Amartya Sen’s contributions to philosophy and economics” (2001) 17 Econ. & Phil. 21 [Anderson].
94. Ibid. at 28.
95. Ibid. at 30.
96. Ibid. at 31.
about the welfare implications of the possible actions; however, as I argued in Part I, the individual’s welfare is not synonymous with that which is maximized by whatever the individual chooses to do in the circumstances.

If it can be rational to cooperate, why does the individual’s choice to defect or cooperate in a prisoner’s dilemma not simply represent his or her “all things considered” welfare ranking, including any regard he or she has for commitments? The answer has to do with the structure of commitment. There is at first glance an ambiguity in Sen’s elaboration of the concept of commitment. On the one hand, as we have just seen, commitments are sources of motivation which are rationalizable with regard to collective principles rather than self-interest. On the other hand, Sen conceptualizes commitments as meta-rankings, and as such they represent own-welfare criteria by which we evaluate our conduct and preferences. The key to unifying these two apparently divergent conceptualizations is to see the act of identifying with a collectivity and adopting collectively rational principles capable of overriding one’s self-interest as also entailing those principles becoming a norm by which the individual judges his or her conduct. In any event, it is because commitments are not only sources of motivation but also criteria of self-evaluation that there is a wedge between welfare and choice. It is for this reason that commitments are an aspect of the individual’s welfare which, ex hypothesi, is not fully reflected in his or her choices.

Third, knowing that their venture will encounter prisoner’s dilemmas, the participants at the constitutional stage have a reason aside from transaction costs not to rely exclusively on the market mechanism to govern their subsequent dealings, because markets are clearinghouses for choices. In addition to the market mechanism, the participants institute deliberative mechanisms so as to ensure that decisions at the operational stage are made with the benefit of additional information about their commitments. The board of directors should be viewed as such a mechanism. By conferring a mandate to pursue the “best interests of the corporation” upon a body that acts by way of meetings at which actions are proposed, justified, and (in principle) debated before being resolved upon, the participants institute a mechanism for the discovery and implementation of the collectively rational principles inherent in the venture.97

The second type of scenario in which the participants in the corporation might anticipate a discrepancy arising between welfare and choice involves moral action. Moral action is distinguished from cooperation on the basis that the beneficiaries of the obligations that motivate moral action are not, or at least need not be, participants in the corporation.98

97. The shareholders’ meeting is a similar mechanism. In the case of the shareholders, the fact that the shareholders act by meeting, and the provisions governing the meeting, are suggestive of the deliberative character of the shareholders’ power (see text accompanying notes 78–80). Unlike the board, the shareholders are in most cases not under an explicit legal obligation to exercise their voting rights with a view to the best interests of the corporation; this is no less true of voters in elections for public office.

98. This is a distinction for convenience of presentation; I acknowledge that it is also possible to understand moral commitment as the limiting case of collective identification, that is, as action on the basis of principles which “it would be rational for a collective encompassing all of humanity to adopt” (Anderson, supra note 93 at 24).
For Sen, moral principles are a paradigmatic example of commitment. Commitment is a manner of conceptualizing what an individual does when he or she acts according to a principle, despite deriving no benefit from the principled action and, in particular, despite being indifferent to the welfare of the beneficiary of the principle. In “Rational Fools,” Sen quotes from Shaw’s play, *The Devil’s Disciple*, in which one character is willing to be hanged in place of another character’s husband, and denies that his readiness owes anything to sympathy:

“What I did last night, I did in cold blood, caring not half so much for your husband, or for you as I do for myself. I had no motive and no interest; all I can tell you is that when it came to the point whether I would take my neck out of the noose and put another man’s into it, I could not do it.”

Moral issues arise in the course of business, for example in relation to environmental responsibility, the conduct of business in developing countries, and dealings with questionable foreign governments. Corporate law scholars are accustomed to thinking of situations such as these as raising “business issues” for the corporation. That is, managers’ “moral” conduct is guided by market forces and external regulation: to the extent that managers are provided with incentives to maximize profits, they will also have an incentive to be responsive to the environmental and ethical sensitivities of customers and other contract counterparties, and to avoid conduct that will attract liability.10

Yet, there is reason to believe that, at the constitutional stage, the participants might not wish to leave the resolution of moral questions arising at the operational stage, within the bounds of lawful conduct, entirely to the interplay of market forces. Our hypothetical participants have moral commitments: this means that moral principles, in addition to other types of commitment, as well as self-interest and sympathy, motivate their conduct, but that this aspect of their welfare is not fully reflected in their choices. As with cooperative commitments, the participants understand that deliberation will bring out information about their moral commitments that the market mechanism, a clearinghouse for choices, will not, and a corporate governance structure in which there is also a space for deliberation may consequently serve their welfare better than a structure based on the market mechanism alone.

The board of directors has a role in respect of moral commitments, as it does in respect of cooperative commitments. The conventional economic approach conceptualizes “business ethics”—to the extent not motivated by profit—as an exercise of corporate officials’ discretion indistinguishable in principle from any other exercise of discretion that fails to maximize the shareholders’ wealth, for example, a decision to provide executives with excessively lavish office furnishings.10 By

In contrast, it is proposed here that the board should be understood as acting within its mandate to pursue the "best interests of the corporation" when it causes the corporation to act ethically, even without a profit justification, just as government officials can act ethically on behalf of citizens in international affairs without thereby failing to pursue the "public interest." There is a difference, in other words, between discretion and ethical representation.

In addition, shareholders' use of the proposal mechanism to raise issues of corporate morality can be understood as a device for the ascertainment of shareholders' moral commitments. The proposal mechanism, it will be recalled, permits shareholders to put forward non-binding resolutions on matters of corporate policy, and to circulate the text of the resolution together with a brief supporting statement to all of the shareholders, at the corporation's expense. A premise of the use of this system to raise an issue of corporate morality is that shareholders might conceivably respond differently in relation to such an issue when it is presented in an argumentative form with an appeal to the shareholders' commitments—that is, as part of a deliberative process—than might be anticipated solely by extrapolating from their marketplace transactions. In other words, the shareholder proposal mechanism is a component of a deliberative process that serves to elicit information about the shareholders' welfare in addition to that which is revealed in their marketplace choices.

Conclusion

The conventional economic view regards the market mechanism as, in principle, a preferable means of coordinating the ongoing interactions among the corporation's participants. It conceives of the authority of boards of directors and their delegates as discretionary power, to which the participants resort only because market interactions incur transaction costs. The conventional view also offers no adequate explanation for shareholder voice, demoting the shareholders' voting rights to a role in support of the market for corporate control. I have suggested, in contrast to this view, that the board's authority is better described as deliberative than as discretionary, and that the shareholders represent a secondary locus of collective, deliberative decision-making authority within the corporation.

In explaining why the participants in the corporation might institute deliberation alongside the market mechanism as a means of advancing their welfare, I have looked to Sen's concept of commitment. In particular, I have argued, following Sen:

That there are good reasons for treating welfare and choice as distinct concepts and, in particular, for regarding choice as a datum about welfare rather than as ex hypothesi synonymous with it; and

That in light of the distinction between welfare and choice, there may be reasons aside from transaction costs for not relying exclusively on the market mechanism.

102. Compare American Law Institute, Principles of Corporate Governance (St. Paul, MN: The Institute, 1994) §2.01 ("the corporation may make decisions based on ethical considerations regardless of their effect on long run profits.")
as a means of coordinating interactions, since markets are clearinghouses for choices, and other, deliberative mechanisms may be useful in eliciting non-choice welfare information.

I concluded that the deliberative features of corporate governance can be understood as means conducive to the ascertainment and consideration of non-choice welfare information—information about the participants’ commitments—in the decision-making processes of the corporation.103

I acknowledge that from a societal perspective, one could envisage a strict separation between the marketplace and deliberative institutions, with corporations situated exclusively within the marketplace and governmental organs constituted as purely deliberative institutions. This is, in theory, a possible way of organizing a society, but (a) it is not consistent with the observed characteristics of either governments or corporations; and (b) the normative case for a strict separation is not made out. In relation to the descriptive point, the market mechanism is employed in the structuring of governmental institutions, as exemplified by interjurisdictional competition in federal systems. Law can be a product, as Romano famously argued.104 Moreover, I have argued in this paper that corporate governance contains features that are not adequately described as instantiations of the market mechanism. Thus, for instance, the alternative to understanding the board’s mandate as deliberative is not to understand it as an example of the market mechanism, but to understand it as fiat. As for the normative point, I recognize that there is something to be said for greater recourse to the deliberative mechanism in the governmental sector, as compared with the corporate sector, on the basis of institutional competence. My argument is not, however, that corporations are, or should be organized primarily as deliberative institutions. I do not dispute that markets place desirable constraints upon corporate deliberation. I defend the more modest claim that the design of corporations leaves “space for deliberation,” and that this aspect of corporate governance is comprehensible from the perspective of the welfare of the participants in the corporation.

This paper does not argue for greater recourse to deliberation, still less for changes to corporate law that would increase the “space for deliberation.” Rather, I am offering an interpretation of the corporation, a rationalization, if you will, of observed features of corporate law. It is a contractarian interpretation, in the sense

103. In reaching this conclusion, I have not discussed certain familiar arguments against collective decision-making based on social choice theory, such as those derived from Arrow’s theorem on the impossibility of a voting rule meeting certain minimalist requirements of fairness and coherence. As Dryzek and List, among others, have argued, deliberation may create conditions in which one or more assumptions underlying Arrow’s impossibility result do not apply, and the impossibility result is avoided. I do not wish to rehearse their arguments here, or otherwise engage in the debate about the implications of deliberation for social choice theory. Indeed, my focus is not particularly on voting. I am concerned instead with the implications for corporate theory of Sen’s insight that if we distinguish between welfare and choice, we may find it useful to have means of obtaining information about individuals’ welfare in addition to the observation of their revealed preferences. See Kenneth Arrow, Social Choice and Individual Values, 2nd ed. (New York: Wiley, 1963); John S. Dryzek & Christian List, “Social Choice Theory and Deliberative Democracy: A Reconciliation” (2003) 33 British J. Pol. Science 1.

104. Romano, supra note 63.
that I attempt to explain why reasonable individuals choose to form, invest and otherwise participate in corporations on the terms that we observe.\textsuperscript{105} Much as conventional economic analysts of corporate law have sought to rationalize the superficially puzzling and worrisome separation of ownership and control, I offer a rationalization of features of corporate governance—its deliberative features—for which the conventional economic approach has been unable to provide a satisfactory explanation.

\textsuperscript{105} See Part II. I, above.