The Essential Elements of Corporate Law

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John Armour
Oxford University and ECGI

Henry Hansmann
Yale Law School and ECGI

Reinier Kraakman
Harvard Law School and ECGI

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John Armour
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Abstract

This article is the first chapter of the second edition of The Anatomy of Corporate Law: A Comparative and Functional Approach, by Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda and Edward Rock (Oxford University Press, 2009). The book as a whole provides a functional analysis of corporate (or company) law in Europe, the U.S., and Japan. Its organization reflects the structure of corporate law across all jurisdictions, while individual chapters explore the diversity of jurisdictional approaches to the common problems of corporate law. In its second edition, the book has been significantly revised and expanded.

As the book's introductory chapter, this article describes the functions and boundaries of corporate law. We first detail the economic importance of the corporate form's hallmark features: legal personality, limited liability, transferable shares, delegated management, and investor ownership. We then identify the major agency problems that attend the corporate form, and that, therefore, corporate law must address: conflicts between managers and shareholders, between controlling and minority shareholders, and between shareholders as a class and non-shareholder constituencies of the firm such as creditors and employees. In our view, corporate law serves in part to accommodate contract and property law to the corporate form and, in substantial part, to address the agency problems that are associated with this form. We next consider the role of law in structuring corporate affairs so as to achieve these goals: whether, and to what extent standard forms - as opposed, on the one hand, to private contract, and on the other, to mandatory rules - are needed, and the role of regulatory competition. Whilst the 'core' features of corporate law are present in all - or almost all - legal systems, different systems have made different choices regarding the form and content of many other aspects of their corporate laws. To assist in explaining these, we review a range of forces that shape the development of corporate law, including domestic share ownership patterns. These forces operate differently across countries, implying that in some cases, complementary differences in corporate laws are functional. However, other such differences may be better explained as a response to purely distributional concerns.

In addition to Chapter 1, Chapter 2 of the Anatomy of Corporate Law (2nd ed.), Agency problems, Legal Strategies, and Enforcement is also available (full text) on SSRN at http://ssrn.com/abstract=1436555.

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John Armour
University of Oxford - Faculty of Law
Oriel College
Oxford OX1 4EW, United Kingdom
phone: +44 1865 286544
e-mail: john.armour@law.ox.ac.uk

Henry Hansmann
Yale Law School
P.O. Box 208215, New Haven,
CT 06520-8215 United States
phone: 203-432-4966
e-mail: henry.hansmann@yale.edu

Reinier Kraakman
Harvard Law School
1575 Massachusetts
Hauser 406
Cambridge, MA 02138
United States
phone: 617-496-3586, fax: 617-496-6118
e-mail: kraakman@law.harvard.edu

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John Armour
University of Oxford – Faculty of Law
Oxford-Man Institute of Quantitative Finance
European Corporate Governance Institute (ECGI)

Henry Hansmann
Yale Law School; European Corporate Governance Institute (ECGI)

Reinier Kraakman
Harvard Law School; European Corporate Governance Institute (ECGI)

1 What is Corporate Law?

JOHN ARMOUR, HENRY HANSMANN, and REINIER KRAAKMAN

1.1 INTRODUCTION

What is the *common structure* of the law of business corporations—or, as it would be put in some jurisdictions, company law—across different national jurisdictions? Although this question is rarely asked by corporate law scholars, it is critically important for the comparative investigation of corporate law. Recent scholarship often emphasizes the divergence among European, American, and Japanese corporations in corporate governance, share ownership, capital markets, and business culture.[1] But, notwithstanding the very real differences across jurisdictions along these dimensions, the underlying uniformity of the corporate form is at least as impressive. Business corporations have a fundamentally similar set of legal characteristics—and face a fundamentally similar set of legal problems—in all jurisdictions.

Consider, in this regard, the basic legal characteristics of the business corporation. To anticipate our discussion below, there are five of these characteristics, most of which will be easily recognizable to anyone familiar with business affairs. They are: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. These characteristics respond—in ways we will explore—to the economic exigencies of the large modern business enterprise. Thus, corporate law everywhere must, of necessity, provide for them. To be sure, there are other forms of business enterprise that lack one or more of these characteristics. But the remarkable fact—and the fact that we wish to stress—is that, in market economies, almost all large-scale business firms adopt a legal form that possesses all five of the basic characteristics of the business corporation. Indeed, most small jointly-owned firms adopt this corporate form as well, although sometimes with deviations from one or more of the five basic characteristics to fit their special needs.

It follows that a principal function of corporate law is to provide business enterprises with a legal form that possesses these five core attributes. By making this form widely available and user-friendly, corporate law enables entrepreneurs to transact easily through the medium of the corporate entity, and thus lowers the costs of conducting business. Of course, the number of provisions that the typical corporation statute[2] devotes to defining the corporate form is likely to be only a small part of the statute as a whole. Nevertheless, these are the provisions that comprise the legal core of corporate law that is shared by every jurisdiction. In this Chapter, we briefly explore the contracting efficiencies (some familiar and some not) that

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[1] See, e.g., Ronald J. Gilson and Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporation Governance and Industrial Organization*, 102 YALE LAW JOURNAL 871 (1993); Mark J. Roe, *Some Differences in Corporation Structure in Germany, Japan, and the United States*, 102 YALE LAW JOURNAL 1927 (1993); Bernard S. Black and John C. Coffee, *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 MICHIGAN LAW REVIEW 1997 (1994); COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS (Klaus J. Hopt and Eddy Wymeersch (eds.), 1997); and Mark J. Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2003).

[2] We use the term 'corporation statute' to refer to the general law that governs corporations, and not to a corporation's individual charter (or 'articles of incorporation', as that document is sometimes also called).

accompany these five features of the corporate form, and that, we believe, have helped to propel the worldwide diffusion of the corporate form.

As with corporate law itself, however, our principal focus in this book is not on establishing the corporate form per se. Rather, it is on a second, equally important function of corporate law: namely, reducing the ongoing costs of organizing business through the corporate form. Corporate law does this by facilitating coordination between participants in corporate enterprise, and by reducing the scope for value-reducing forms of opportunism among different constituencies. Indeed, much of corporate law can usefully be understood as responding to three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation's other constituencies, including creditors and employees. All three of these generic conflicts may usefully be characterized as what economists call 'agency problems.' Consequently, Chapter 2 examines these three agency problems, both in general and as they arise in the corporate context, and surveys the range of legal strategies that can be employed to ameliorate those problems.

The reader might object that these agency conflicts are not uniquely 'corporate'. After all, *any* form of jointly-owned enterprise must expect conflicts among its owners, managers, and third-party contractors. We agree; insofar as the corporation is only one of several legal forms for the jointly-owned firm, it faces the same generic agency problems that confront all jointly-owned firms. Nevertheless, the characteristics of this particular form matter a great deal, since it is the form that is chosen by most large-scale enterprises—and, as a practical matter, the only form that firms with widely dispersed ownership can choose in many jurisdictions.[3] Moreover, the unique features of this form determine the contours of its agency problems. To take an obvious example, the fact that shareholders enjoy limited liability—while, say, general partners in a partnership do not—has traditionally made creditor protection far more salient in corporate law than it is in partnership law. Similarly, the fact that corporate investors may trade their shares is the foundation of the anonymous trading stock market—an institution that has encouraged the separation of ownership from control, and so has sharpened the management-shareholder agency problem.

In this book, we explore the role of corporate law in minimizing agency problems—and thus, making the corporate form practicable—in the most important categories of corporate actions and decisions. More particularly, Chapters 3–9 address, respectively, seven categories of transactions and decisions that involve the corporation, its owners, its managers, and the other parties with whom it deals. Most of these categories of firm activity are, again, generic, rather than uniquely corporate. For example, Chapters 3 and 4 address governance mechanisms that operate over the firm's ordinary business decisions, whilst Chapter 5 turns to the checks that operate on the corporation's transactions with creditors. As before, however, although similar agency problems arise in similar contexts across all forms of jointly-owned enterprise, the response of corporate law turns in part on the unique legal features that characterize the corporate form.

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[3] Only the corporate form is available in many jurisdictions for firms that want access to the capital markets for *equity financing*. Some jurisdictions, however, permit the equity of non-corporate entities to trade in the public markets as well: for example, in the U.S., the equity securities of so-called 'master' limited partnerships and limited liability companies may be registered for public trading.

Taken together, the latter seven chapters of our book cover nearly all of the important problems in corporate law. In each Chapter, we describe how the basic agency problems of the corporate form manifest themselves in the given category of corporate activity, and then explore the range of alternative legal responses that are available. We illustrate these alternative approaches with examples from the corporate law of various prominent jurisdictions. We explore the patterns of homogeneity and heterogeneity that appear. Where there are significant differences across jurisdictions, we seek to address both the sources and the consequences of those differences. Our examples are drawn principally from a handful of major representative jurisdictions, including France, Germany, Italy, Japan, the UK, and the U.S., though we also make reference to the laws of other jurisdictions to make special points.[4]

In emphasizing a strongly functional approach to the issues of comparative law, this book differs from some of the more traditional comparative law scholarship, both in the field of corporate law and elsewhere.[5] We join an emerging tendency in comparative law scholarship by seeking to give a highly integrated view of the role and structure of corporate law that provides a clear framework within which to organize an understanding of individual systems, both alone and in comparison with each other.[6] Moreover, while comparative law scholarship often has a tendency to emphasize differences between jurisdictions, our approach is to focus on similarities. Doing so, we believe, illuminates an underlying commonality of structure that transcends national boundaries. It also provides an important perspective on the potential basis for the international integration of corporate law that is likely to take place as economic activity continues to become more global in scope in the decades to come.

We realize that the term 'functional', which we have used here and in our title, means different things to different people, and that some of the uses to which that term has been put in the past—particularly in the field of sociology—have made the term justifiably suspect. It would perhaps be more accurate to call our approach 'economic' rather than 'functional,' though the sometimes tendentious use of economic argumentation in legal literature to support particular (generally laissez-faire) policy positions, as well as the tendency in economic analysis to neglect non-pecuniary motivations or assume an unrealistic degree of rationality in human action, have also caused many scholars—particularly outside of the United States—to be as wary of 'economic analysis' as they are of 'functional analysis.' For the purposes at hand, however, we need not commit ourselves on fine points of social science

[4] We focus on developed, rather than developing, economies, because where foundational legal institutions, such as functioning courts and the protection of property rights, are absent or compromised, then the way in which corporate law responds to specific problems is less likely to make a difference to the real economy. A discussion of the ways in which such institutions can be engendered, or replicated by extra-legal means, is beyond the scope of our enquiry.

[5] Compare, e.g., Arthur R. Pinto and Gustavo Visentini (eds.), THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS, A COMPARATIVE APPROACH 1998).

[6] Other examples of this trend include Dennis C. Mueller and B. Burcin Yurtoglu, *Country Legal Environments and Corporate Investment Performance*, 1 GERMAN ECONOMIC REVIEW 187 (2000); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY 1113 (1998); Henry Hansmann and Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 NEW YORK UNIVERSITY LAW REVIEW 434 (1998); Curtis Milhaupt and Katharina Pistor, LAW AND CAPITALISM (2008); Konrad Zweigert and Hein Kötz, INTRODUCTION TO COMPARATIVE LAW (Tony Weir trans., 3rd ed. 1998); Ugo Mattei, COMPARATIVE LAW AND ECONOMICS (1997).

methodology. We need simply note that the exigencies of commercial activity and organization present practical problems that have a rough similarity in developed market economies throughout the world. Our analysis is 'functional' in the sense that we organize discussion around the ways in which corporate laws respond to these problems, and the various forces that have led different jurisdictions to choose roughly similar—though by no means always the same—solutions to them.

That is not to say that our objective here is just to explore the commonality of corporate law across jurisdictions. Of equal importance, we wish to offer a *common language* and a general *analytic framework* with which to understand the purposes that can potentially be served by corporate law, and with which to compare and evaluate the efficacy of different legal regimes in serving those purposes.[7] Indeed, it is our hope that the analysis offered in this book will be of use not only to students of comparative law, but also to those who simply wish to have a more solid framework within which to view their own country's corporation law.

Likewise, we take no strong stand here in the current debate on the extent to which corporate law is or should be 'converging,' much less on what it might converge to.[8] That is a subject on which reasonable minds can differ. Indeed, it is a subject on which the reasonable minds that have written this book sometimes differ.[9] Rather, we are seeking to set out a conceptual framework and a factual basis with which that and other important issues facing corporate law can be fruitfully explored.

1.2 WHAT IS A CORPORATION?

[7] In very general terms, our approach echoes that taken by Dean Robert Clark in his important treatise, CORPORATE LAW (1986), and Frank Easterbrook and Daniel Fischel, in their discussion of U.S. law, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). However, our analysis differs from—and goes beyond—that offered by these and other commentators in several key respects. First, and most obviously, we present a comparative analysis that addresses the corporate law of multiple jurisdictions. Second, we provide an integrated functional overview that stresses the agency problems at the core of corporate law, rather than focusing on more particular legal institutions and solutions. Finally, we offer a more expansive account than do other commentators of the functions of central features of the corporate form such as limited liability and the governance structure of the corporate board. Our analysis, moreover, is informed not only by a comparative perspective across jurisdictions, but also, occasionally, by a comparative perspective across legal forms for business enterprise.

[8] Compare Lucian A. Bebchuk and Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STANFORD LAW REVIEW 127 (1999); William M. Bratton and Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUMBIA JOURNAL OF TRANSNATIONAL LAW 213 (1999); John C. Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Significance*, 93 NORTHWESTERN UNIVERSITY LAW REVIEW 641 (1999); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AMERICAN JOURNAL OF COMPARATIVE LAW 329 (2001); Amir N. Licht, *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DELAWARE JOURNAL OF CORPORATE LAW 147 (2001); Mathias M. Siems, CONVERGENCE IN SHAREHOLDER LAW (2007).

[9] The views of the authors of this chapter are briefly set out in Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 GEORGETOWN LAW JOURNAL 439 (2001) and John Armour and Jeffrey N. Gordon, *The Berle-Means Corporation in the Twenty-First Century*, Working Paper (2008), at http://www.law.upenn.edu.

As we noted above, the five core structural characteristics of the business corporation are: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital. In virtually all economically important jurisdictions, there is a basic statute that provides for the formation of firms with all of these characteristics. As this pattern suggests, these characteristics have strongly complementary qualities for many firms. Together, they make the corporation uniquely attractive for organizing productive activity. But these characteristics also generate tensions and tradeoffs that lend a distinctively corporate character to the agency problems that corporate law must address.

1.2.1 Legal personality

In the economics literature, a firm is often characterized as a 'nexus of contracts'. As commonly used, this description is ambiguous. It is often invoked simply to emphasize that most of the important relationships within a firm—including, in particular, those among the firm's owners, managers, and employees—are essentially contractual in character, and hence based on consent, rather than involving some form of extracontractual command-and-control authority. This is an important insight, but it does not distinguish firms from other networks of contractual relationships. It is perhaps more accurate to describe a firm as a 'nexus *for* contracts', in the sense that a firm serves, fundamentally, as the common counterparty in numerous contracts with suppliers, employees, and customers, coordinating the actions of these multiple persons through exercise of its contractual rights.[10] The first and most important contribution of corporate law, as of other forms of organizational law, is to permit a firm to serve this role by permitting the firm to serve as a single contracting party that is distinct from the various individuals who own or manage the firm. In so doing, it enhances the ability of these individuals to engage together in joint projects.

The core element of the firm as a nexus for contracts is what the civil law refers to as 'separate patrimony.' This involves the demarcation of a pool of assets that are distinct from other assets owned, singly or jointly, by the firm's owners (the shareholders),[11] and of which the firm in itself, acting through its designated managers, is viewed in law as being the owner. The firm's rights of ownership over its designated assets include the rights to use the assets, to sell them, and—of particular importance—to make them available for attachment by its creditors. Conversely, because these assets are conceived as belonging to the firm, rather than the firm's owners, they are *unavailable* for attachment by the personal creditors of these persons. The core function of this separate patrimony has been termed '*entity shielding*,' to emphasize that it involves shielding the assets of the entity—the corporation—from the creditors of the entity's owners.[12]

[10] The characterization of a firm as a 'nexus of contracts' originates with Michael Jensen and William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305 (1976), building on Armen Alchian and Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AMERICAN ECONOMIC REVIEW 777 (1972).

[11] We use the term 'owners' simply to refer to the group who have the entitlement to control the firm's assets.

[12] The term 'entity shielding' derives from Henry Hansmann, Reinier Kraakman and Richard Squire, *Law and the Rise of the Firm*, 119 HARVARD LAW REVIEW 1333 (2006). The centrality of entity shielding to organizational law is explored in Henry Hansmann and Reinier Kraakman, *The Essential*

Where corporations are concerned, entity shielding involves two relatively distinct rules of law. The first is a priority rule that grants to creditors of the firm, as security for the firm's debts, a claim on the firm's assets that is prior to the claims of the personal creditors of the firm's owners. This rule is shared by all modern legal forms for enterprise organization, including partnerships.[13] The consequence of this priority rule is that a firm's assets are, as a default rule of law,[14] automatically made available for the enforcement of contractual liabilities entered into in the name of the firm.[15] By thus bonding the firm's contractual commitments, the rule makes these commitments credible.

The second component of entity shielding—a rule of 'liquidation protection'—provides that the individual owners of the corporation (the shareholders) cannot withdraw their share of firm assets at will, thus forcing partial or complete liquidation of the firm, nor can the personal creditors of an individual owner foreclose on the owner's share of firm assets.[16] This liquidation protection rule serves to protect the going concern value of the firm against destruction either by individual shareholders or their creditors.[17] In contrast to the priority rule just mentioned, it is not found in some other standard legal forms for enterprise organization, such as the partnership.[18] Legal entities, such as the business corporation, that are characterized by both these rules—priority for business creditors and liquidation protection—can therefore be thought of as having 'strong form' entity shielding, as opposed to the 'weak form' entity shielding found in partnerships, which are characterized only by the priority rule and not by liquidation protection.

For a firm to serve effectively as a contracting party, two other types of rules are also needed. First, there must be rules specifying to third parties the individuals who have authority to buy and sell assets in the name of the firm, and to enter into contracts that are bonded by those assets.[19] Whilst of course participants in a firm are free to specify the delegation of authority by contract amongst themselves, background rules are needed—beyond such contractual agreement—to deal with situations where agents induce third parties to rely on the mere appearance of their authority. Such rules differ according to organizational form. The particular rules of authority that characterize the corporation are treated below as a separate core

Role of Organizational Law, 110 YALE LAW JOURNAL 387 (2000), where the attribute was labelled 'affirmative asset partitioning'.

[13] While even unregistered common law partnerships are subject to this priority rule, the civil law recognizes a class of unregistered 'partnerships' that lack this rule of priority. In effect, such partnerships are just special forms for co-ownership of assets rather than distinct entities for purposes of contracting.

[14] On default rules, see Section 1.4.1 *infra*.

[15] The effect is the same as if the firm's owners had themselves entered into a joint contract and granted non-recourse security over certain personal assets to the counterparty, as opposed to transferring those assets to the corporate patrimony, and then procuring the company to enter into the contract.

[16] Hansmann and Kraakman, *supra* note 12, at 411–13.

[17] Edward B. Rock and Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 JOURNAL OF CORPORATION LAW 913, 918–20 (1999); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA LAW REVIEW 387, 441–9 (2003).

[18] However, it is possible in many jurisdictions to effect liquidation protection by agreement amongst the owners of a partnership.

[19] John Armour and Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD JOURNAL OF LEGAL STUDIES 429, 441–2 (2007).

characteristic, 'delegated management'. They provide that a board of directors, as opposed to individual owners, has power to bind the company in contract.[20]

Second, there must be rules specifying the procedures by which both the firm and its counterparties can bring lawsuits on the contracts entered into in the name of the firm. Corporations are subject to rules that make such suits easy to bring as a procedural matter. In particular, they eliminate any need to name, or serve notice on, the firm's individual owners—procedures that characterize the rules of suit that, for example, characterized the Anglo-American partnership until the late 19th century.

The outcomes achieved by each of these three types of rules—entity shielding, authority, and procedure—require dedicated legal doctrines to be effective, in the sense that, absent such doctrine, they could not feasibly be replicated simply by contracting among a business's owners and their suppliers and customers. Entity shielding doctrine is needed to create common expectations, among a firm and its various present and potential creditors, concerning the effect that a contract between a firm and one of its creditors will have on the security available to the firm's other creditors.[21] Rules governing the allocation of authority are needed to establish common expectations as to who has authority to transfer rights relating to corporate assets *prior to* entering into a contract for their transfer.[22] And procedures for lawsuits need to be specified by the state, whose third-party authority is invoked by those procedures. This need for special rules of law distinguishes these three types of rules from the other basic elements of the corporate form discussed here, which could in theory be crafted by contract even if the law did not provide for a standard form of enterprise organization that embodies them.[23]

The concept of the 'separate legal personality' of the corporation, as understood in the legal literature, is in our terms a convenient heuristic formula for describing organizational forms which enjoy the benefit of each of the three foregoing 'foundational' rule types. Starting from the premise that the company is itself a person, in the eyes of the law, it is straightforward to deduce that it should be capable of entering into contracts and owning its own property; capable of delegating authority to agents; and capable of suing and being sued in its own name. For expository convenience, we use the term 'legal personality' to refer to organizational forms—such as the corporation—which share these three attributes. However, we should make clear that legal personality in the lawyer's sense is not in itself an attribute that is a necessary precondition for the existence of any—or indeed all—of

[20] Associated rules—such as the doctrine of *ultra vires*—may also prescribe limits as to the extent to which the board may bind the company in contract.

[21] To establish the priority of business creditors by contract, a firm's owners would have to contract with its business creditors to include subordination provisions, with respect to business assets, in all contracts between individual owners and individual creditors. Not only would such provisions be cumbersome to draft and costly to monitor, but they would be subject to a high degree of moral hazard—an individual owner could breach her promise to subordinate the claims of her personal creditors on the firm's assets with impunity, since this promise would be unenforceable against personal creditors who were not party to the bargain. See Hansmann and Kraakman, *supra* note 12, at 407–9.

[22] To leave questions of authority to be determined simply by agreement between the owners of the firm will make it costly for parties wishing to deal with the firm to discover whether authority has in fact been granted in relation to any particular transaction. Authority rules must therefore trade off contracting parties' 'due diligence' costs against preserving flexibility for owners to customize their allocations of authority. See Armour and Whincop, *supra* note 19, at 442–7.

[23] See Hansmann and Kraakman, *supra* note 12, at 407–9

these rules,[24] but merely a handy label for a package that conveniently bundles them together. Moreover, although it is common in the legal literature to extend syllogistic deduction from the premise of legal personality to the existence of characteristics beyond the three foundational features we have described in this section, we see no functional rationale that compels this.

1.2.2 Limited liability

The corporate form effectively imposes a default term in contracts between a firm and its creditors whereby the creditors are limited to making claims against assets that are held in the name of ('owned by') firm itself, and have no claim against assets that the firm's shareholders hold in their own names. This rule of 'limited liability' has not, historically, always been associated with the corporate form. Some important corporate jurisdictions long made unlimited shareholder liability for corporate debts the governing rule.[25] Nevertheless, today limited liability has become a nearly universal feature of the corporate form. This evolution indicates strongly the value of limited liability as a contracting tool and financing device.

Limited liability is a (strong) form of 'owner shielding' that is effectively the converse of the 'entity shielding' described above as a component of legal personality.[26] Entity shielding protects the assets of the firm from the creditors of the firm's owners, while limited liability protects the assets of the firm's owners from the claims of the firm's creditors. Together, they set up a regime of 'asset partitioning' whereby business assets are pledged as security to business creditors, while the personal assets of the business's owners are reserved for the owners' personal creditors. (By 'creditors' we mean here, broadly, all persons who have a contractual claim on the firm, including employees, suppliers, and customers.) This partitioning can increase the value of both types of assets as security for debt. Creditors of the firm commonly have a comparative advantage in evaluating and monitoring the value of the firm's assets, while an owner's personal creditors are likely to have a comparative advantage in evaluating and monitoring the individual's personal assets. As a consequence, corporate-type asset partitioning can reduce the overall cost of capital to the firm and its owners.

A related aspect of asset partitioning is that it permits firms to isolate different lines of business for the purpose of obtaining credit. By separately incorporating, as subsidiaries, distinct ventures or lines of business, the assets associated with each venture can conveniently be pledged as security just to the creditors who deal with

[24] Thus, a common law partnership, which is commonly said by lawyers to lack legal personality, can under English law enjoy each of the three foundational features described in this section: see §§ 31, 33, 39 Partnership Act 1890 (UK); Armour and Whincop, *supra* note 19, at 460–1; *Burnes v. Pennell* (1849) 2 HL Cas 497, 521; 9 ER 1181, 1191; PD 7, para. 5A Civil Procedure Rules (UK).
[25] Limited liability did not become a standard feature of the English law of joint stock companies until the mid-19th century, and in the American state of California shareholders bore unlimited personal liability for corporation obligations until 1931. See Paul L. Davies, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 40–6 (6th ed., 1997); Phillip Blumberg, *Limited Liability and Corporate Groups*, 11 JOURNAL OF CORPORATE LAW 573 (1986).
[26] The term comes from Hansmann, Kraakman and Squire, *supra* note 12. Note that the owner shielding established by a rule of limited liability is less fundamental than entity shielding, in the sense that it can be achieved by contract, without statutory fiat. Id.; Hansmann and Kraakman, *supra* note 12.

that venture.[27] Those creditors are commonly well positioned to assess and keep track of the value of those assets, but may have little ability to monitor the parent firm's other ventures.

By virtue of asset partitioning—entity shielding and limited liability—the formation of corporations and subsidiary corporations can also be used as a means of sharing the risks of transactions with the firm's creditors, in situations in which the latter are in a better position to identify or bear those risks in relation to the assets shielded by the corporate form. Thus, use of the corporate form can assist in raising debt finance even in situations where there is no need to raise additional equity capital, as in the case of the parent company of a wholly owned subsidiary.[28]

Asset partitioning also permits flexibility in the allocation of risk and return between equity-holders and debt-holders, greatly simplifies the administration of both business and individual bankruptcy, and—by isolating the value of the firm from the personal financial affairs of the firm's owners—facilitates tradability of the firm's shares, which is the third characteristic of the corporate form.[29]

Finally, asset partitioning, and limited liability in particular, plays an important function—but more subtle and less often remarked—in facilitating delegated management, which is the fourth of the core characteristics of the corporate form. In effect, by shifting downside business risk from shareholders to creditors, limited liability enlists creditors as monitors of the firm's managers, a task which they may be in a better position to perform than are the shareholders in a firm in which share ownership is widely dispersed.[30]

We should emphasize that, when we refer to limited liability, we mean specifically limited liability *in contract*—that is, limited liability to creditors who have contractual claims on the corporation. The compelling reasons for limited liability in contract generally do not extend to limited liability *in tort*—that is, to persons who are unable to adjust the terms on which they extend credit to the corporation, such as third parties who have been injured as a consequence of the corporation's negligent behavior.[31] Limited liability to such persons is arguably not a necessary feature of the corporate form, and perhaps not even a socially valuable one, as we discuss more thoroughly in Chapter 5**.**

1.2.3 Transferable shares

[27] Conversely, asset partitioning can also be used to reduce transparency as to the location of assets. This concern underlies an important part of corporate law's creditor-oriented rules: see *infra* 5.2.1.3.

[28] See, e.g., Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 UNIVERSITY OF CHICAGO LAW REVIEW 499 (1976); Henry Hansmann and Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE LAW JOURNAL 1879 (1991).

[29] Whilst strong form entity shielding seems essential for free tradability of shares (see Hansmann and Kraakman, *supra* note 12), limited liability does not: so long as shareholder liability for a firm's debts is pro rata rather than joint and several, free tradability of shares is feasible with unlimited personal shareholder liability for corporate debts (see Hansmann and Kraakman, *supra* note 28).

[30] See Julian Franks, Colin Mayer and Luc Renneboog, *Who Disciplines Management in Poorly Performing Companies?*, 10 JOURNAL OF FINANCIAL INTERMEDIATION 209, 225–7 (2001); Hansmann and Kraakman, *supra* note 12.

[31] This category of 'non-adjusting' creditors might include some persons whose relationship with the firm is, in formal terms, contractual. Cf. Lucian Ayre Bebchuk and Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE LAW JOURNAL 857, at 885–6 (1996).

Fully transferable shares in ownership are yet another basic characteristic of the business corporation that distinguishes the corporation from the partnership and various other standard-form legal entities. Transferability permits the firm to conduct business uninterruptedly as the identity of its owners changes, thus avoiding the complications of member withdrawal that are common among, for example, partnerships, cooperatives, and mutuals.[32] This in turn enhances the liquidity of shareholders' interests and makes it easier for shareholders to construct and maintain diversified investment portfolios.

Fully transferable shares do not necessarily mean *freely tradable* shares. Even if shares are transferable, they may not be tradable without restriction in public markets, but rather just transferable among limited groups of individuals or with the approval of the current shareholders or of the corporation. Free tradability maximizes the liquidity of shareholdings and the ability of shareholders to diversify their investments. It also gives the firm maximal flexibility in raising capital. For these reasons, all jurisdictions provide for free tradability for at least one class of corporation. However, free tradability can also make it difficult to maintain negotiated arrangements for sharing control and participating in management. Consequently, all jurisdictions also provide mechanisms for restricting transferability. Sometimes this is done by means of a separate statute, while other jurisdictions simply provide for restraints on transferability as an option under a general corporation statute.

As a matter of terminology, we will refer to corporations with freely tradable shares as 'open' or 'public' corporations, and we will correspondingly use the terms 'closed' or 'private' corporations to refer to corporations that have restrictions on the tradability of their shares. In addition to this general division, two other distinctions are important. First, the shares of open corporations may be listed for trading on an organized securities exchange, in which case we will refer to the firm as a 'listed' or 'publicly-traded' corporation, in contrast to an 'unlisted' corporation. Second, a company's shares may be held by a small number of individuals whose interpersonal relationships are important to the management of the firm, in which case we refer to it as 'closely held', as opposed to 'widely held'. It is common to speak, loosely, as if all companies can be categorized as either 'public' or 'close' corporations, bundling these distinctions together (and the widely-used term 'close corporation' itself embodies this ambiguity, being used sometimes to mean 'closed corporation,' sometimes to mean 'closely-held corporation,' and sometimes to mean both). But not all companies with freely-tradable shares in fact have widely-held share ownership, or are listed on securities exchanges. Conversely, it is common in some jurisdictions to find corporations whose shares are not freely tradable but that nonetheless have hundreds or thousands of shareholders, and that consequently have little in common with a typical closely-held corporation that has only a handful of shareholders, some or all of whom are from the same family.

Transferability of shares, as we have already suggested, is closely connected both with the liquidation protection that is a feature of strong form legal personality, and with limited liability. Absent either of these rules, the creditworthiness of the firm as a whole could change, perhaps fundamentally, as the identity of its shareholders changed. Consequently, the value of shares would be

[32] See Henry Hansmann, THE OWNERSHIP OF ENTERPRISE 152–5 (1996).

difficult for potential purchasers to judge.[33] Perhaps more importantly, a seller of shares could impose negative or positive externalities on his fellow shareholders depending on the wealth of the person to whom he chose to sell. It is therefore not surprising that strong form legal personality, limited liability, and transferable shares tend to go together, and are all features of the standard corporate form everywhere. This is in contrast to the conventional general partnership, which lacks all of these features.

1.2.4 Delegated management with a board structure

Standard legal forms for enterprise organization differ in their allocation of control rights, including the authority to bind the firm to contracts (discussed above), the authority to exercise the powers granted to the firm by its contracts, and the authority to direct the uses made of assets owned by the firm.[34] As a default rule, the general partnership form grants power to a majority of partners to manage the firm in the ordinary course of business; more fundamental decisions require unanimity. Both aspects of this allocation are unworkable for business corporations with numerous and constantly changing owners. Consequently, corporate law typically vests principal authority over corporate affairs in a board of directors or similar committee organ that is periodically elected, exclusively or primarily, by the firm's shareholders. More specifically, business corporations are distinguished by a governance structure in which all but the most fundamental decisions are delegated to a board of directors that has four basic features.[35]

First, the board is, at least as a formal matter, separate from the operational managers of the corporation. The nature of this separation varies according to whether the board has one or two tiers. In two-tier boards, top corporate officers occupy the board's second (managing) tier, but are generally absent from the first (supervisory) tier, which is at least nominally independent from the firm's hired officers (i.e. from the firm's senior managerial employees). In single-tier boards, in contrast, hired officers may be members of, and even dominate, the board itself. Regardless of the actual allocation of power between a firm's directors and officers, the legal distinction between them formally divides all corporate decisions that do not require shareholder approval into those requiring approval by the board of directors and those that can be made by the firm's hired officers on their own authority. This formal distinction between the board and hired officers facilitates a separation

[33] Paul Halpern, Michael Trebilcock and Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 UNIVERSITY OF TORONTO LAW JOURNAL 117, 136–8 (1980).

[34] We have already observed that an important precondition for a firm to serve as a nexus for contracts is a rule designating, for the benefit of third parties, the individuals who have authority to enter into contracts that bind the firm and its assets (*supra*, text accompanying notes 19–20). Because there is often overlap in practice between the scope of such external authority and the internal division of power to control assets, the latter, unlike the former, cannot be based purely on agreement between participants in the firm, but rather must be designated to some degree by rules of law. Because the underlying problem is one of notice to third parties, the law governing closely-held firms often leaves these matters to be designated at will in the firm's charter, while for widely-held firms, in which it is advantageous to let public shareholders and creditors know the allocation of authority without having to read the charter, the law is generally more rigid in designating the allocation of authority.

[35] This is not to say that other legal entities, such as partnerships, business trusts, or limited liability companies, cannot have a board structure similar to that of a typical corporation; in fact, they often do. But those forms, unlike the corporation form, do not presume a board of directors as a matter of law. Consequently, they bear the burden of placing third parties on notice that authority to commit the firm differs from the pattern established by the law as a default rule.

between, on the one hand, initiation and execution of business decisions, which is the province of hired officers, and on the other hand the monitoring and ratification of decisions, and the hiring of the officers themselves, which are the province of the board. That separation serves as a useful check on the quality of decision-making by hired officers.[36] It also performs the key function—noted earlier—of permitting third parties to rely on a well-defined institution to formally bind the firm in its transactions with outsiders.

Second, the board of a corporation is elected—at least in substantial part—by the firm's shareholders. The obvious utility of this approach is to help assure that the board remains responsive to the interests of the firm's owners, who bear the costs and benefits of the firm's decisions and whose interests, unlike those of other corporate constituencies, are not strongly protected by contract. This requirement of an elected board distinguishes the corporate form from other legal forms, such as nonprofit corporations or business trusts, that permit or require a board structure, but do not require election of the board by the firm's (beneficial) owners.

Third, though largely or entirely chosen by the firm's shareholders, the board is formally distinct from them. This separation economizes on the costs of decision-making by avoiding the need to inform the firm's ultimate owners and obtain their consent for all but the most fundamental decisions regarding the firm. It also permits the board to serve as a mechanism for protecting the interests of minority shareholders and other corporate constituencies, in ways we will explore in Chapter 4.

Fourth, the board ordinarily has multiple members. This structure—as opposed, for example, to a structure concentrating authority in a single trustee, as in many private trusts—facilitates mutual monitoring and checks idiosyncratic decision-making. However, there are exceptions. Many corporation statutes permit business planners to dispense with a collective board in favor of a single general director or one-person board[37]—the evident reason being that, for a very small corporation, most of the board's legal functions, including its service as shareholder representative and focus of liability, can be discharged effectively by a single elected director who also serves as the firm's principal manager.

1.2.5 Investor ownership

There are two key elements in the ownership of a firm, as we use the term 'ownership' here: the right to control the firm, and the right to receive the firm's net earnings. The law of business corporations is principally designed to facilitate the organization of investor-owned firms—that is, firms in which both elements of ownership are tied to investment of capital in the firm. More specifically, in an investor-owned firm, both the right to participate in control—which generally involves voting in the election of directors and voting to approve major transactions—and the right to receive the firm's residual earnings, or profits, are typically proportional to the amount of capital contributed to the firm. Business corporation

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[36] See Eugene Fama and Michael Jensen, *Agency Problems and Residual Claims*, 26 JOURNAL OF LAW AND ECONOMICS 327 (1983).

[37] This is true not only of most statutes designed principally for nonpublic corporations, such as France's SARL (Art. L. 223-18 Code de Commerce) and SAS (Art. L. 227-6 Code de Commerce) and Germany's GmbH (§ 6 GmbH-Gesetz), but also of the general corporate laws in the UK (§ 154(1) Companies Act 2006), in Italy (Article 2380-2 Civil Code), and in the U.S. state of Delaware, § 141(b) Delaware General Corporation Law.

statutes universally provide for this allocation of control and earnings as the default rule.

There are other forms of ownership that play an important role in contemporary economies, and other bodies of organizational law—including other bodies of corporate law—that are specifically designed to facilitate the formation of those other types of firms.[38] For example, cooperative corporation statutes— which provide for all of the four features of the corporate form just described except for transferable shares, and often permit the latter as an option as well— allocate voting power and shares in profits proportionally to acts of patronage, which may be the amount of inputs supplied to the firm (in the case of a producer cooperative), or the amount of the firm's products purchased from the firm (in the case of a consumer cooperative). Indeed, business corporations are effectively a special kind of producer cooperative, in which control and profits are tied to supply of a particular type of input, namely capital. As a consequence, business corporations could, in principle, be formed under a well-designed general cooperative corporation statute. But the law provides, instead, a special statutory form for corporations owned by investors of capital ('capital cooperatives,' as we might think of them).[39]

This specialization follows from the dominant role that investor-owned firms have come to play in contemporary economies, and the consequent advantages of having a form that is specialized to the particular needs of such firms, and that signals clearly to all interested parties the particular character of the firm with which they are dealing. The dominance of investor ownership among large firms, in turn, reflects several conspicuous efficiency advantages of that form. One is that, among the various participants in the firm, investors are often the most difficult to protect simply by contractual means.[40] Another is that investors of capital have (or, through the design of their shares, can be induced to have) highly homogeneous interests among themselves, hence reducing—though definitely not eliminating—the potential for costly conflict among those who share governance of the firm.[41]

Specialization to investor ownership is yet another respect in which the law of business corporations differs from the law of partnership. The partnership form typically does not presume that ownership is tied to contribution of capital, and though it is often used in that fashion, it is also commonly used to assign ownership of the firm in whole or in part to contributors of labor or of other factors of production—as in partnerships of lawyers and other service professionals, or simply in the prototypical two-person partnership in which one partner supplies labor and the other capital. As a consequence, the business corporation is less flexible than the partnership in terms of assigning ownership. To be sure, with sufficient special contracting and manipulation of the form, ownership shares in a business corporation can be granted to contributors of labor or other factors of production, or in proportion to consumption of the firm's services. Moreover, as the corporate form has evolved, it has achieved greater flexibility in assigning ownership, either by

[38] For a discussion of the varieties of forms of ownership found in contemporary economies, of their respective economic roles, and of the relationship between these forms and the different bodies of organizational law that govern them, see Hansmann, *supra* note 32.

[39] Cooperative corporation statutes, in turn, commonly prohibit the grant of ownership shares— voting rights and rights to a share of profits—to persons who simply contribute capital to the firm, thus preventing the formation of investor-owned firms under the cooperative corporation statutes.

[40] See, e.g., Oliver Williamson, *Corporate Governance,* 93 YALE LAW JOURNAL 1197 (1984).

[41] See Hansmann, *supra* note 32, Ch. 4.

permitting greater deviation from the default rules in the basic corporate form (e.g., through restrictions on share ownership or transfer), or by developing a separate and more adaptable form for close corporations. Nevertheless, the default rules of corporate law are generally designed for investor ownership, and deviation from this pattern can be awkward. The complex arrangements for sharing rights to earnings, assets, and control between entrepreneurs and investors in high-tech start-up firms offer a familiar example.[42]

Sometimes corporate law itself deviates from the assumption of investor ownership to permit or require that persons other than investors of capital— for example, creditors or employees—participate to some degree in either control or net earnings or both. Worker codetermination is a conspicuous example. The wisdom and means of providing for such non-investor participation in firms that are otherwise investor-owned remains one of the basic controversies in corporate law. We address this subject further in Chapter 4.

Most jurisdictions also have one or more statutory forms—such as the U.S. nonprofit corporation, the civil law foundation and association, and the UK company limited by guarantee—that provide for formation of nonprofit firms. These are firms in which no person may participate simultaneously in both the right to control and the right to residual earnings (which is to say, the firms have no owners). While nonprofit organizations, like cooperatives, are sometimes labelled 'corporations,' however, they will not be within the specific focus of our attention here. Thus, when we use the term 'corporation' in this book, we refer only to the business corporation, and not to other types of incorporated entities. When there is potential for ambiguity, we will explicitly use the term 'business corporation' to make specific reference to the investor-owned company that is our principal focus.

1.3 SOURCES OF CORPORATE LAW

All jurisdictions with well-developed market economies have a least one core statute that establishes a basic corporate form with the five characteristics described above, and that is designed particularly to permit the formation of public corporations—that is, corporations with freely tradable shares. Nevertheless, corporate law as we understand it here generally extends well beyond the bounds of this core statute.

1.3.1 Special and partial corporate forms

First, major jurisdictions commonly have at least one distinct statutory form specialized for the formation of closed corporations. These forms—the French SARL, the German GmbH, the Italian Srl, Japanese close corporation, the American close corporation and (more recent) limited liability company, and the UK private company[43]—typically exhibit all of the canonical features of the corporate form. They differ from open companies chiefly because their shares, though transferable at least in principle, are presumed—and in some cases required—not to trade freely in a public market. Sometimes these forms also permit departure from one of our five core characteristics—delegated management—by permitting elimination of the board in

[42] Stephen N. Kaplan and Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REVIEW OF ECONOMIC STUDIES 281 (2003).
[43] In the case of the UK private company, the standard form is provided not by a separate statute, but by a range of provisions in a single statute with differential application to public and private companies.

favor of direct management by shareholders.[44] The statutes creating these forms also commonly permit, and sometimes facilitate, special allocations of control, earnings rights, and rights to employment among shareholders that go beyond those permitted in the core public corporation statute.

Second, some jurisdictions have, in addition to these special closed corporation forms, *quasi*-corporate statutory forms that can be used to form business corporations with all of our five core characteristics, though some of these characteristics must be added by contract. One example is the limited liability partnership, which has been provided for recently in the law of the U.S. and some European jurisdictions. This form simply grafts limited liability onto the traditional general partnership. U.S. law now allows the partnership to have something close to strong form entity shielding (by limiting the rights of partners or their creditors to force liquidation).[45] Consequently, with appropriate governance provisions in the partnership agreement, it is effectively possible to create a closed corporation as a limited liability partnership.

Another example is offered by the U.S. statutory business trust. The statutory business trust provides for (unambiguous) strong form legal personality and limited liability, but leaves all elements of internal organization to be specified in the organization's governing instrument (charter), failing even to provide statutory default rules for most such matters.[46] With appropriate charter provisions, a statutory business trust can be made the equivalent of a public corporation, with the trust's beneficiaries in the role of shareholders.

The analysis we offer in this book extends to all these special and quasi-corporate forms insofar as they display the five core corporate characteristics.

1.3.2 Other bodies of law

There are bodies of law that, at least in some jurisdictions, are embodied in statutes or decisional law that are separate from the core corporation statutes, and from the special and quasi-corporation statutes just described, but that are nonetheless concerned with particular core characteristics of the corporate form as we define them here. Insofar as they are so concerned, we view them functionally as part of corporate law.

To begin, the German law of groups, or *Konzernrecht,* qualifies limited liability and limits the discretion of boards of directors in corporations that are closely related through cross ownership, seeking to protect the creditors and minority shareholders of corporations with controlling shareholders. Although the *Konzernrecht*—described in more detail in Chapters 5 and 6—is embodied in statutory and decisional law that is formally distinct from the corporation statutes, it is clearly an integral part of German corporate law. Similarly, the statutory rules in many jurisdictions that require employee representation on a corporation's board of directors—such as, conspicuously, the German law of codetermination—qualify as elements of corporate law, even though they occasionally originate outside the

[44] See *supra*, note 37.
[45] See Hansmann, Kraakman and Squire, *supra* note 12, at 1391–4.
[46] It differs from the common law private trust, from which it evolved, principally in providing unambiguously for limited liability for the trust's beneficiaries even if they exercise control.

principal corporate law statutes, because they impose a detailed structure of employee participation on the boards of directors of large corporations.

Securities laws in many jurisdictions, including conspicuously the U.S., have strong effects on corporate governance through rules mandating disclosure and sometimes, as well, regulating sale and resale of corporate securities, mergers and acquisitions, and corporate elections. Stock exchange rules, which can regulate numerous aspects of the internal affairs of exchange-listed firms, can also serve as an additional source of corporate law, as can other forms of self-regulation, such as the UK's City Code on Takeovers and Mergers.[47] These supplemental sources of law are necessarily part of the overall structure of corporate law, and we shall be concerned here with all of them.

There are many constraints imposed on companies by bodies of law designed to serve objectives that are, in general, independent of the form taken by the organizations they affect. While we will not explore these bodies in general, we will sometimes discuss them where they are specifically tailored for the corporate form in ways that have important effects on corporate structure and conduct. Bankruptcy law—- or 'insolvency law,' as it is termed in some jurisdictions—is an example. Bankruptcy effects a shift in the ownership of the firm from one group of investors to another—from shareholders to creditors. By providing creditors with an ultimate sanction against defaulting firms, it casts a shadow over firms' relations with their creditors, and affects the extent to which creditors may need generalized protections in corporate law. We thus consider the role of bankruptcy law in Chapter 5. Tax law also affects directly the internal governance of corporations at various points; the U.S. denial of deductibility from corporate income, for tax purposes, of executive compensation in excess of $1 million unless it is in the form of incentive pay, discussed in Chapter 3, is a clear example.[48] And, beyond providing for board representation of employees, labor law in some countries—as emphasized in Chapter 4—involves employees or unions in the corporate decision-making process, as in requirements that works councils or other workers' organs be consulted prior to taking specified types of actions.

1.4 Law Versus Contract in Corporate Affairs

The relationships among the participants in a corporation are, to an important degree, contractual. The principal contract that binds them is the corporation's *charter* (or 'articles of association' or 'constitution,' as it is termed in some jurisdictions). The charter sets out the basic terms of the relationship among the firm's shareholders, and between the shareholders and the firm's directors and other managers.[49] By explicit or

[47] We term such self-regulation a source of 'law' in part because it is commonly supported, directly or indirectly, by law in the narrow sense. The self-regulatory authority of the American stock exchanges, for example, is both reinforced and constrained by the U.S. Securities Exchange Act and the administrative rules promulgated by the Securities and Exchange Commission under that Act. Similarly, the authority of the UK's Takeover Panel was supported indirectly until 2006 by the recognition that if its rulings were not observed, formal regulation would follow. Since 2006, it has been directly supported by formal statutory authority in 2006 (Part 28 Companies Act 2006 (UK)), and so is no longer, strictly speaking, 'self-regulatory'.
[48] § 162(m) Internal Revenue Code.
[49] The charter may be supplemented by a separate set of bylaws, which commonly govern less fundamental matters and are subject to different—generally more flexible—amendment rules than is the charter.

implicit reference, the charter can also become part of the contract between the firm and its employees or creditors. Some or all of a corporation's shareholders may, in addition, be bound by one or more shareholders' agreements.

At the same time, corporations are the subject of the large body of law whose various sources we have just reviewed. That body of law is the principal focus of this book. Before examining the details of that law, however, we must address a fundamental—and surprisingly difficult—question: What role does this law play? As we have already seen, with the exception of legal personality, the defining elements of the corporate form could in theory be established simply by contract. And the same is true of most of the other rules of law that we examine throughout this book. If those rules of law did not exist, the relationships they establish could still be created by means of contract, just by placing similar provisions in the organization's charter. This was, in fact, the approach taken by the numerous unincorporated joint stock companies formed in England during the 18th and early 19th centuries, before incorporation became widely available in 1844. Those companies obtained their legal personality from partnership and trust law, and created the rest of their corporate structure—including limited liability—by means of contract.[50] Why, then, do we today have, in every advanced economy, elaborate statutes providing numerous detailed rules for the internal governance of corporations?

1.4.1 Mandatory laws versus default provisions

In addressing this question, it is important to distinguish between legal provisions that are merely default rules, in the sense that they govern only if the parties do not explicitly provide for something different, and laws that are mandatory, leaving parties no option but to conform to them.[51]

A significant part of corporate law—more in some jurisdictions, less in others—consists of default provisions.[52] To this extent, corporate law simply offers a standard form contract that the parties can adopt, at their option, in whole or in part. A familiar advantage of such a legally provided standard form is that it simplifies contracting among the parties involved, requiring that they specify only those elements of their relationship that deviate from the standard terms. Corporate law's provision of such standard terms as default is thereby seen in economic terms as a 'public good'. Default provisions can serve this function best if they are 'majoritarian' in content—that is, if they reflect the terms that the majority of well-informed parties would themselves most commonly choose.[53]

Defaults can, however, also serve other functions, such as encouraging the revelation of information. For example, where one contracting party is likely to have superior information relevant to the transaction than is the other (or as economists say, that party has 'private information'), then a default provision may impose a burden, or 'penalty', on the informed party, with the understanding that the default may be waived by disclosure of the information. The purpose of such a rule is to encourage

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[50] Ron Harris, INDUSTRIALIZING ENGLISH LAW (2000); Hansmann, Kraakman and Squire, *supra* note 12.
[51] See generally the papers in the symposium edition, entitled *Contractual Freedom and Corporate Law*, in 89 COLUMBIA LAW REVIEW 1395–1774 (1989).
[52] They are 'defaults' in the sense that they apply (as with computer settings) 'in *default*' of the parties stipulating something else.
[53] Easterbrook and Fischel, *supra* note 7, at 34–5.

parties to reveal their private information—so that they can avoid the default outcome—and consequently induce explicit bargaining between the parties that will lead to an outcome superior to that which would otherwise be expected.[54] Such a 'penalty default' may not be a majoritarian default.

Default provisions can be supplied in a variety of ways, the choice of which affects the ease and means of 'contracting around' them.[55] A common form of corporate law default is a statutory provision that will govern unless the parties explicitly provide an alternative. The common U.S. requirement that a merger can be approved by a vote of 50% of all outstanding shares is an example. That rule can be displaced by a charter provision that explicitly requires approval by, say, 60% of the shareholders, or 70%, or some other number.

Alternatively, corporate law itself sometimes specifies the rule that will govern if the default provision is not chosen—an 'either-or' provision. An example is offered by French corporate law, which allows companies' charters to opt for a two-tier board structure as an alternative to the default single-tier one.[56] In other words, the law in this case gives the corporation a choice between two statutory provisions, one of which is the default and the other of which is the 'secondary' provision, with the latter applying only if the firm opts out of the default (or, equivalently, 'opts in' to the secondary provision). The law may also impose special procedures for altering a default rule. For example, the law may impose a rule that is highly protective of non-controlling shareholders, and then permit deviation from that rule only with approval by a supermajority of all shareholders, or with separate approval by a majority of the non-controlling shareholders, thereby providing some assurance that the default rule will be altered only if the chosen alternative is superior for all shareholders.[57]

An extension of the binary two-alternative-provisions approach just described is to provide corporations with a choice among a 'menu' of more than two alternative statutorily-specified rules.[58] Although to date this approach is rarely taken within any given corporation statute,[59] it can in effect be seen in the increasing choice among alternative corporate forms, as we discuss below.

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[54] See Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE LAW JOURNAL 87 (1989).

[55] The ease with which parties can 'contract around' a default provision will affect the way it operates. For example, if the costs of contracting around a provision are high, it may be less useful as an information-forcing 'penalty' default (although this will depend on the size of the 'penalty'), but still capable of functioning adequately as a 'majoritarian' default (as a majority of parties would prefer it anyway). For a nuanced discussion of these and other issues, see Ayres and Gertner, *supra* note 54, at 121–5. For an empirical perspective, see Yair Listokin, *What do Corporate Default Rules and Menus Do? An Empirical Examination*, Working Paper (2006), at http://www.ssrn.com.

[56] See Article 225-57 Code de commerce.

[57] On the latter consideration, see Lucian Bebchuk and Assaf Hamdani, *Optimal Defaults For Corporate Law Evolution*, 96 NORTHWESTERN UNIVERSITY LAW REVIEW 489 (2002).

[58] Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts,* 81 VIRGINIA LAW REVIEW 757, 839–41 (1995).

[59] An exception is the UK's Companies Act 2006, which makes provision for multiple forms of model articles of association to be made available for different types of company: *id.*, § 19(2). Another is Italy's menu of three board systems: a default single-tier one with a separate body in charge of internal controls ('collegio sindacale'), a new single-tier system with no such separate body, and a two-tier system. See Article 2380, Civil Code.

There are also important rules of corporate law that are mandatory.[60] Large German corporations, for example, have no alternative but to give half of their supervisory board seats to representatives of their employees, and publicly-traded U.S. corporations have no alternative but to provide regular detailed financial disclosure in a closely prescribed format.[61] The principled rationale for mandatory terms of these types is usually based on some form of 'contracting failure': that some parties might otherwise be exploited because they are not well informed; that the interests of third parties might be affected; or that collective action problems (such as the notorious 'prisoners' dilemma') might otherwise lead to contractual provisions that are inefficient or unfair.[62] Mandatory terms may also serve a useful standardizing function, in circumstances (such as accounting rules) where the benefits of compliance increase if everyone adheres to the same provision.

Mandatory rules need not just serve a prescriptive function, however. When used in conjunction with a choice of corporate *forms*, they can perform an enabling function similar to that served by default rules. More particularly, mandatory rules can facilitate freedom of contract by helping corporate actors to signal the terms they offer and to bond themselves to those terms. The law accomplishes this by creating corporate forms that are to some degree inflexible (i.e., are subject to mandatory rules), but then permitting choice among different corporate forms.[63] There are two principal variants to this approach.

First, a given jurisdiction can provide for a menu of different standard form legal entities from which parties may choose in structuring an organization. In some U.S. jurisdictions, for example, a firm with the five basic attributes of the business corporation can be formed, alternatively, under a general business corporation statute, a close corporation statute, a limited liability company statute, a limited liability partnership statute, or a business trust statute—with each statute providing a somewhat different set of mandatory and default rules. Most conspicuously, the number of mandatory rules decreases as one moves from the first to the last of these statutory forms. The result is to enhance an entrepreneur's ability to signal, via her choice of form, the terms that the firm offers to other contracting parties, and to make credible the entrepreneur's commitment not to change those terms. Formation as a business corporation, for example, signals simply and clearly—to all who deal with the firm, whether by purchasing shares or simply by contract—that the firm is characterized by a variety of familiar governance provisions, and that it will continue to have those characteristics unless and until it changes statutory form.[64] Thus, paradoxically, greater rigidity within any particular form may actually enhance overall freedom of contract in structuring private enterprise, so long as there is a sufficiently broad range of alternative forms to choose from.

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[60] See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUMBIA LAW REVIEW 1549 (1989).
[61] See *infra* 3.3.1 (codetermination) and 4.1.4 and 8.2 (disclosure).
[62] See generally Michael J. Trebilcock, THE LIMITS OF FREEDOM OF CONTRACT (1993).
[63] Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence From LLCs*, 73 WASHINGTON UNIVERSITY LAW QUARTERLY 369 (1995); John Armour and Michael J. Whincop, *An Economic Analysis of Shared Property in Partnership and Close Corporations Law*, 26 JOURNAL OF CORPORATION LAW 983 (2001).
[64] Third parties dealing with the firm can then ensure that no such change will occur by reserving a contractual veto on it, e.g. in the form of an acceleration clause in a loan agreement.

Second, even with respect to a particular type of legal entity, such as the publicly-traded business corporation, the organizers of a firm may be permitted to choose among different jurisdictions' laws. This leads us to the general issue of 'regulatory competition' in corporation law. Before addressing that topic, however, we need to say more about the role of corporation law in general.

1.4.2 Legal rules versus contract

Default rules of corporate law do more than simply provide convenient standard forms, encourage revelation of information, and facilitate choice of the most efficient[65] among several alternative rules. They also provide a means of accommodating, over time, developments that cannot easily be foreseen at the outset.

A contract that, like a corporation's charter, must govern complex relationships over a long period of time, is—to use the word favored by economists—necessarily *incomplete*. Situations will arise for which the contract fails to provide clear guidance, either because the situation was not foreseeable at the time the contract was drafted or because the situation, though foreseeable, seemed too unlikely to justify the costs of making clear provision for it in the contract. Statutory amendments, administrative rulings, and judicial decisions can provide for such situations as they arise, either by adding new rules of corporation law or by interpreting existing rules. This is the *gap-filling* role of corporation law.

Courts can, of course, also fill gaps without making new law, simply by interpreting privately-drafted contractual terms in a corporation's charter. But a firm will get the greatest advantage from the courts' interpretive activity if the firm adopts standard charter terms used by many other firms, since those standard terms are likely to be subject to repeated interpretation by the courts.[66] And the most widely-used standard charter terms are often the default rules embodied in the corporation law. So another advantage of adopting default rules of law, rather than drafting specialized charter terms, is to take advantage of the constant gap-filling activity stimulated by the body of precedents developed as a result of other corporations that are also subject to those rules. This is one example of a *network effect* that creates an incentive to choose a common approach.[67]

The problem of contractual incompleteness goes beyond mere gap-filling, however. Given the long lifespan of many corporations, it is likely that some of a firm's initial charter terms, no matter how carefully chosen, will become obsolete with the passage of time owing to changes in the economic and legal environment. Default rules of law have the feature that they are altered over time—by statutory amendments and by judicial interpretation—to adapt them to such changing circumstances. Consequently, by adopting a statutory default rule, a firm has a degree

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[65] Here, as elsewhere, we use the term 'efficient', as conventionally used in the economics literature, and as discussed below in Section 1.5, to refer to an organization of affairs that maximizes aggregate social welfare.

[66] Ian Ayres, *Making A Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 UNIVERSITY OF CHICAGO LAW REVIEW 1391, 1403–8 (1992).

[67] A related network effect that may encourage firms to adopt standardized charter terms, and in particular to accept default rules of law, is that those provisions are more familiar to analysts and investors, thus reducing their costs of evaluating the firm as an investment. Similar network effects may cause legal services to be less expensive for firms that adopt default rules of law. See Marcel Kahan and Michael Klausner, *Standardization and Innovation In Corporate Contracting (or "The Economics of Boilerplate")*, 83 VIRGINIA LAW REVIEW 713 (1997).

of assurance that the provision will not become anachronistic. If, in contrast, the firm puts in its charter a specially-drafted provision in place of the statutory default, only the firm itself can amend the provision when, over time, a change is called for. This runs into the problem that the firm's own mechanisms for charter amendment may be vetoed or hijacked by particular constituencies in order, respectively, to protect or further their partial interests. Simply adopting the statutory default rules, and delegating to the state the responsibility for altering those rules over time as circumstances change, avoids these latter problems.[68]

However, the quality and speed with which default rules are supplied, interpreted and updated will depend on a range of institutional variables concerning the legislative system, civil procedure, and judicial expertise. In the presence of poorly designed rules of civil procedure, judicial resolution of disputes over the interpretation of statutory provisions can also become a vehicle by which particular constituencies can protect or further their partial interests. Conversely, the design of the procedures for charter amendment will greatly influence the extent to which they can be used for the furtherance of partial interests, as opposed to fostering efficient change.

For example, in the U.S., Delaware, the leading state of incorporation for publicly-traded corporations, has a 'rolling' default regime under which changes in default rules of law are applied to all corporations that do not have explicitly inconsistent terms in their charters. One indication that these statutory default rules successfully play a role of 'delegated (re)contracting,' is the striking rarity with which U.S. publicly traded corporations deviate from their provisions. It is rare for a U.S. publicly traded corporation to include, in its charter, a provision that is not clearly specified as a default rule in the statutory law of the state in which the firm is incorporated.[69] In contrast, in the UK, the 'model' articles of association provided by the companies legislation apply on a 'fixed' basis, so that changes to the model provisions do not automatically update the articles of association of companies formed under the previous provisions.[70] Concomitantly, rates of 'opt out' from the UK's model provisions seem to be quite high.[71] However, alteration of the articles of association for a UK company is a more straightforward procedure than for a Delaware-incorporated firm.[72]

It follows from much of the foregoing that, for many corporations, there may often be little practical difference between mandatory and default rules. Firms end up, as a practical matter, adopting default rules as well as the mandatory rules. This suggests that there may be more scope for introducing flexibility into firms' choice of structure through the provision of menus of alternative default rules. There is arguably room for further development of this approach, with corporation statutes providing

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[68] See Henry Hansmann, *Corporation and Contract*, 8 AMERICAN LAW AND ECONOMICS REVIEW 1 (2006).

[69] See Listokin, *supra* note 55. The position regarding close corporations is more varied. Many of these have highly specialized charters—arguably reflecting the greater ease of efficiently renegotiating the corporate structure among the small number of parties involved and the fact that structural changes are likely to occur anyway as the firm (hopefully) evolves from a start-up to a listed company.

[70] §§ 19(4), 20(2) Companies Act 2006 (UK).

[71] See Richard C. Nolan, *The Continuing Evolution of Shareholder Governance*, 65 CAMBRIDGE LAW JOURNAL 92, 115–19 (2006).

[72] In the UK, this is a decision purely for the shareholders, albeit requiring a supermajority vote (75%) (§§ 21and 283 Companies Act 2006 (UK)), whereas in Delaware, a charter amendment must first be proposed by the board, prior to a shareholder vote (§ 242(b) Delaware General Corporation Law).

richer menus of alternative default terms for various aspects of corporate governance, all of which are (re)interpreted and amended over time to keep them current. At present, however, the closest that the law comes to such a menu approach lies in the abilities of participants to select from a range of different business forms—which we have discussed—and of corporations to choose the jurisdiction by whose corporation law they will be governed, which is the subject to which we turn next.

1.4.3 Regulatory competition

The various forms of flexibility in corporate law on which we have so far concentrated—the choice of specially-drafted charter provisions versus default provisions, the choice of one default rule in a given statute as opposed to another, and the choice of one statutory form versus another—can all be provided within any given jurisdiction. As we have noted, however, there can be yet another dimension of choice—namely, choice of the jurisdiction in which to incorporate.

In the United States, for example, the prevailing choice of law rule for corporate law is the 'place of incorporation' rule, which permits a business corporation to be incorporated under—and hence governed by—the law of any of the 50 individual states (or any foreign country), regardless of where the firm's principal place of business, or other assets and activities, are located. Where, as in the U.S., such choice is available at low cost, a given jurisdiction's corporation statute simply serves as an item on a menu of alternative standard forms available to the parties involved. As in the case where there is intra-jurisdictional choice of alternative forms, mandatory rules in any given jurisdiction's corporation law may serve not to constrain choice of form but actually to enhance it, by making it easier for firms to signal, and to bond themselves to, their choice among alternative attributes.

That form of choice, long available within the United States and in a number of other countries as well, is now being extended to corporations throughout the European Union as a consequence of recent decisions of the European Court of Justice that have largely substituted the place of incorporation rule for the 'real seat' doctrine under which, in many European countries, firms were formerly required to incorporate under the law of the state where the firm had its principal place of business.[73]

The consequence of choice across jurisdictions is not just to enlarge the range of governance rules from which a given firm can choose, but also to create the opportunity and the incentive for a jurisdiction to induce firms to incorporate under its law—and thereby bring revenue to the state directly (through franchise fees) and indirectly (through increased demand for local services) by making the jurisdictions' corporate law unusually attractive. Whether such 'regulatory competition' is good or bad has been the subject of vigorous debate. Pessimists argue that it creates a 'race to the bottom' in which the state that wins is that which goes furthest in stripping its law

[73] Case C-212/97, *Centros Ltd v. Erhvervs-og Selskabssyrelsen* [1999] ECR I-1459; Case C-208/00, *Überseering BV v. Nordic Construction Company Baumanagement GmbH* (NCC) [2002] ECR I-9919; Case C-167/01, *Kamel van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd* [2003] ECR I-10155; Case C-210/06, *Cartesio Oktató és Szolgáltató bt*, Judgment of 16 December 2008. See Jens C. Dammann, *Freedom of Choice in European Company Law*, 29 YALE JOURNAL OF INTERNATIONAL LAW 477 (2004); John Armour, *Who Should Make Corporate Law: EC Legislation versus Regulatory Competition*, 48 CURRENT LEGAL PROBLEMS 369 (2005); Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law*, 5 JOURNAL OF CORPORATE LAW STUDIES 1 (2005).

of protections for constituencies who do not control the reincorporation decision. Optimists argue that, on the contrary, regulatory competition in corporate law creates a virtuous 'race to the top' in which—because the capital markets price, more or less accurately, the effects of corporate law on shareholder welfare—the state that wins is that whose law is most effective in protecting the rights of shareholders and other corporate constituencies.[74] Clearly, the process by which reincorporation is effected will also be an important factor in determining the nature of any such 'race' that is conducted.[75] The more inclusive the process of parties involved in the firm, the less likely it is that reincorporation will result in a 'race to the bottom'.

Moreover, the effectiveness of regulatory competition presumably depends on the context in which it operates. In contrast to the European Union, for example, the United States offers the advantage of homogeneous property and contract law across its member states and largely federalized bankruptcy and tax law.[76] Even so, only one among the fifty American states—Delaware—has made a sustained effort to attract incorporation by out-of-state firms.[77] It has been quite successful in this effort, now serving as the state of incorporation for roughly half of all U.S. publicly-traded corporations, even though few of those corporations do any significant amount of business in Delaware. As part of its effort to remain attractive as a place of incorporation, Delaware's legislature regularly updates its corporation statute, generally deferring to a drafting committee dominated by practising lawyers. The Delaware judiciary, in turn, has a particular court (the 'chancery court') that is largely specialized to deal with corporate law cases, and is a constant source of judge-made law that interprets and supplements the statutory law. This focused attention to law-

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[74] The classical statements of the two polar views are William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE LAW JOURNAL 663 (1974), and Ralph Winter, *State Law, Shareholder Protection and the Theory of the Corporation*, 6 JOURNAL OF LEGAL STUDIES 251 (1977). The extensive subsequent literature has debated whether in fact states compete for corporate charters, see Marcel Kahan and Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STANFORD LAW REVIEW 679 (2002), whether any competition that does exist leads to law that is better or worse for shareholders, see Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 JOURNAL OF LAW ECONOMICS AND ORGANIZATION 225, 280–1 (1985); Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition In Corporate Law*, 105 HARVARD LAW REVIEW 1435, 1441 (1992); and William Carney and George Shepherd, *The Mystery of the Success of Delaware Law*, 2009 University of Illinois Law Review 1, and, if competition leads to more valuable firms, what is the amount of increased value, *see* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 JOURNAL OF FINANCIAL ECONOMICS 525 (2001), and Guhan Subramanian, *The Disappearing Delaware Effect*, 20 JOURNAL OF LAW ECONOMICS AND ORGANIZATION 32 (2004).

[75] Bebchuk, *supra* note 74, at 1459–61, 1470–5; Simon Deakin, *Regulatory Competition Versus Harmonization in European Company Law*, in REGULATORY COMPETITION AND ECONOMIC INTEGRATION, 190, 209–13 (Daniel C. Esty and Damien Geradin (eds.), 2001).

[76] On the implications of non-federalized tax and bankruptcy laws for regulatory competition in European corporate law, see Mitchall Kane and Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICHIGAN LAW REVIEW 1229 (2008) (tax) and Horst Eidenmüller, *Free Choice in International Company Insolvency Law in Europe*, 6 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 423 (2005); Armour, *supra* note 73, at 401–11; Luca Enriques and Martin Gelter, *Regulatory Competition in European Company Law and Creditor Protection*, 7 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 417 (2006) (bankruptcy).

[77] In recent years, Nevada has made a modest and largely unsuccessful effort to compete with Delaware. Going back to the beginning of the 20th century, New Jersey was also a competitor.

making clearly has important virtues, although not all agree that the result is an optimal body of corporate law.[78]

Of course, there is dispute as to what constitutes an 'optimal' body of corporate law, even in theory. That is our next topic.

1.5 WHAT IS THE GOAL OF CORPORATE LAW?

What is the goal of corporate law, as distinct from its immediate functions of defining a form of enterprise and containing the conflicts among the participants in this enterprise? As a normative matter, the overall objective of corporate law—as of any branch of law—is presumably to serve the interests of society as a whole. More particularly, the appropriate goal of corporate law is to advance the aggregate welfare[79] of all who are affected by a firm's activities, including the firm's shareholders, employees, suppliers, and customers, as well as third parties such as local communities and beneficiaries of the natural environment. This is what economists would characterize as the pursuit of overall social efficiency.

It is sometimes said that the goals of corporate law should be narrower. In particular, it is sometimes said that the appropriate role of corporate law is simply to assure that the corporation serves the best interests of its shareholders or, more specifically, to maximize financial returns to shareholders or, more specifically still, to maximize the current market price of corporate shares. Such claims can be viewed in two ways.

First, these claims can be taken at face value, in which case they neither describe corporate law as we observe it nor offer a normatively appealing aspiration for that body of law. There would be little to recommend a body of law that, for example, permits corporate shareholders to enrich themselves through transactions that make creditors or employees worse off by $2 for every $1 that the shareholders gain.

Second, such claims can be understood as saying, more modestly, that focusing principally on the maximization of shareholder returns is, in general, the best means by which corporate law can serve the broader goal of advancing overall social welfare. In general, creditors, workers, and customers will consent to deal with a corporation only if they expect themselves to be better off as a result. Consequently, the corporation—and, in particular, its shareholders, as the firm's residual claimants[80] and risk-bearers—have a direct pecuniary interest in making sure that corporate transactions are beneficial, not just to the shareholders, but to all parties who deal with the firm. We believe that this second view is—and surely ought to be—the appropriate

[78] See, e.g., Jonathan R. Macey and Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEXAS LAW REVIEW 469 (1987); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUMBIA LAW REVIEW 1908 (1998).

[79] When we speak here of advancing or maximizing the 'aggregate welfare' of society we are using a metaphor that is conceptually a bit loose. There is no coherent way to put a number on society's aggregate welfare, much less to maximize that number—and particularly so when many benefits are in appreciable part non-pecuniary. What we are suggesting here might be put more precisely in the language of welfare economics as pursuing Kaldor-Hicks efficiency within acceptable patterns of distribution.

[80] Shareholders are a corporation's 'residual claimants' in the sense that they are entitled to appropriate all (and only) the net assets and earnings of the corporation after all contractual claimants—such as employees, suppliers, and customers—have been paid in full.

interpretation of statements by legal scholars and economists asserting that shareholder value is the proper object of corporate law.

Whether, in fact, the pursuit of shareholder value is generally an effective means of advancing overall social welfare is an empirical question on which reasonable minds can differ. While each of the authors of this book has individual views on this claim, we do not take a strong position on it in the Chapters that follow. Rather, we undertake the broader task of offering an analytic framework within which this question can be explored and debated.

1.6 WHAT FORCES SHAPE CORPORATE LAW?

To say that the pursuit of aggregate social welfare is the appropriate goal of corporate law is not to say, of course, that the law always serves that goal. Legislatures and courts are sometimes less attentive to overall social welfare than to the particular interests of influential constituencies, such as controlling shareholders, corporate managers, or organized workers. Moreover, corporate law everywhere continues to bear the imprint of the historical path through which it has evolved, and reflects as well the influence of a variety of non-efficiency-oriented intellectual and ideological currents.[81]

We touch here briefly on several of the most conspicuous of these various forces that help shape corporate law.

1.6.1 Patterns of corporate ownership

The nature and number of corporate shareholders differ markedly even among the most developed market economies, and surely leave a mark on the structure of corporate law.

In the U.S. and the UK, there are large numbers of publicly-traded corporations that have *dispersed share ownership*, such that no single shareholder, or affiliated group of shareholders, is capable of exercising control over the firm.[82] Shareholdings among major Japanese firms are also often very dispersed,[83] though in the second half of the 20th century it was common for a substantial fraction of a firm's stock to be held by other firms in a loose group with substantial reciprocal cross-shareholdings.[84] In the nations of continental Europe, in contrast, even firms with publicly-trading shares have traditionally had a *controlling shareholder*, in the

[81] See generally, Mark J. Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2003); Peter A. Gourevitch and James Shinn, POLITICAL POWER AND CORPORATE CONTROL (2005).

[82] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *Corporate Ownership Around the World*, 54 JOURNAL OF FINANCE 471, 492–3; Mara Faccio and Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations,* 65 JOURNAL OF FINANCIAL ECONOMICS 365, 379–80; cf. Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, REVIEW OF FINANCIAL STUDIES (forthcoming), available at http://www.ssrn.com..

[83] By some accounts, share ownership in Japanese publicly-held corporations is more dispersed than in the U.S.: see Holderness, *supra* note 82; Julian Franks, Colin Mayer and Hideaki Miyajima, *Evolution of Ownership: The Curious Case of Japan*, Working Paper (2007), at http://www.hbs.edu.

[84] See TOKYO STOCK EXCHANGE, 2006 SHAREOWNERSHIP SURVEY, 4 (2007); Hideaki Miyajima and Fumiaki Kuroki, *The Unwinding of Cross-Shareholding in Japan: Causes, Effects, and Implications*, in CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 79 (Masahiko Aoki, Gregory Jackson and Hideaki Miyajima (eds.), 2007).

form of an individual or family (as in Italy), another firm, or a closely coordinated group of other firms (as in Germany),[85] or the state (as in France).

The types of entities by or through which shares are held also differ substantially from one country to another. In the U.S., for example, while individuals continue to hold a substantial amount of stock directly, the majority of stock is now owned by two types of '*institutional investors*' – *mutual funds* and employer-established *pension funds*—though there are many thousands of both types of funds and an individual fund rarely holds a significant fraction of a given company's stock.[86] In England, institutional investors (mainly pension funds and insurance companies) also own a large fraction of corporate stock,[87] but—in contrast to the U.S. pattern—the thirty or so largest funds together hold a sufficiently large share of the stock in many companies to exert substantial control.[88] In Germany, large commercial banks traditionally held substantial blocks of corporate stock on their own account, and also served as custodians for large amounts of stock owned by individuals, whose votes were often effectively exercised by the banks themselves.[89] Recent years have seen the rise of new types of institutional investors as well. Conspicuous among these are *hedge funds*—relatively unregulated collective investment funds that, despite their name,[90] often adopt highly speculative strategies that involve substantial stakes in individual firms, and that sometimes seek to exercise control over those firms—and private equity firms, which are (typically) nonpublic firms that acquire, at least temporarily, complete ownership of formerly public companies to effect major changes in the firms' structure, strategy, or management.[91]

Arguably, such differences in patterns of shareholding across countries are the consequence, at least in part, of differences in the structure of corporate law. There is now a large empirical 'law and finance' literature that seeks to demonstrate, in particular, that countries with greater protection for non-controlling shareholders against opportunism by managers and controlling shareholders have less concentrated shareholdings as a consequence,[92] though subsequent studies have sometimes failed to

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[85] However, there are indications that the traditional position in some jurisdictions, notably Germany, is starting to change in favour of more dispersed stock ownership: see Darius Wojcik, *Change in the German Model of Corporate Governance: Evidence from Blockholdings 1997–2001*, 35 ENVIRONMENT AND PLANNING A 1431; Steen Thomsen, *Convergence of Corporate Governance during the Stock Market Bubble: Towards Anglo-American or European Standards?* in Grandori (ed.), CORPORATE GOVERNANCE AND FIRM ORGANIZATION (2004), 297, 306–12.

[86] Board of Governors of the Federal Reserve System, FLOW OF FUNDS ACCOUNTS IN THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS, 1995–2006, 82 (Table L.213) (2007).

[87] Office for National Statistics (UK), SHARE OWNERSHIP: A REPORT ON OWNERSHIP OF SHARES AS AT 31ST DECEMBER 2006, 9 (2007).

[88] See Geof P. Stapledon, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE (1996); Armour and Gordon, *supra* note 9, at 29–30.

[89] See e.g., Ralf Elsas and Jan P. Krahnen, *Universal Banks and Relationships with Firms*, in THE GERMAN FINANCIAL SYSTEM 197 (Jan P. Krahnen and Reinhard H. Schmidt (eds.), 2006). This pattern has, however, become less clearly pronounced in recent years, with only private banks still operating in this fashion and many commercial banks finding proxy voting too costly. See also sources cited *supra* note 85.

[90] Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1021 (2007).

[91] See Brian R. Cheffins and John Armour, *The Eclipse of Private Equity*, 33 DELAWARE JOURNAL OF CORPORATE LAW 1 (2008).

[92] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, *Legal Determinants of External Finance*, 52 JOURNAL OF FINANCE 1131 (1997); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, *Law and Finance*, 106 JOURNAL OF POLITICAL

replicate these results,[93] and the conclusions to be drawn from them are much debated.[94]

There can be little doubt, however, that the reverse is (also?) true: the structure of corporate law in any given country is in important part a consequence of that country's particular pattern of corporate ownership, which is in turn determined at least in part by forces exogenous to corporate law.[95] It has been argued, for example, that the fragmented pattern of U.S. shareholdings is to a substantial degree a result of that country's tradition of populist politics, which has produced a number of policies successfully designed to frustrate family and institutional control of industrial enterprise.[96] Correspondingly, it is said that the traditionally more concentrated share ownership patterns in continental Europe and Japan complemented particular patterns of industrial development.[97] In particular, a controlling shareholder may be better placed to make credible long-term commitments to employees, which in turn may facilitate labor relations—and hence productivity—where the goal is to motivate workers to use existing technology, rather than to develop new technologies.[98]

These patterns of share ownership, in turn, have helped shape corporate law in two ways. The first, which we might term the 'distributional' effect of corporate ownership on corporate law, is through the influence they give to particular interest groups to shape corporate law in ways that distribute a larger fraction of the fruits of enterprise to themselves. For example, the dispersed share ownership of U.S. publicly traded corporations has given corporate managers substantial autonomy, which they have used—via lobbying, litigation, and choice of their state of incorporation—to help give U.S. corporation law a distinctly managerialist character. Second, in what we might term in contrast the 'efficiency effect,' share ownership patterns shape the problems to which reforms designed to facilitate investment respond. Thus the dispersed pattern of U.S. shareholdings has brought changes in corporate law,[99] such

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ECONOMY 1113 (1998); Thorsten Beck, Asli Demirgüc-Kunt and Ross Levine, *Law and Finance: Why does Legal Origin Matter?*, 31 JOURNAL OF COMPARATIVE ECONOMICS 653–75 (2003); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, *What Works in Securities Laws?*, 61 JOURNAL OF FINANCE 1 (2006).

[93] See Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.'s, 'Antidirector Rights Index' Under Consistent Coding*, Working Paper (2006), at http://www.ssrn.com; John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siems and Ajit Singh, *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, Working Paper (2007), *at* http://www.ssrn.com; Howell Jackson and Mark J. Roe, *Public Enforcement of Securities Laws: Preliminary Evidence*, JOURNAL OF FINANCIAL ECONOMICS (forthcoming), available at http://hku.hk/law.

[94] For an overview, see Kenneth A. Dam, THE LAW-GROWTH NEXUS (2006).

[95] Brian R. Cheffins, Does Law Matter? The Separation of Ownership and Control in the United Kingdom, 30 JOURNAL OF LEGAL STUDIES 459 (2001); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE LAW JOURNAL 1 (2001).

[96] Mark J. Roe, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

[97] See Wendy Carlin and Colin Mayer, *Finance, Investment and Growth*, 69 JOURNAL OF FINANCIAL ECONOMICS 191 (2003).

[98] See VARIETIES OF CAPITALISM (Peter A. Hall and David Soskice (eds.), 2001); Barry Eichengreen, EUROPE'S ECONOMY SINCE 1945 (2006).

[99] See, e.g. Raghuram G. Rajan and Luigi Zingales, *The Persistence of Underdevelopment: Institutions, Human Capital, or Constituencies?*, Working Paper, (2006), at http://www.ssrn.com.

as investor-oriented disclosure rules, designed to reassure investors and hence make it less costly for firms to raise capital within that pattern of ownership.[100]

Both the distributional effect and the efficiency effect of corporate ownership on corporate law are likewise evident in other countries. Corporate law everywhere clearly reflects the institutional and political power of a country's dominant corporate interests, whether they be banks, prominent families, investment funds, or unions. At the same time, all of the wealthy countries whose law we focus on have, to a greater or lesser degree, self-consciously shaped their law to enhance the efficiency with which corporations can be financed and managed in the context of the country's particular pattern of ownership.[101]

The distributional effects of ownership patterns often work against efficiency. But that is not necessarily the case. Sometimes the interests of a dominant interest group are aligned with broader social welfare. We turn next to some factors that affect the tradeoff between distributional effects and efficiency effects.

1.6.2 International competition

Dominant ownership groups in a society are likely to be reasonably satisfied with the current corporate law regime if it gives them access to capital on terms more favorable than their competitors. In economies relatively closed to outside competition, the principal competitors of an established firm will be newer and smaller domestic firms. The owners of the established firms therefore have no interest in legal reforms that make it easier for such competitors to obtain capital financing, particularly from public capital markets—something the law might do, for example, by making corporate managers and controlling shareholders more accountable to non-controlling shareholders.[102] Meanwhile, the established firms can themselves rely on other forms of capital financing, such as retained earnings and privileged access to bank loans.[103]

These incentives change, however, in periods such as the present when world tariff levels are low and the most important competitors of a country's dominant domestic firms are no longer other, smaller domestic firms but rather large foreign firms. In such circumstances, it has been argued,[104] established domestic firms are more concerned with raising more capital for themselves, to keep up with their foreign competitors, than they are in denying capital to smaller domestic firms. Consequently, the dominant ownership groups—for example, established industrial families—become more amenable to investor-friendly reforms in corporate law. Hence, the current fervor for corporate governance reform is perhaps in part a

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[100] Coffee, *supra* note 95.

[101] Insightful and informative accounts of the mutual evolution of corporate ownership and corporate law in a variety of countries are collected in Randall K. Morck (ed.), A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD (2005). See also sources cited *supra* note 95.

[102] Gerard Hertig, *Efficient Fostering of EU Regulatory Competition*, 76 SWISS REVIEW OF BUSINESS AND FINANCIAL MARKET LAW 369, 370 (2004).

[103] Mechanisms that rely upon reputation for enforcement also tend to favour incumbent firms and deter market entry, as it is costly to acquire a reputation: see Simon Johnson, John McMillan and Christopher Woodruff, *Courts and Relational Contracts*, 18 JOURNAL OF LAW, ECONOMICS AND ORGANIZATION 221 (2002).

[104] Raghuram G. Rajan and Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 JOURNAL OF FINANCIAL ECONOMICS 5 (2003).

consequence of the great success, in recent decades, in reducing barriers to international trade.

1.6.3 Cross-jurisdictional coordination

Self-conscious supranational efforts to coordinate the regulation of corporations across jurisdictions are another important source of both distributional and efficiency pressures on corporate law. To some extent this coordination is being undertaken on a global level—for example, in international efforts to develop common accounting standards.[105] It is currently most conspicuous, however, in the European Union's efforts to further the integration of its common market. Loosely speaking, those efforts take two different—and largely conflicting—forms: harmonization and regulatory competition.

Harmonization was the initial route pursued towards integration of corporate law. These efforts, generally in the form of EC legislation, sought to impose uniform, or at least minimum, rules of corporate law upon all member states. Successful harmonization changes the arena for the exercise of interest group influence from the individual member states to the EC. As such, it encountered a great deal of domestic interest group opposition. The effect so far has largely been deadlock: many of the EC directives that have been adopted, and that are mandatory for the member states, deal with relatively unimportant matters.[106] Whether that is a bad thing is subject to debate. At least some of the directives adopted to date—such as uniform minimum legal capital requirements—might be seen as favoring distributional pressures more than pressures for efficiency, raising the concern that truly comprehensive harmonization might lock in forms of regulation that are seriously inefficient.

More recently, among the EU states a certain degree of regulatory competition—which, in contrast to harmonization, is a 'bottom-up' rather than a 'top-down' process of legal change—has been unleashed by decisions of the European Court of Justice. As we noted earlier, the Court has struck down various efforts by individual states to impose their rules of corporation law on firms operating locally but incorporated in other member states.[107] As a mechanism for market integration, this bypasses the domestic interest groups that have held up legislative harmonization. However, it too may be susceptible to distributional pressures if the person(s) choosing a company's state of incorporation stand to benefit from this decision at the expense of other constituencies. The future path of European company law will be determined in large part by the relative scope that harmonization and regulatory competition are given in the years to come.

A similar though more attenuated tug-of-war between the creation of uniform rules of law at the supra-jurisdictional level and the creation of a uniform *market* for corporate law across jurisdictions via regulatory competition has long been playing out as well among the federated states of the United States. The result has been an uneasy and fluid allocation of corporate law between the federal government on the one hand and the individual states (led by Delaware) on the other. A widely-noted step in this process was taken with the Sarbanes-Oxley Act of 2003 which—in the

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[105] See *infra*, Ch 5 and Ch 10.

[106] See Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 UNIVERSITY OF PENNSYLVANIA JOURNAL OF INTERNATIONAL ECONOMIC LAW 1086 (2006).

[107] See sources cited *supra*, note 73.

wake of the Enron series of corporate scandals—extended federal law to further aspects of corporate governance previously left to the states.

This is principally a book about the structure and functions of corporate law, not about its origins. Nonetheless, in the chapters that follow we will here and there explore, briefly and a bit speculatively, the influence of the forces just surveyed—and of others as well—in shaping the patterns of corporate law that we see across jurisdictions.

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