# The Anatomy of Corporate Law

*A Comparative and Functional Approach*

Third Edition


REINIER KRAAKMAN
JOHN ARMOUR
PAUL DAVIES
LUCA ENRIQUES
HENRY HANSMANN
GERARD HERTIG
KLAUS HOPT
HIDEKI KANDA
MARIANA PARGENDLER
WOLF-GEORG RINGE
EDWARD ROCK

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OXFORD
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Great Clarendon Street, Oxford, OX2 6DP,
United Kingdom

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship, and education by publishing worldwide. Oxford is a registered trade mark of Oxford University Press in the UK and in certain other countries



First edition published in 2004
Third edition published in 2017
Impression: 1



Published in the United States of America by Oxford University Press
198 Madison Avenue, New York, NY 10016, United States of America

British Library Cataloguing in Publication Data
Data available

Library of Congress Control Number: 2016953194

ISBN 978–0–19–872431–5 (pbk.)
ISBN 978–0–19–873963–0 (hbk.)

Printed and bound by
CPI Group (UK) Ltd, Croydon, CR0 4YY



# Acknowledgments

The process of preparing the third edition was eased by the hospitality which we jointly enjoyed from the University of Oxford and the University of Pennsylvania Law School.

As with prior editions, we have drawn shamelessly on our friends and colleagues for comment on various parts of the book. We list them here and apologize in advance to any whom we have omitted: Dan Awrey, Marcello Bianchi, Horst Eidenmüller, Martin Gelter, Sergio Gilotta, Amir Licht, Alessio Pacces, Jenny Payne, Viviane Muller Prado, Lorenzo Stanghellini, Tobias Tröger, Umakanth Varottil, Marco Ventoruzzo, and Andrea Zorzi.

Once again, we should like to thank research centers and our home institutions for providing financial support as we worked on this book. We thank the University of Oxford for funding John Armour, Sofie Cools, Paul Davies, and Luca Enriques, and Martin Bengtzen and Antonios Chatzivasileiadis for research assistance; the Yale Law School for funding Henry Hansmann; the ETH for funding Gerard Hertig; the Harvard Law School John M. Olin Center for Law, Economics, and Business for funding Reinier Kraakman; the Fundação de Amparo à Pesquisa do Estado de São Paulo (FAPESP) and FGV Law School in São Paulo (FGV Direito SP) for funding Mariana Pargendler, and Rafael Bresciani for research assistance; Copenhagen Business School for funding Wolf-Georg Ringe; and the Saul Fox Research Endowment at the University of Pennsylvania Law School for funding Edward Rock who held the Saul Fox Distinguished Professorship in Business Law from 2001 to 2016.

As ever, we thank our nearest and dearest, who may legitimately wonder why such a short book always involves so much toing and froing.

The Authors

# 1

# What Is Corporate Law?

*John Armour, Henry Hansmann, Reinier Kraakman, and Mariana Pargendler*

## 1.1 Introduction

What is the *common structure* of corporate (or company) law across different jurisdictions? Although this question is rarely asked by corporate law scholars, it is critically important for the comparative investigation of the subject. Existing scholarship often emphasizes the divergence among European, American, Japanese, and emerging market corporations in terms of corporate governance, share ownership, capital markets, and business culture.[1] But, despite 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 business participants 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 devotes to defining the corporate form is likely to be only a small part of the statute as a

[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); Bernard S. Black and John C. Coffee, *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 Michigan Law Review 1997 (1994); Varieties of Capitalism (Peter A. Hall and David Soskice eds., 2001); Mark J. Roe, Political Determinants of Corporate Governance (2003); Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US (Klaus J. Hopt et al. eds., 2005); Comparative Company Law: A Case-Based Approach (Mathias Siems and David Cabrelli eds., 2013).

The Anatomy of Corporate Law. Third Edition. Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe, and Edward Rock. Chapter 1 © John Armour, Henry Hansmann, Reinier Kraakman, and Mariana Pargendler, 2017. Published 2017 by Oxford University Press.

whole.[2] 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 that accompany these five features of the corporate form, and that, we believe, have helped to propel the worldwide diffusion of the corporate form.

However, our principal focus in this book is not on the basic attributes that define the corporate form. 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. As we outline in Section 1.2, corporate laws everywhere share core features which can be understood as serving to reduce the costs for participants of organizing their activities in business firms.[3]

Most of corporate law can be understood as responding to three principal sources of opportunism that are endemic to such organization: conflicts between managers and shareholders, conflicts between controlling and non-controlling shareholders, and conflicts between shareholders and the corporation's other contractual counterparties, including particularly creditors and employees. All three of these generic conflicts may usefully be characterized as what economists call "agency problems." 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 tackle those problems.

The reader might object that these three types of coordination costs and agency conflicts are not uniquely "corporate." After all, *any* form of jointly owned enterprise faces coordination costs and engenders 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 functional challenges that confront all jointly owned firms. Nevertheless, the particular characteristics of the corporate form matter a great deal, since it is the form 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.[4] In our view, this is because its particular characteristics make it uniquely effective at minimizing coordination costs. Moreover, these same features determine the particular 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 coordination and agency problems—and thus, making the corporate form practicable—in the most

[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).

[3] These include the costs of searching for contracting partners and negotiating and drafting the relevant agreements. Although such costs are often referred to as "transaction costs," we eschew this term because it is also used more broadly in other contexts, rendering it a fertile source of confusion.

[4] This is because in most jurisdictions, only firms taking the corporate form may raise equity finance from capital markets. However, there are exceptions to this general proposition. 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.



important categories of corporate actions and decisions. More particularly, Chapters 3 to 9 address 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, while 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.

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 coordination costs and agency problems of the corporate form manifest themselves in a 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 laws 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, which we label our "core jurisdictions." These are Brazil, France, Germany, Italy, Japan, the UK, and the U.S., though we sometimes make incidental reference to the laws of other jurisdictions to make particular points. We do not—and cannot, in a short book—attempt to be comprehensive in our coverage of the substantive law; rather we make reference to the laws of these jurisdictions as appropriate to illustrate and develop analytic propositions. In focusing on the jurisdictions we know best, an element of subjectivity is of course introduced. This reflects a heuristic endeavor on our part: the goal is not so much to provide a definitive account of corporate laws anywhere (let alone everywhere), but a common language for understanding them.

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 highlight similarities as well. Doing so illuminates an underlying commonality of structure that transcends national boundaries. It also provides an important perspective on the basis for the international cross-fertilization of corporate law that has become more common in the wake of the growth of global economic activity.

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 it justifiably

[5] Compare e.g. The Legal Basis of Corporate Governance in Publicly Held Corporations: A Comparative Approach (Arthur R. Pinto and Gustavo Visentini eds., 1998); Gunther H. Roth and Peter Kindler, The Spirit of Corporate Law (2013).

[6] Other examples of this approach include John Armour et al., Principles of Financial Regulation (2016); Gregor Bachmann et al., Regulating the Closed Corporation (2012); Curtis Milhaupt and Katharina Pistor, Law and Capitalism (2008).

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 the U.S.—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 methodology. We need simply note that the exigencies of commercial activity and organization present practical problems that are roughly similar in 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.

Nor does emphasizing similarities in underlying structure mean ignoring differences between countries' corporate laws. Even if, as we think, corporate laws everywhere respond to similar economic problems, there may be differences in the way they do so, often reflecting local variety in the way other aspects of the system of economic production are organized.[8] The basis for such differences in corporate law rules is consequently illuminated by reference to the broader economic environment. Yet in other cases, differences may result from the various concerns of domestic politics over distribution or from diverse interest group dynamics. Our unitary account cannot explain the presence of such differences, but it does have implications for their persistence. To the extent that such matters impede corporate law's ability to respond to economic exigencies, they will in time face economically motivated pressure for reform.

That said, we take no strong stand here in the enduring debate on the extent to which corporate law is or should be "converging," much less on to what it might converge.[9] That is a subject on which reasonable minds (including, indeed, the authors of this book) can reasonably disagree.[10] Rather, we are seeking to set out a conceptual

[7] In very general terms, our approach echoes that taken by 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. Most obviously, we both present a comparative analysis that addresses the corporate law of multiple jurisdictions and 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.

[8] See Section 1.6.

[9] See e.g. CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon and Mark J. Roe eds., 2004), COMPARATIVE CORPORATE GOVERNANCE: A FUNCTIONAL AND INTERNATIONAL ANALYSIS (Andreas M. Fleckner and Klaus J. Hopt eds., 2013).

[10] 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); Henry Hansmann and Reinier Kraakman, *Reflections on the End of History for Corporate Law*, in CONVERGENCE OF CORPORATE GOVERNANCE: PROMISE AND PROSPECTS (Abdul Rasheed and Toru



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?

As anticipated, 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 equity 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 especially 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."[11] 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. 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. The first and most important contribution of corporate law, as of other forms of organizational law, is to permit a firm to serve this coordinating role by operating 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 civil lawyers refer 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),[12] and of which the firm itself, acting through its designated managers, is viewed in law as being the owner. The firm's entitlements of ownership over its designated assets include

Yoshikawa eds., 2012); John Armour, Simon Deakin, Priya Lele, and Mathias Siems, *How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection*, 57 AMERICAN JOURNAL OF COMPARATIVE LAW 579, 619–29 (2009); and Mariana Pargendler, *Corporate Governance in Emerging Markets*, in OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey N. Gordon and Wolf-Georg Ringe eds., 2017).

[11] 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).

[12] We use the term "owners" simply to refer to the group who have the entitlement to control the firm's assets. For an account of how this relates to the legal concept of "ownership" see John Armour and Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD JOURNAL OF LEGAL STUDIES 429, 436–48 (2007).

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 owners' personal creditors. 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.[13]

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 modern legal forms for enterprise organization, including partnerships.[14] The consequence of this priority rule is that a firm's assets are, as a default rule of law,[15] automatically made available for the enforcement of contractual liabilities entered into in the name of the firm.[16] 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, nor can the personal creditors of an individual owner foreclose on the owner's share of firm assets.[17] Such withdrawal or foreclosure would force partial or complete liquidation of the firm. So the liquidation protection rule serves to protect the going concern value of the firm against destruction by individual shareholders or their creditors.[18] In contrast to the priority rule just discussed, it is not found in some other standard legal forms for enterprise organization, such as the partnership.[19] 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 usually characterized only by the priority rule and not by liquidation protection. By isolating the value of the firm from the personal financial affairs of the firm's owners, strong-form entity shielding facilitates tradability of the firm's shares, which is the third characteristic of the corporate form. [20]

[13] 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 Role of Organizational Law*, 110 Yale Law Journal 387 (2000), where this same attribute was labelled "affirmative asset partitioning."

[14] While even unregistered common law partnerships are subject to this priority rule, many civil law jurisdictions recognize a class of unregistered "partnerships" that lack this rule of priority. In effect, such partnerships are just special forms for the joint management of assets rather than distinct entities for purposes of contracting.

[15] On default rules, see Section 1.4.1.

[16] 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 entity, and then procuring the company to enter into the contract.

[17] Hansmann and Kraakman, note 13, at 411–13.

[18] 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).

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

[20] While strong-form entity shielding seems essential for free tradability of shares (see Hansmann and Kraakman, note 13), 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 Henry Hansmann and Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale Law Journal 1879 (1991); Charles R. Hickson and John D. Turner, *The Trading of Unlimited Liability Bank Shares in Nineteenth-Century Ireland: The Bagehot Hypothesis*, 63 Journal of Economic History 931 (2003).



The benefits of these two rules—creditor priority and liquidation protection—reinforce one another where the "assets" in question comprise contractual agreements.[21] An increasingly important part of a firm's value creation comes from the interaction of the various contracts it has negotiated. These two rules assure counterparties that their performance will be delivered by reference to the value generated by that bundle of contracts and the associated assets, amongst which there will typically be complementarities. Not only does this make it easier to negotiate such contracts, but it also facilitates liquidity on the part of shareholders. It is far easier for the owner of a corporation to transfer her shares than it would be for a sole proprietor to transfer her contracts.

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.[22] While participants in a firm are to a large extent 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 governing the corporation are treated below as a separate core characteristic, "delegated management." They provide that a subset of corporate managers (such as the board of directors or certain officers), as opposed to individual owners, has power to bind the company in contract.[23]

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 plagued the Anglo-American partnership until the late nineteenth 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 doctrines, they could not be replicated simply by contracting among a business's owners and their suppliers and customers. That is, the law here serves to reduce the costs of doing business. 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.[24] Rules governing the allocation

[21] Kenneth Ayotte and Henry Hansmann, *Legal Entities as Transferable Bundles of Contracts*, 111 Michigan Law Review 715 (2013).

[22] Armour and Whincop, note 12, at 441–2.

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

[24] 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, note 13, at 407–9.

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.[25] 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, almost all of 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.[26]

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—that 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 these rules,[27] but merely a handy label for a package that conveniently bundles them together. Although it is common in the legal literature to extend syllogistic deduction from the premise of legal personality to the existence of other characteristics of "personhood" beyond the three foundational features we have described in this section, such as ethnicity,[28] or the protected enjoyment of civil rights,[29] we see no functional rationale that compels this.

### 1.2.2 Limited liability

The corporate form effectively provides 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 (or "owned by") the firm itself, and have no claim against assets that the firm's shareholders hold in their own names. While this rule of "limited liability" was not, historically, always associated with the corporate form,[30] the association

[25] 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, note 12, at 442–7.

[26] See Hansmann and Kraakman, note 13, at 407–9. The exception is limited shareholder liability to corporate tort victims. See Section 1.2.2.

[27] 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, note 12, at 460–1; *Burnes v. Pennell* (1849) 2 HL Cas 497, 521; 9 ER 1181, 1191; PD 7A, para. 5A Civil Procedure Rules (UK).

[28] Richard R.W. Brooks, *Incorporating Race*, 106 Columbia Law Review 2023 (2006).

[29] *See Cnty. of Santa Clara v. S. Pac. R.R. Co.*, 118 United States Reports 394 (1886), and, more recently, *Burwell v. Hobby Lobby*, 134 Supreme Court Reporter 2751 (2014).

[30] For example, limited liability was not a standard feature of the English law of joint stock companies until the mid-nineteenth century, and in California, shareholders bore unlimited personal liability for corporation obligations until 1931. See e.g. Paul L. Davies, Gower and Davies' Principles of Modern Company Law 40–6 (6th edn., 1997); Phillip Blumberg, *Limited Liability and Corporate Groups*, 11 Journal of Corporate Law 573 (1986).



has over time become nearly universal. This evolution indicates strongly the value of limited liability as a contracting tool and financing device.

Limited liability shields the firm's owners—the shareholders—from creditors' claims. Importantly, this facilitates diversification.[31] With unlimited liability, the downside risk borne by shareholders depends on the way the business is carried on. Shareholders will therefore generally prefer to be actively involved in the running of the business, to keep this risk under control. This need to be "hands-on" makes investing in multiple businesses difficult. Limited liability, by contrast, imposes a finite cap on downside losses, making it feasible for shareholders to diversify their holdings.[32] It lowers the aggregate risk of shareholders' portfolios, reducing the risk premium they will demand, and so lowers the firm's cost of equity capital.

The "owner shielding" provided by limited liability is the converse of the "entity shielding" described above as a component of legal personality.[33] 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, these forms of asset shielding (or "asset partitioning") ensure that 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.[34] As creditors of the firm commonly have a comparative advantage in evaluating and monitoring the value of the firm's assets, and an owner's personal creditors are likely to have a comparative advantage in evaluating and monitoring the individual's personal assets, such asset shielding can reduce the overall cost of capital to the firm and its owners. It also permits firms to isolate different lines of business—and focus creditors' monitoring efforts accordingly—by incorporating separate subsidiaries.[35]

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 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. 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.

[31] Henry Manne, *Our Two Corporation Systems: Law and Economics*, 53 Virginia Law Review 259, 262 (1967).

[32] "Unlimited liability" would ordinarily be joint and several amongst business owners. In terms of the incentives discussed in the text, a form of liability that is imposed pro rata to the number of shares held—but without pre-agreed limitation—falls somewhere between this and the case of fully limited liability. Shareholders with pro rata liability can reduce their downside exposure either by holding only a small stake—hence facilitating diversification—or by exerting control over the way the business is run: see Hansmann and Kraakman, note 20.

[33] Hansmann, Kraakman, and Squire, note 13. 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.

[34] By "creditors" we mean here all persons who have a contractual claim on the firm, including employees, suppliers, and customers.

[35] Of course, asset shielding through group structures 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 Chapter 5.2.1.3.

### 1.2.3 Transferable shares

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.[36] This in turn enhances the liquidity of shareholders' interests and makes it easier for shareholders to construct and maintain diversified investment portfolios.

Transferability of shares is the flipside of the liquidation protection that the corporation's legal personality assures to its contractual counterparties. Precisely because counterparties can be confident that the "bundle of contracts" that constitutes the firm will be kept together, there is no need for a rule requiring owners to continue to participate. In the absence of a legal entity—that is, if the owner contracts as sole proprietor—then counterparties would be concerned that assignment of their contracts would reduce the value of their expected performance and hence wish to restrict it. It is precisely for these reasons that all jurisdictions have a default rule prohibiting the assignment of most contracts without the prior consent of the other contracting party. At the same time, however, these consent requirements make it more difficult for the owner to sell the business and liquidate her investment. Legal personality addresses these problems by enabling the simultaneous transfer of all, but no less than all, of a firm's contracts by transferring the corporation's shares. In other words, it permits the free transferability of all of a firm's contracts taken together ("bundle assignability"), while preserving the general default rule that makes individual contracts non-assignable without consent of the contractual counterparty.[37]

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 a stock 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

36 See Henry Hansmann, The Ownership of Enterprise 152–5 (1996).

37 Ayotte and Hansmann, note 21. To be sure, the parties to individual contracts may—and at times do—opt out of such a general rule of bundle assignability by requiring counterparty consent in the event of a change of control of the firm.



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 "closed" 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 stock exchanges. Conversely, it is common in some jurisdictions to find corporations which, though their shares are not freely tradable, have hundreds or thousands of shareholders, and 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 features, 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 difficult for potential purchasers to judge.[38] Ensuring a single price for shares, independent of the wealth of the purchaser, permits securities markets to aggregate information about the firm's expected future performance through its stock price.[39] Moreover, 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, 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.[40] For example, the default rules applicable to general partnership forms usually grant power to a majority of partners to manage the firm in the ordinary course of business, while more fundamental decisions require unanimity. Both aspects of this allocation are unworkable for business corporations with numerous and constantly changing owners, because of information and

38 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).

39 Ibid. See also Chapter 9.1.1.

40 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 (text accompanying notes 22–3). Because there is often overlap in practice between the scope of such external authority and the internal division of power to control assets, the former, unlike the latter, cannot be based purely on agreement between participants in the firm, but rather must be designated to some degree by rules of law. The underlying problem being 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 (and presumably large) firms, in which it is advantageous to let multiple shareholders, creditors, and other third parties know the allocation of authority without incurring the cost of reading the charter, the law is generally more rigid in designating the allocation of authority.

coordination costs.[41] Consequently, corporate law typically vests principal authority over corporate affairs in a board of directors or similar body 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 generally delegated to a board of directors that has four basic features.

First, the board is, at least as a formal matter, separate from the operational managers of the corporation.[42] 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 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.[43]

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, which 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 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[44]—the evident reason being that, for a very small corporation, most of the

[41] See Clark, note 7, at 23–4 and 801–16; Sofie Cools, *The Dividing Line Between Shareholder Democracy and Board Autonomy*, 11 European Company and Financial Law Review 258, 272–3 (2014).

[42] 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 (supervisor) tier, which is at least nominally independent from the firm's hired officers (i.e. from the firm's senior managerial employees, though employees may sit in the codetermined supervisory boards). See Chapter 3.1.

[43] See Eugene Fama and Michael Jensen, *Agency Problems and Residual Claims*, 26 Journal of Law and Economics 327 (1983).

[44] This is true not only of most statutes designed principally for private 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), Italy (Art. 2380–II Civil Code), and the U.S. state of Delaware, § 141(b) Delaware General Corporation Law.



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 equity 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 statutes generally provide for this allocation of control and earnings as the default rule.[45]

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.[46] 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).

The facilitation of investor ownership became a feature of the corporate form only in the second half of the nineteenth century. Until then, both investor- and consumer-owned firms worldwide had been routinely organized under a single corporate form.[47] The subsequent specialization toward investor ownership followed 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.[48] Another is that investors of capital have (or, through the design of their shares, can be induced to have) relatively homogeneous interests among themselves, hence reducing—though definitely not eliminating—the potential for costly conflict among those who share governance of the firm.[49]

[45] For a recently enacted rule providing for a different default (double voting rights for longer term shareholders in French listed corporations), see Chapter 4.1.1.

[46] 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, note 36.

[47] Henry Hansmann and Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption*, 123 Yale Law Journal 948 (2014).

[48] See e.g. Oliver Williamson, *Corporate Governance*, 93 Yale Law Journal 1197 (1984).

[49] See Hansmann, note 36. For a discussion of the consequences of different risk preferences of diversified and undiversified investors, see John Armour and Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 Journal of Legal Analysis 35, 50–6 (2014).

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 employed 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 of 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 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 closed corporations. Nevertheless, the default rules of corporate law continue to be 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 are a good example.[50]

There has been further specialization even amongst investor-owned companies, with the recent emergence of special forms of "public benefit" or "community interest" corporations designed to accommodate the needs of hybrid firms that, while investor owned, also commit to the pursuit of a specified social objective.[51] In other instances, state-owned enterprises (SOEs) embrace the corporate form, hence permitting the government to share ownership with private investors. Because the state is seldom, if ever, a typical financial investor, state ownership entails a degree of heterogeneity in the shareholder base that exceeds that of the typical investor-owned firm, with potential for unique conflicts of interest.[52] Sometimes core corporate law itself deviates from the assumption of investor ownership to permit persons other than investors of capital—for example, creditors or employees—to participate in either control or profit-sharing, 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 central controversies in corporate law, which we address 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 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—even though a number of successful industrial

[50] 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).

[51] See e.g. Jesse Finfrock and Eric L. Talley, *Social Entrepreneurship and Uncorporations*, 2014 Illinois Law Review 1867; Regulator of Community Interest Companies (UK), Annual Report 2013/2014 (2014).

[52] See e.g. Mariana Pargendler, Aldo Musacchio, and Sergio G. Lazzarini, *In Strange Company: The Puzzle of Private Investment in State-Controlled Firms*, 46 Cornell International Law Journal 569 (2013).



firms around the world are organized as nonprofits.[53] Thus, when we use the term "corporation" in this book, we refer only to the business corporation, and not to cooperative corporations, nonprofit corporations, municipal corporations, or 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. Nevertheless, corporate law as we understand it here—in functional terms—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 or limited liability companies. These forms—including the Brazilian Ltda, the French SARL, the German GmbH, the Italian Srl, the Japanese *godo kaisha*, the American limited liability company, and the UK private company[54]—typically exhibit most of the canonical features of the corporate form. They differ from open, or "public," companies chiefly because their shares, though generally 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 favor of direct management by shareholders.[55] 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 recently been added to the forms available in the law of the U.S., Japan, and some European jurisdictions. This form simply grafts limited liability onto the traditional general partnership. U.S. and UK law now allow a limited partnership to have something close to strong-form entity shielding (by limiting the rights of partners or their creditors to force liquidation).[56] Consequently, with appropriate governance provisions in the partnership agreement, it is effectively possible to create a closed corporation as a limited liability partnership.

[53] On the so-called "industrial foundations," see Steen Thomsen and Henry Hansmann, *Managerial Distance and Virtual Ownership: The Governance of Industrial Foundations*, Working Paper (2013), at ssrn.com.

[54] 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.

[55] See note 44.

[56] See Hansmann, Kraakman and Squire, note 13, at 1391–4.

The U.S. statutory business trust offers another example. It provides for 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.[57] With appropriate charter provisions, a statutory business trust can be made equivalent to 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 most or all of the core corporate characteristics. Although we make occasional reference to some of these forms to underscore certain peculiarities, the description of our core jurisdictions' corporate laws in Chapters 3 to 9 focuses mainly on public corporations.

### 1.3.2 Other bodies of law

There are bodies of law that, at least in some jurisdictions, are contained in statutes or case law that are separate from the core corporation statutes, and from the special and quasi-corporation statutes just described, but that are nonetheless instrumental to the functioning of the five core characteristics of the corporate form or to addressing the corporate agency problems we describe in Chapter 2. Hence, 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 common ownership, seeking to protect the creditors and minority shareholders of corporations with controlling shareholders. Although the *Konzernrecht*—touched upon in more detail in Chapters 5 and 6—is embodied in statutory law that is formally distinct from the corporation statutes and case law, 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 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,[58] and sometimes 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.[59] 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.

[57] 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.

[58] A claim strongly put by Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 Vanderbilt Law Review 859 (2003).

[59] 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 then, it has enjoyed



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 discuss those 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.[60] 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.[61] By explicit or implicit reference, the charter can also become part of the contract between the firm and its employees or creditors. One or more shareholders' agreements may, in addition, bind some or all of a corporation's shareholders.

At the same time, corporations are the subject of a large body of statutory law. 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 few exceptions, 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. Indeed, this was the approach taken by the numerous unincorporated joint stock companies formed in England during the eighteenth and early nineteenth 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.[62] Why, then, do we today

formal statutory authority (Part 28 Companies Act 2006 (UK)), and so is no longer, strictly speaking, "self-regulatory."

[60] § 162(m) Internal Revenue Code (U.S.).

[61] 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.

[62] Ron Harris, Industrializing English Law (2000); Hansmann, Kraakman, and Squire, note 13.

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.[63]

A significant part of corporate law—more in some jurisdictions, less in others—consists of default provisions.[64] 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 saves costs—specifically, it simplifies contracting among the parties involved by 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.[65]

Default provisions can be supplied in a variety of ways, the choice of which affects the ease and means of "contracting around" them.[66] A common form of corporate law default is a statutory provision that will govern unless the parties explicitly provide an alternative. The common provision that each share carries one vote is an example. A charter clause can deviate from that default by, for instance, providing for the issuance of a class of stock carrying no voting right.

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.[67] In other words, the law in this case gives the corporation a choice between two statutory provisions: one is the default and the other 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, such as by requiring minority approval to alter default rules that protect their interests.[68] 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 specified rules.[69]

[63] See generally the papers in the symposium edition entitled *Contractual Freedom and Corporate Law*, in 89 Columbia Law Review 1395–774 (1989).

[64] They are "defaults" in the sense that they apply (as with computer settings) "in *default*" of the parties stipulating something else.

[65] Easterbrook and Fischel, note 7, at 34–5.

[66] The ease with which parties can "contract around" a default provision will affect the way it operates. For a nuanced discussion of these and other issues, see Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale Law Journal 2032 (2012). For an empirical perspective, see Yair Listokin, *What do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 Journal of Empirical Legal Studies 279 (2009).

[67] See Art. 225-57 Code de commerce.

[68] See Lucian A. Bebchuk and Assaf Hamdani, *Optimal Defaults For Corporate Law Evolution*, 96 Northwestern University Law Review 489 (2002).

[69] Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 Virginia Law Review 757, 839–41 (1995).



There are also important rules of corporate law that are mandatory.[70] 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.[71] The rationale for mandatory terms of these types is usually based on some form of "contracting failure": some parties might otherwise be exploited because they are not well informed; the interests of third parties might be affected; or collective action problems might otherwise lead to contractual provisions that are inefficient or unfair.[72] Mandatory terms may also serve a useful standardizing function, in circumstances (such as with 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.[73] 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. Second, even with respect to a particular type of legal entity, such as the publicly traded business corporation, the organizers of a firm may often choose among different jurisdictions' laws. This leads us to the general issue of choice of law and the related debate about "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 The benefits of legal rules

Default rules of corporate law do more than simply provide convenient standard forms, encourage revelation of information, and facilitate choice of the most efficient 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 necessarily *incomplete*. Situations will arise for which the

[70] See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Columbia Law Review 1549 (1989).

[71] See Chapter 4.2.1 (codetermination) and 6.2.1 and 9.1.1 (disclosure).

[72] See generally Michael J. Trebilcock, The Limits of Freedom of Contract (1993).

[73] 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).

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, by either altering or interpreting existing rules. This is the *gap-filling* role of corporation law.

Courts play a key role in filling gaps, simply by interpreting privately drafted contractual terms in a corporation's charter. A firm will get the greatest advantage from the courts' interpretive activity if it adopts standard charter terms used by many other firms, since those standard terms are likely to be subject to repeated interpretation by the courts.[74] And the most widely used standard charter terms are often the default rules embodied in the corporation law. So, another advantage of sticking to the default provisions, rather than drafting specialized charter terms, is to benefit from 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.[75] This is one example of a *network effect* that creates an incentive to choose a common approach.[76]

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 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.[77]

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. The most empirically significant dimensions of selection lie in the ability 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.

[74] Ian Ayres, *Making A Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 University of Chicago Law Review 1391, 1403–8 (1992).

[75] Klausner, note 69, at 826–9.

[76] 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).

[77] See Henry Hansmann, *Corporation and Contract*, 8 American Law and Economics Review 1 (2006).



### 1.4.3 Choice of legal regime

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 U.S., 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 fifty individual states (or any foreign country), regardless of where the firm's principal place of business, or other assets and activities, are located. That form of choice, long available within the U.S. and in a number of other countries as well, has now been largely extended to entrepreneurs throughout the European Union as a consequence of European Court of Justice decisions requiring the domestic recognition of corporations formed in other member states adopting the place of incorporation rule.[78] These denied the efficacy of 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.[79]

The consequence of choice amongst jurisdictions is not simply to enlarge the range of governance rules from which a given firm can choose. It also creates the opportunity 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 that jurisdiction's corporate law attractive. This permits the emergence of corporate law systems that are driven primarily by market forces based on companies' demand, and less influenced by other political forces that typically shape democratic lawmaking.[80] Whether such "regulatory competition" exists at all—and if it does, whether it is a good thing—has long been the subject of vigorous debate.[81] 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 of protections for constituencies who do not control the (re)incorporation decision. Optimists argue that, on the contrary, regulatory competition in corporate law creates a virtuous "race to the

[78] Case C-212/97, *Centros Ltd v. Erhverss-og Selskabsstyrelsen* [1999] European Court Reports I-1459; Case C-208/00, *Überseering BV v. Nordic Construction Company Baumanagement GmbH* (NCC) [2002] European Court Reports I-9919; Case C-167/01, *Kamel van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd* [2003] European Court Reports I-10155; Case C-210/06, *Cartesio Oktató és Szolgáltató bt* [2008] European Court Reports I-9641; Case C-378/10 *VALE Építési kft* ECLI:EU:C:2012:440. See Marco Becht, Colin Mayer, and Hannes F. Wagner, *Where Do Firms Incorporate? Deregulation and the Cost of Entry*, 14 Journal of Corporate Finance 241 (2008); John Armour and Wolf-Georg Ringe, *European Company Law 1999–2010: Renaissance and Crisis*, 48 Common Market Law Review 125, 131–43. The position as respects change of corporate law for existing companies is more complex: see ibid., 158–69.

[79] However, insolvency law rules are more likely to be applied according to the place of business: see Art. 3(1) and preamble para (30) Regulation (EU) 2015/848, 2015 O.J. (L 141) 19; Case C-341/04 *Eurofood IFSC ltd* [2006] European Court Reports I-3813; Case C-306/09 *Re Interedil Srl* [2011] European Court Reports I-9915; Case C-594/14 *Kornhaas v Dithmar* ECLI:EU:C:2015:806.

[80] See Section 1.6; Ronald J. Gilson, Henry Hansmann, and Mariana Pargendler, *Corporate Chartering and Federalism: A New View*, Working Paper (2015).

[81] On the existential question, see e.g. Marcel Kahan and Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stanford Law Review 679 (2002); Luca Enriques, *EC Company Law and the Fears of a European Delaware*, 15 European Business Law Review 1259 (2004).

top"; because the capital markets price, more or less accurately, the effects of corporate law choice, the state that wins is that whose law maximizes shareholder welfare.[82]

Of course, there is dispute as to what constitutes an "optimal" body of corporate law, even in theory—a topic to which we will turn shortly. Yet an important benefit associated with the existence of *choice* among multiple regulatory regimes is that it creates opportunities for regulatory experimentation. That is, diverse legal regimes serve as laboratories from which regulators and firms can learn more about the merits and drawbacks of different modes of regulation.[83] Moreover, there is unlikely to be a single optimal body of corporate law applicable to all firms, since companies vary in their needs for regulation. Choice among jurisdictions (or statutory menus) therefore enables diverse legal regimes to cater to the needs of different types of firms.[84] While much of the literature on regulatory competition tends to assume corporate law is a single uniform commodity, this is not always what we observe in practice.[85]

Finally, even if the optimal corporate law regime were uniform and known to parties, the existence of dual—or even multiple—regulatory regimes might be justified by reference to politics. Reform of inefficient rules may be blocked by powerful interests—such as those of managers, controlling shareholders, or workers—who benefit from the status quo. In such instances, framing a reform as voluntary can disable opposition by creating a more efficient parallel regime which, because it only applies to those who opt into it, does not impinge on the entitlements of incumbents. Both the establishment of the Novo Mercado premium listing segment in Brazil and certain EU measures such as the creation of the European Company (*Societas Europaea—SE*) can be interpreted as bypassing the political clout of interest groups in existing companies.[86]

## 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 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

[82] 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). For a recent review of this literature, see Roberta Romano, *The Market for Corporate Law Redux*, in Oxford Handbook of Law and Economics (Francesco Parisi ed., 2015).

[83] See Simon Deakin, *Regulatory Competition Versus Harmonization in European Company Law* in Regulatory Competition and Economic Integration 190, 216–17 (Daniel Esty and Damien Gerardin eds., 2001).

[84] See John Armour, *Who Should Make Corporate Law? EC Legislation versus Regulatory Competition*, 58 Current Legal Problems 369 (2005).

[85] See K.J. Martin Cremers and Simone M. Sepe, *The Financial Value of Corporate Law: Evidence from (Re)incorporations*, Working Paper (2015), at ssrn.com; Jens Dammann and Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 Journal of Law, Economics, and Organization 79 (2011).

[86] Ronald J. Gilson, Henry Hansmann, and Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 Stanford Law Review 475 (2011).



the natural environment.[87] This is what economists would characterize as the pursuit of overall social welfare.

At least in theory, however, the pursuit of overall social welfare may be compatible with different immediate goals for corporate law. One view is that corporate law best advances social welfare by reducing the costs of contracting among the corporation's contractual constituencies—which include not only managers and shareholders but also certain creditors and employees. The underlying assumption is that any externalities that the corporation generates are best addressed by regulatory constraints from other areas of law. Indeed, legal strategies designed to maximize the value of firms adopting the corporate structure constitute both the lion's share of corporate law as it is generally understood and the primary object of our analysis.

It is sometimes said that the goals of core corporate law should be even 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[88] 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 interpretation of statements by legal scholars and economists asserting that shareholder value is the proper object of corporate law.

We should keep in mind, as well, that to say that shareholder value is the principal objective toward which corporations should be managed is not to say that the corporation should maximize pecuniary profits regardless of the means employed. In particular, an unappealing implication of the unrestrained pursuit of profit is that firms should not take the legal regime as pre-determined, but instead become actively involved in seeking to relax rules that constrain their imposition of externalities.[89] Such corporate influence in the rule-making process is clearly problematic, and to the extent

[87] We speak here of maximizing the "aggregate welfare" of society more as a loose metaphor than a precise yardstick. 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.

[88] 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.

[89] For firms in industries subject to regulation to control externalities, corporate political spending is universal: John C. Coates IV, *Corporate Politics, Governance, and Value Before and After* Citizens United, 9 Journal of Empirical Legal Studies 657 (2012).

that regulation is consequently compromised, it may be appropriate for corporate law to seek to modify internal governance arrangements accordingly.[90]

How generally the pursuit of shareholder value is 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.

Another view is that, given the prominent role of the business corporation in the modern economy, corporate law can be harnessed to promote social welfare directly through more tailored interventions, for example by imposing socially oriented disclosure obligations or molding the corporation's internal governance arrangements to address broader social problems. From this perspective, corporate law may be used to promote economic or social objectives beyond maximizing the value of the firm, such as reducing systemic risk, mitigating gender inequity, or protecting the environment.[91] Although as old as corporate law itself,[92] the deployment of corporate law to protect the interests of parties external to the firm has found renewed favor among lawmakers in the wake of the recent financial crisis. We consider some examples of this in Chapter 4, but otherwise concentrate on the role of corporate law in maximizing the value of the firm by protecting the interests of its contractual constituencies.

## 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 pursues it in the same way. The particular contours of the problems to which corporate law responds may be, at least in part, determined by other aspects of the corporate governance environment—for example, predominant industry type, institutions governing employee relations, and the structure of share ownership. These may consequently *complement* particular features of corporate law.[93] Similarly, other features of the environment—for example, the quality of legal institutions—may make certain aspects of corporate law more or less effective in performing these functions. In each case, these point to particular ways in which corporate law can enhance social welfare—the selection of which might be termed an "efficiency" effect on corporate law.

[90] Leo E. Strine, Jr. and Nicholas Walter, *Conservative Collision Course: The Tension between Conservative Law Theory and Citizens United*, 100 Cornell Law Review 335 (2015).

[91] By far the most popular means to protect interests external to the firm is through the imposition of substantive rules or standards of different stripes (as those of antitrust law, environmental laws, human rights laws, antidiscrimination laws, financial regulation, etc.). For our purposes, as in general parlance, the use of legal rules for purposes other than increasing the value of the firm is the boundary separating corporate from other areas of law. On the use of corporate governance to address a variety of economic and social problems, see Mariana Pargendler, *The Corporate Governance Obsession*, 42 Journal of Corporation Law 101 (2016).

[92] See e.g. Herbert Hovenkamp, Enterprise and American Law, 1836–1937, 63–4 (1991); Hansmann and Pargendler, note 47, at 145.

[93] For instance, an educational system that favors vocational and firm-specific training will work best under a labor law regime that protects employees against dismissal and under a system of corporate finance that is more relational and immune to short-term oscillations in market conditions. Germany traditionally embodied this institutional bundle. In the U.S., by contrast, a labor regime of at-will employment favors a more generalist style of education and facilitates vibrant capital markets subject to dispersed ownership and hostile takeovers. See Hall and Soskice, note 1.



Nor indeed does saying that the pursuit of social welfare is the appropriate goal of corporate law imply that corporate law always does serve that goal. Understanding how corporate law comes to pursue particular goals is a question of political economy—that is, the political and economic forces that shape lawmaking.[94] The political economy of corporate law generally reflects the interests of influential constituencies, such as controlling shareholders, corporate managers, or organized workers. In the presence of competitive markets, these interests often coalesce on welfare-enhancing laws, producing the "efficiency" effect on corporate law. Yet in some circumstances, lawmakers pay undue regard to the interests of particular constituencies, a fondness for which might be termed a "political" effect on corporate law.

Another political effect is the phenomenon of populist reforms after a scandal or crisis. In the period after a crisis, lawmakers feel strong pressure from the electorate to implement reforms, the content of which is determined by what appeals generally, which may be quite different from what will actually solve the underlying economic problems.[95] The extent to which there is a divergence is another political effect on corporate law. Corporate law everywhere continues to bear the imprint of the historical path through which it has evolved, reflecting both political and efficiency effects along the way.

Reforms triggered by the recent financial crisis illustrate both efficiency and political concerns. In the immediate aftermath of the crisis, many asked whether it did not call into question effectiveness of corporate law in promoting social welfare.[96] As the dust settled, it became tolerably clear—at least to us—that the implications of the crisis were mostly confined to the governance regimes applicable to banks and other financial institutions,[97] which have an unusual degree of interconnection and propensity to contagion. Consequently, there are good functional reasons for introducing special regimes for bank governance that differ from ordinary business firms. However, some post-crisis reforms have been more general in their scope—which may be understood as reflecting populist political concerns triggered by the crisis.[98]

We touch here briefly on perhaps the most conspicuous of the various forces that help shape—and, in turn, are shaped by—corporate law: the pattern of corporate ownership. The nature and number of corporate shareholders differ markedly even among the most developed market economies. In recent years, the extent of these differences has lessened, but their historic and remaining contours surely leave a mark on the structure of corporate law. Its relevance for our account is twofold: ownership structure affects the functionality of different legal strategies, and also the interest group dynamics that govern changes in 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.[99] Shareholdings among

[94] See e.g. Mark J. Roe, Political Determinants of Corporate Governance (2003); Peter A. Gourevitch and James Shinn, Political Power and Corporate Control (2005).

[95] See Pepper D. Culpepper, Quiet Politics and Business Power (2011).

[96] For a discussion of the goals of corporate law, see Section 1.5.

[97] See Armour and Gordon, note 49; Armour et al., note 6, ch 17.

[98] See e.g. Roberta Romano, *Regulating in the Dark*, 1 Journal of Financial Perspectives 23 (2013).

[99] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *Corporate Ownership Around the World*, 54 Journal of Finance 471, 492–3 (1999); Mara Faccio and Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 Journal of Financial Economics 365, 379–80 (2002). But see Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 Review of Financial Studies 1377 (2009).

major Japanese firms are also often highly dispersed,[100] though in the second half of the twentieth 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.[101] In our other jurisdictions, in contrast, even firms with publicly trading shares have traditionally had a *controlling shareholder*, in the form of another firm often at the top of a closely coordinated group of other firms,[102] individuals, families, or the state.[103]

The types of entities by or through which non-controlling stakes are held also differ substantially from one country to another. The U.S. traditionally had high levels of ownership by *retail investors*. In contrast, UK stock ownership in the late twentieth century was dominated by *institutional investors*—primarily domestic pension funds and insurance companies.[104] In Germany, large commercial banks traditionally held substantial blocks of shares 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.[105]

However, this pattern has changed in recent years. A secular growth in assets under management by U.S. institutional investors—principally mutual funds and employer-established pension funds[106]—means their ownership of stock now dwarves that of retail investors. This growth has also led U.S. institutions to invest in other stock markets around the world. Thus in the UK, domestic institutions have, since the turn of the century, ceded ownership of the majority of stock to international investors, thought to be mainly U.S. institutions.[107] In Germany, many large companies also now have a majority of foreign shareholders. And even elsewhere international investors hold a substantial chunk of listed companies' free float. While there is a certain degree of convergence in ownership structures across jurisdictions, there is arguably greater variance in the shareholding patterns of different firms within any given jurisdiction.

The past two decades have also seen the rise of new types of institutional investor. Conspicuous among these are *hedge funds* and *private equity funds*. Hedge funds are

[100] By some accounts, share ownership in Japanese publicly held corporations is more dispersed than in the U.S.: see Holderness, note 99; Julian Franks, Colin Mayer, and Hideaki Miyajima, *The Ownership of Japanese Corporations in the 20th Century*, 27 Review of Financial Studies 2580 (2014).

[101] See Tokyo Stock Exchange, 2013 Share Ownership Survey, 4 (2014); Franks et al., note 100, at 29–40. For recent unwinding of cross-shareholdings, see Gen Goto, *Legally "Strong" Shareholders of Japan*, 3 Michigan Journal of Private Equity and Venture Capital 125, 144–6 (2014).

[102] However, there are indications that the traditional position in some jurisdictions, notably Germany, is starting to change in favor of more dispersed stock ownership: see Steen Thomsen, *Convergence of Corporate Governance during the Stock Market Bubble: Towards Anglo-American or European Standards?* in Corporate Governance and Firm Organization 297, 306–12 (Anna Grandori ed., 2004); Wolf-Georg Ringe, *Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG*, 63 American Journal of Comparative Law 493 (2015).

[103] See Alexander Aganin and Paolo Volpin, *The History of Corporate Ownership in Italy*, in A History of Corporate Governance Around the World (Randall K. Morck ed., 2005); Mariana Pargendler, *State Ownership and Corporate Governance*, 80 Fordham Law Review 2917 (2012); Aldo Musacchio and Sergio Lazzarini, Reinventing State Capitalism: Leviathan in Business, Brazil and Beyond (2014).

[104] See Geof P. Stapledon, Institutional Shareholders and Corporate Governance (1996).

[105] 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). See also sources cited note 102.

[106] Board of Governors of the Federal Reserve System, Flow of Funds Accounts in the United States: Annual Flows and Outstandings, 2005–13, 98 (Table L.213) (2014).

[107] Office for National Statistics (UK), Ownership of UK Quoted Shares, 2013 (2014).



relatively unregulated collective investment funds which, despite their name, often adopt highly speculative strategies including purchasing substantial stakes in individual firms,[108] and sometimes agitate for major changes in the firms' structure, strategy, or management. Private equity firms, in turn, are (typically) investment vehicles that acquire, at least temporarily, control, and then complete ownership of formerly public companies to effect major changes in the firms' structure, strategy, or management.[109] We have also seen the proliferation of state-controlled institutional investors, such as sovereign wealth funds.

Plausibly, differences in patterns of shareholding across countries correlate with differences in the structure of corporate law. An influential series of empirical studies on "law and finance" reported that, at the end of the twentieth century, countries with greater legal protection for shareholders (against opportunism by managers and controlling shareholders) had less concentrated shareholdings,[110] although subsequent studies found the results to be sensitive to the way in which "protection" is measured.[111] Such a pattern is consistent with both changes in the configuration of interest groups who call for changes in corporate laws, and changes in the types of corporate law rules that yield functional outcomes.

To some extent, therefore, the structure of corporate law in any given country is a consequence of that country's pattern of corporate ownership. This in turn is determined at least in part by forces exogenous to corporate law.[112] It has been argued, for example, that the traditionally retail-oriented pattern of U.S. shareholdings was a product of that country's history of populist politics, which generated a number of policies successfully designed to frustrate family and institutional control of industrial enterprise.[113] Correspondingly, it is said that the traditionally more concentrated share ownership patterns in continental Europe and Japan complemented particular patterns of industrial development.[114] On this view, a controlling shareholder may, under certain circumstances, 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.[115]

[108] Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review 1021 (2007); Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Columbia Law Review 863 (2013).

[109] See Brian R. Cheffins and John Armour, *The Eclipse of Private Equity*, 33 Delaware Journal of Corporate Law 1 (2008); Viral V. Acharya, Oliver F. Gottschalg, and Moritz Hahn, *Corporate Governance and Value Creation: Evidence from Private Equity*, 26 Review of Financial Studies 368 (2013).

[110] For a review, see Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 Journal of Economic Literature 285 (2008).

[111] See Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 Delaware Journal of Corporate Law 697 (2005); John Armour, Simon Deakin, Prabirjit Sarkar, and Ajit Singh, *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 2 Journal of Empirical Legal Studies 343 (2009); Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 Review of Financial Studies 467 (2010).

[112] 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).

[113] Mark J. Roe, Strong Managers, Weak Owners (1994).

[114] See Wendy Carlin and Colin Mayer, *Finance, Investment and Growth*, 69 Journal of Financial Economics 191 (2003).

[115] See Hall and Soskice, note 1; Barry Eichengreen, Europe's Economy Since 1945 (2006); Colin Mayer, Firm Commitment (2013). Compare also Chapter 4.4.1.

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 somewhat speculatively, the influence of ownership structure—and of other forces as well—in shaping the patterns of corporate law that we see across jurisdictions.

# 2

# Agency Problems and Legal Strategies

*John Armour, Henry Hansmann, and Reinier Kraakman*

## 2.1 Three Agency Problems

As we explained in Chapter 1,[1] corporate law performs two general functions: first, it establishes the structure of the corporate form as well as ancillary housekeeping rules necessary to support this structure; second, it attempts to control conflicts of interest among corporate constituencies, including those between corporate "insiders," such as controlling shareholders and top managers, and "outsiders," such as minority shareholders or creditors. These conflicts all have the character of what economists refer to as "agency problems" or "principal-agent" problems. For readers unfamiliar with the jargon of economists, an "agency problem"—in the most general sense of the term—arises whenever one party, termed the "principal," relies upon actions taken by another party, termed the "agent," which will affect the principal's welfare. The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest. Viewed in these broad terms, agency problems arise in a broad range of contexts that go well beyond those that would formally be classified as agency relationships by lawyers.

In particular, almost any contractual relationship, in which one party (the "agent") promises performance to another (the "principal"), is potentially subject to an agency problem. The core of the difficulty is that, because the agent commonly has better information than does the principal about the relevant facts, the principal cannot easily assure himself that the agent's performance is precisely what was promised. As a consequence, the agent has an incentive to act opportunistically,[2] skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent's performance to the principal will be reduced, either directly or because, to assure the quality of the agent's performance, the principal must engage in costly monitoring of the agent. The greater the complexity of the tasks undertaken by the agent, and the greater the discretion the agent must be given, the larger these "agency costs" are likely to be.[3]

As we noted in Chapter 1, three generic agency problems arise in business firms. The first involves the conflict between the firm's owners and its hired managers. Here the owners are the principals and the managers are the agents. The problem lies in assuring

[1] See Chapter 1.1.

[2] We use the term "opportunism" here, following the usage of Oliver Williamson, to refer to self-interested behavior that involves some element of guile, deception, misrepresentation, or bad faith. See Oliver Williamson, The Economic Institutions of Capitalism 47–9 (1985).

[3] See e.g. Steven Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 American Economic Review 134 (1973); Principals and Agents: The Structure of Business (John W. Pratt and Richard J. Zeckhauser eds., 1984).

The Anatomy of Corporate Law. Third Edition. Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe, and Edward Rock.