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1

What is Corporate Law?

HENRY HANSMANN and REINIER KRAAKMAN

1.1 Introduction

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

Consider, in this regard, the basic legal characteristics of the business corporation. To anticipate our discussion below, there are five of these characteristics, most of which will be easily recognizable to anyone familiar with business affairs. They are: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. These characteristics are—for reasons we will explore—induced by 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 the special needs of closely held firms. (Throughout this book, we will follow the usual

[1] See, e.g., Ronald J. Gilson and Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporation Governance and Industrial Organization*, 102 Yale Law Journal 871 (1993); Mark J. Roe, *Some Differences in Corporation Structure in Germany, Japan, and the United States*, 102 Yale Law Journal 1927 (1993); Bernard S. Black and John C. Coffee, *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 Michigan Law Review 1997 (1994); Klaus J. Hopt and Eddy Wymeersch (eds.), Comparative Corporate Governance: Essays and Materials (1997); and Mark J. Roe, Political Determinants of Corporate Governance (2003).

practice of using the term 'closely held' to refer to corporations whose shares—unlike those of 'publicly held' corporations—do not trade freely in impersonal markets, either because the shares are held by a small number of persons or because they are subject to restrictions that limit their transferability.)

Self-evidently, 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—i.e., by altering background property rights[2] and providing off-the-shelf housekeeping rules—corporate law enables entrepreneurs to transact easily through the medium of the corporate entity, and thus lowers the costs of business contracting. 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 whole. Nevertheless, these are the provisions that comprise the legal core of corporate law that is shared by every jurisdiction. In this Chapter, we briefly explore the contracting efficiencies (some familiar and some not) that accompany these five features of the corporate form, and that, we believe, have helped to propel the worldwide diffusion of the corporate form.

Like corporate law itself, however, our principal focus in this book is not on establishing the corporate form per se, but rather on a second, equally important function of corporate law: that is, constraining value-reducing forms of opportunism among the constituencies of the corporate enterprise. In particular, we address three principal conflicts within the corporation: those between managers and shareholders, those among shareholders, and those between shareholders and the corporation's other constituencies, including creditors and employees. All three of these generic conflicts give rise to problems that are usefully characterized as what economists call 'agency problems.' Consequently, Chapter 2 examines these three agency problems, both in general and as they arise in the corporate context, and surveys the range of legal strategies that can be employed to deal with those problems.

The reader might object that these agency conflicts—which, in our view, occupy most of corporate law—are not uniquely 'corporate.' After all, *any* form of jointly-owned enterprise must expect conflicts among its owners, managers, and third-party contractors. We agree; insofar as the corporation is only one of several legal forms for the jointly-owned firm, it faces the same generic agency problems that confront all jointly-owned firms. Nevertheless, the characteristics of this particular form matter a great deal, since it is the form that is chosen by most large-scale enterprises—and, as a practical matter, the only form that widely held firms can choose in many jurisdictions.[3] Moreover, the unique

[2] See Henry Hansmann and Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE LAW JOURNAL 387 (2000).

[3] Only the corporate form is available in many jurisdictions to the extent that large-scale enterprises are forced to look to the public equity markets for financing. Some jurisdictions permit the equity of non-corporate entities to trade in the public markets as well: for example, in the U.S., the equity securities of so-called 'master' limited partnerships and limited liability companies may be registered for public trading.

features of this form determine the contours of its agency problems. To take an obvious example, the fact that shareholders enjoy limited liability—while, say, general partners in a partnership do not—has traditionally made creditor protection far more salient in corporate law than it is in partnership law. Similarly, the fact that corporate investors may trade their shares is the foundation of the anonymous trading stock market—an institution that has encouraged the separation of ownership from control, and so has sharpened the management–shareholder agency problem.

In this book, we explore the role of corporate law in minimizing agency problems—and thus, making the corporate form practicable—in the most important categories of corporate actions and decisions. More particularly, Chapters 3–8 address, respectively, six 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, Chapter 3 addresses the governance mechanisms that operate over the firm's ordinary business decisions, while Chapter 4 turns to the checks that operate on the corporation's transactions with creditors. As before, however, if 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 six chapters of our book cover nearly all of the important problems in corporate law—apart, that is, from the fundamental project of establishing the corporate form itself. In each Chapter, we describe how the basic agency problems of the corporate form manifest themselves in the given category of corporate activity, and then explore the range of alternative legal responses that are available. We illustrate these alternative approaches with examples from the corporate law of various prominent jurisdictions. We explore the patterns of homogeneity and the patterns of 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 form a handful of major representative jurisdictions, including France, Germany, Japan, the U.S., and the UK, though we also make reference to the law of other jurisdictions to make special points.

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.[4] 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.[5] Moreover, while comparative

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

[5] Other examples of this trend include Dennis C. Mueller and B. Burcin Yurtoglu, *Country Legal Environments and Corporate Investment Performance*, 1 GERMAN ECONOMIC REVIEW 187 (2000);

law scholarship often has a tendency to emphasize differences between jurisdictions, our approach is to focus on similarities. Doing so, we believe, illuminates an underlying commonality of structure that transcends national boundaries. It also provides important perspective on the potential basis for the international integration of corporate law that must necessarily take place as economic activity continues to become more global in scope in the decades to come.

We realize that the term 'functional,' which we have used here and in our title, means different things to different people, and that some of the uses to which that term has been put in the past—particularly in the field of sociology—have made the term justifiably suspect. It would perhaps be more accurate to call our approach 'economic' rather than 'functional,' though the sometimes tendentious use of economic argumentation in legal literature has also caused many scholars, particularly outside of the United States, to be as wary of 'economic analysis' as they are of 'functional analysis.' For the purposes at hand, however, we need not commit ourselves on fine points of social science methodology. We need simply note that the exigencies of commercial activity and organization present practical problems that have a rough similarity in developed market economies throughout the world, that corporate law everywhere must necessarily address these problems, and that the forces of logic, competition, interest group pressure, imitation, and compatibility tend to lead different jurisdictions to choose roughly similar solutions to these problems.

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.[6] Indeed, it is our hope that the analysis offered in this book will be of use not only to students of comparative law, but that it will be equally valuable

Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY 1113 (1998); Henry Hansmann and Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 NEW YORK UNIVERSITY LAW REVIEW 434 (1998); Konrad Zweigert and Hein Kötz, INTRODUCTION TO COMPARATIVE LAW (3rd ed. translated from the German by Tony Weir, 1998); Ugo Mattei, COMPARATIVE LAW AND ECONOMICS (1997).

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

to those who simply wish to have a more solid framework within which to view their own country's corporation law.

Likewise, we take no strong stand here in the current debates on the extent to which corporate law is or should be 'converging,' much less on what it might converge to.[7] That is a subject on which reasonable minds can differ. Indeed, it is a subject on which the reasonable minds that have written this book sometimes differ.[8] Rather, we are seeking to set out a conceptual framework and a factual basis with which that and other important issues facing corporate law can be fruitfully explored.

1.2 WHAT IS A CORPORATION?

As we noted above, the five core structural characteristics of the business corporation are: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital. In virtually all economically important jurisdictions, there is a basic statute that provides for the formation of firms with all of these characteristics, at least as the default regime. This is to say that firms formed under the statute will have these characteristics unless (if the statute permits) those who form the firm make explicit provision for omitting one or more of them. As this pattern suggests, these characteristics have strongly complementary qualities for many firms. Together, they make the corporation uniquely attractive for organizing productive activity. But these characteristics also generate tensions and tradeoffs that lend a distinctively corporate character to the agency problems that corporate law must address.

While our principal focus is on companies that share all five of these core characteristics, firms that have only some but not all of these characteristics are also commonplace. Sometimes these firms are formed under a jurisdiction's basic corporation statute, taking advantage of the statute's flexibility to omit one or more of the characteristics that are provided for simply as defaults. Other times these firms are formed under special 'close' corporation statutes that, in addition, provide mechanisms for restricting the transferability of shares—such as those

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

[8] The views of the principal 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).

governing the German *Gesellschaft mit beschränkter Haftung* (GmbH), the French *Société à responsabilité limitée* (SARL), the British private corporation, the Japanese close corporation, and the close corporation forms that are provided for in some U.S. jurisdictions. Most of the larger firms organized under these statutes are full corporations in precisely the sense that we intend. But even when a closely held firm drops a core feature of the corporate form (typically the board of directors), it shares the remaining characteristics and problems of this form. Likewise, our analysis extends to important aspects of legal regimes addressed to the regulation of corporate groups, such as the German *Konzernrecht*.[9]

Much of what we say here also applies to firms that are governed by special statutes—such as those for limited liability companies[10] or business trusts[11]—that omit one or more of the core characteristics from their default regime. While these statutes are not corporate law statutes,[12] our analysis offers insight into the interpretation of these bodies of law, and we shall occasionally address them explicitly.

1.2.1 Legal personality

As an economic entity, a firm fundamentally serves as a nexus of contracts: a single contracting party that coordinates the activities of suppliers of inputs and of consumers of products and services.[13] The first and most important contribu-

[9] While group law is most developed in Germany, other jurisdictions have elements of group law as well. See, e.g., Klaus J. Hopt (ed.), GROUPS OF COMPANIES IN EUROPEAN LAWS: LEGAL AND ECONOMIC ANALYSES ON MULTINATIONAL ENTERPRISES (1982); Clive M. Schmitthoff and Frank Wooldridge (eds.), GROUPS OF COMPANIES (1991). See also *infra* 4.1.2.

[10] The American limited liability company statutes, which are of relatively recent origin, are not the equivalent of the European close corporation statutes, such as the German GmbH statute or the French SARL statute. Rather, the American limited liability company is a highly flexible hybrid of corporate and partnership forms that does not impose either delegated management under a board structure or transferable shares as the default regime. See, e.g., National Conference of Commissioners on Uniform State Laws, Uniform Limited Liability Company Act §§203, 405, 502, 503 (1995).

[11] The business trust is a statutory form that has developed in the U.S. as an evolution of the basic Anglo-American private trust. In its contemporary form—perhaps best illustrated by the business trust statute found in the U.S. state of Delaware—the form is essentially an empty shell. It provides for what we term below affirmative asset partitioning, as well as for limited liability. Other features of an organization formed under the Act—including the governance structure and rights to earnings and assets—are left to be specified (in the certificate of trust) by the firm's organizers, with virtually no restraints imposed on the choices that can be made. For further discussion and references, see Hansmann and Mattei, *supra* note 5; Hansmann and Kraakman, *supra* note 2.

[12] See *infra* 1.3.1.

[13] The nexus of contracts image of the firm 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). We mean this description literally: a firm is, in fact, the common legal counterparty in numerous contracts with suppliers, employees, and customers. We do not comment on why production is organized in this fashion, nor do we join the controversy over whether relationships among the firm and its participants can be described exhaustively in contractual terms. See, e.g., Robert Clark, *Agency Costs versus Fiduciary Duties*, in John W. Pratt and Richard J. Zeckhauser (eds.), PRINCIPALS AND AGENTS:

tion of corporate law, as of other forms of organizational law, is to permit a firm to serve this role by providing for the creation of a legal person—a contracting party distinct from the various individuals who own or manage the firm, or are suppliers or customers of the firm.[14]

The core element of legal personality (as we use the term here) is what the civil law refers to as 'separate patrimony.' This is the ability of the firm to own assets that are distinct from the property of other persons, such as the firm's investors, and that the firm is free not only to use and sell but—most importantly—pledge to creditors. Elsewhere we have termed this asset-pledging effect of legal personality 'affirmative asset partitioning' to emphasize that it involves shielding the assets of the entity—the corporation—from the creditors of the entity's managers and owners.[15]

Where corporations are concerned, there are two relatively distinct rules of law involved. The first is a priority rule that grants to creditors of the firm, as security for the firm's debts, a claim on the firm's assets that is prior to the claims of the personal creditors of the firm's owners. This rule is shared by all modern legal forms for enterprise organization, including partnerships. The consequence of this priority rule is that a firm's assets are automatically pledged as security for all contractual liabilities entered into by the firm. Its obvious advantage is to increase the credibility of the firm's contractual commitments.

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

The pattern of creditors' rights created by strong form legal personality is, in effect, the converse of that created by limited liability. It protects the assets of the

THE STRUCTURE OF BUSINESS 55 (1984). What matters for our purposes is that the firm organizes production in large part by entering formal contracts with numerous other parties.

[14] It is sometimes said that partnerships (or trusts, or various other forms) are not legal persons, in contrast to corporations. Jurists who take that view have, of course, a conception of legal personality that differs from ours. Our own view is that legal personality is most helpfully viewed in terms of the rules of creditors' rights we describe here. Those who are uncomfortable with this use of the term 'legal personality' can simply ignore our use of that term here, which is not important in itself and is not meant to suggest anything broader than what we say, and focus instead on the specific rules of law that we describe under that heading.

[15] See Hansmann and Kraakman, *supra* note 2.

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. Strong form legal personality reinforces the stability and creditworthiness of the firm and, when combined with limited liability, isolates the value of the firm from the personal financial affairs of the firm's owners sufficiently to permit the firm's shares to be freely traded.

The priority rule component of corporate legal personality requires special legal doctrine to be effective. It could not feasibly be replicated, in the absence of such doctrine, simply by contracting among a business's owners and their creditors because contracts among these parties cannot bind the individual creditors of the firm's owners.[16] The same is true of the liquidation protection feature of corporate law so far as it binds the creditors of a firm's owners. (The owners could bind themselves not to liquidate the firm simply by contract, as members of partnerships in fact often do.) This distinguishes legal personality from the other four basic elements of the corporate form discussed here, which could all in theory be crafted by contractual means even if the law did not provide for a standard form of enterprise organization that embodies them.[17]

1.2.2 Limited liability

The corporate form effectively imposes a default term in contracts between a firm and its creditors whereby the creditors are limited to making claims against the assets that are the property of the firm itself, and have no further claim against the personal assets of the firm's shareholders (or managers). This limitation of owner liability distinguishes the corporate form from some other important forms of organization that have legal personality (as we define the latter feature here), including in particular partnerships.

Historically, limited liability has not always been associated with the corporate form. Some important corporate jurisdictions long made unlimited shareholder liability for corporate debts the governing rule.[18] Nevertheless, today

[16] To establish the priority of business creditors by contract, a firm's owners would have to contract with its business creditors to include subordination provisions, with respect to business assets, in all contracts between individual owners and individual creditors. Not only would such provisions be cumbersome to draft and costly to monitor, but they would be subject to a high degree of moral hazard—an individual owner could breach her promise to subordinate the claims of her personal creditors on the firm's assets with impunity, since this promise would be unenforceable against personal creditors who were not party to the bargain. See Hansmann and Kraakman, *supra* note 2, 407–9.

[17] See id. Authority doctrines, which determine when an agent has power to bind her principal to contracts, and which form a component of the fourth characteristic (delegated management) of the corporate form described here, arguably also require background rules of law, and hence constitute an exception to this statement. See John Armour and Michael Whincop, *The Proprietary Structure of Corporate Law* (Working Paper 2001).

[18] Limited liability did not become a standard feature of the British law of joint stock companies until the mid-nineteenth century, and in the American state of California shareholders bore unlimited personal liability for corporation obligations until 1931. See Paul L. Davies, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 40–46 (6th ed., 1997); Phillip Blumberg, *Limited Liability and Corporate Groups*, 11 JOURNAL OF CORPORATE LAW 573 (1986).

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

Elsewhere we have described limited liability as 'defensive asset partitioning' to distinguish it from the 'affirmative' partitioning effects of legal personality.[19] While legal personality permits the business to own assets, and thus serves as a kind of floating lien favoring business creditors over the individual creditors of investors and managers, limited liability reserves shareholders' individual assets exclusively for their personal creditors. Thus, legal personality and limited liability together set up a default regime whereby a shareholder's personal assets are pledged as security to his personal creditors, while corporation assets are reserved for corporation creditors. In an enterprise of any substantial magnitude, this allocation generally increases the value of both types of assets as security for debt. It permits creditors of the corporation to have first claim on the corporation's assets, which those creditors have a comparative advantage in evaluating and monitoring. Conversely, it permits an individual's personal creditors to have first claim on personal assets, which those creditors are in a good position to evaluate and monitor and which creditors of the corporation, conversely, are not in a good position to check. As a consequence, legal personality and limited liability together can reduce the overall cost of capital to the firm and its owners.

A related aspect of asset partitioning is that limited liability permits firms to isolate different lines of business for the purpose of obtaining credit. By separately incorporating, as subsidiaries, distinct ventures or lines of business, the assets associated with each venture can conveniently be pledged as security just to the creditors who deal with that venture. Those creditors are commonly well positioned to assess and keep track of the value of those assets, but may have little ability to monitor the corporation's other ventures.

Finally, by virtue of limited liability, the formation of corporations and subsidiary corporations can be used as a means of sharing the risks of transactions with the parties with whom a firm contracts, in situations in which the latter parties are in a better position to bear those risks. Thus, limited liability can play a valuable contracting role even in situations where a corporation has a single shareholder who does not require the corporate form to raise equity capital, as in the case of the parent company of a wholly owned subsidiary.[20]

Beyond this function of defensive asset partitioning, limited liability permits flexibility in the allocation of risk and return between equityholders and debtholders, reduces transaction costs of collection in case of insolvency, and

[19] See Hansmann and Kraakman, *supra* note 2. Note that the defensive asset partitioning established by a rule of limited liability is less fundamental, in the sense that it can be achieved by contract, without statutory fiat, at lower cost than can the affirmative asset partitioning established by the doctrinal element of legal personality. Id.

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

simplifies and substantially stabilizes the pricing of stock[21]—something we shall say more about below in the discussion of transferability of shares.

Limited liability also plays an important function—but more subtle and less often remarked—in facilitating delegated management, which is the fourth of the core characteristics of the corporate form. In effect, by shifting downside business risk from shareholders to creditors, limited liability enlists creditors as monitors of the firm's managers, a task which they may be in a better position to perform than are the shareholders in a firm in which share ownership is widely dispersed.[22]

We should emphasize that when we refer to limited liability, we mean specifically limited liability *in contract*—that is, limited liability to voluntary creditors who have contractual claims on the corporation. The compelling reasons for limited liability in contract generally do not extend to limited liability *in tort*—that is, limited shareholder liability to persons who are *involuntary* creditors of the corporation, such as third parties who have been injured as a consequence of the corporation's negligent behavior. Limited liability to involuntary creditors is arguably not a necessary feature of the corporate form, nor even a socially valuable one, as we discuss more thoroughly in Chapter 4.

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 from various other standard-form legal entities as well. 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. This in turn enhances the liquidity of shareholders' interests and makes it easier for shareholders to construct and maintain diversified investment portfolios.

Fully transferable shares do not necessarily mean *freely tradable* shares. Even if shares are transferable, they may not be tradable without restriction in public markets, but rather just transferable among limited groups of individuals or with the approval of the current shareholders or of the corporation. Free tradability maximizes the liquidity of shareholdings and the ability of shareholders to diversify their investments. It also gives the firm maximal flexibility in raising capital. For these reasons, all jurisdictions provide for free tradability as the default regime for at least one class of corporations (sometimes referred to as 'open' corporations). However, free tradability can also make it difficult to

[21] See, e.g., Paul Halpern, Michael Trebilcock and Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 University of Toronto Law Journal 117 (1980); Frank Easterbrook and Daniel Fischel, *Limited Liability and the Corporation*, 52 University of Chicago Law Review 89 (1985); Susan E. Woodward, *Limited Liability in the Theory of the Firm*, 141 Journal of Institutional and Theoretical Economics 601 (1985).

[22] See Hansmann and Kraakman, *supra* note 2.

maintain negotiated control arrangements. Consequently, all jurisdictions also provide mechanisms for restricting transferability. Sometimes this is done by means of a separate statute, such as the special European statutes for close corporations, while other jurisdictions simply provide for restraints on transferability as an option under a basic corporation statute.

Transferability of shares, as we have already suggested, is closely connected both with the liquidation protection that is a feature of strong form legal personality, and with limited liability. Absent either of these rules, the creditworthiness of the firm as a whole could change, perhaps fundamentally, as the identity of its shareholders changed. Consequently, the value of shares would be difficult for potential purchasers to judge. Perhaps more importantly, a seller of shares could impose negative or positive externalities on his fellow shareholders depending on the wealth of the person to whom he chose to sell. It is therefore not surprising that strong form legal personality, limited liability, and transferable shares tend to go together, and are all features of the standard corporate form everywhere. This is in contrast to the conventional general partnership, which lacks all of these features.

1.2.4 Delegated management with a board structure

Delegated management is an attribute of nearly all large firms with numerous fractional owners. Delegation permits the centralization of management necessary to coordinate productive activity. Equally important, delegation of decision-making power to specific individuals notifies third parties as to who in the firm has the authority to make binding agreements. The authority issue, in particular, quickly becomes intractable in a firm in which numerous owners and managers are not distinct, as in a large general partnership that fails to allocate authority by agreement and to signal this allocation of authority clearly to third parties.

Organizational forms differ, however, in the way in which they delegate management power and authority. The limited partnership and the common-law private trust, for example, typically invest full control rights in a general partner or trustee who cannot be displaced without cause. By contrast, corporate law typically vests principal authority over corporate affairs in a board of directors or similar committee organ that is periodically elected, exclusively or primarily, by the firms' shareholders. More specifically, business corporations are distinguished by a governance structure in which all but the most fundamental decisions are put in the hands of a board of directors that has four basic features.[23]

First, the board is, at least as a formal matter, separate from the operational managers of the corporation. The nature of this separation varies according to

[23] This is not to say that other legal entities, such as partnerships, business trusts, or limited liability companies, cannot have a board structure similar to that of a typical corporation; in fact, they often do. But those forms, unlike the corporation form, do not presume a board of directors as a matter of law.

whether the board has one or two tiers. In two-tier boards, top corporate officers occupy the board's second (subordinate) tier, but are generally absent from the first (supervisory) tier, which is at least nominally independent from the firm's hired officers (i.e. from the firm's senior managerial employees). In single-tier boards, in contrast, hired officers may be members of, or even dominate, the board itself. Regardless of the actual allocation of power between a firm's directors and officers, the legal distinction between them formally divides all corporate decisions that do not require shareholder approval into those requiring approval by the board of directors and those that can be made by the firm's hired officers on their own authority. This formal distinction between the board and hired officers facilitates a separation 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.[24] It also performs the key function—noted earlier—of permitting third parties to rely on a well-defined institution to formally bind the firm in its transactions with outsiders.

Second, the board is formally distinct from the firm's shareholders. 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. Beyond this, a separately-constituted board can also provide a check on opportunistic behavior by controlling shareholders—either toward their fellow shareholders or toward other parties who deal with the firm, such as creditors or employees—by providing a convenient target of personal liability for decisions made by the firm. Membership on the board can likewise provide minority shareholders or other constituencies, such as employees or creditors, with a means for obtaining credible access to information or direct participation in firm decision-making. Also, by assigning designated individuals a specific role as decision-makers on behalf of the enterprise, the corporate form enhances the probability that those individuals will respond in a principled fashion to the interests of all corporate constituencies simply through moral principles and social pressure, quite apart from formal legal or electoral accountability.

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

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

require a board structure, but do not require election of the board by the firm's (beneficial) owners.

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. For example, most close corporation statutes, such as those governing Germany's GmbH or France's SARL, permit business planners to dispense with a collective board in favor of a single general director or one-person board—the evident reason being that, for a very small corporation, most of the board's legal functions, including its service as shareholder representative and focus of liability, can be discharged effectively by a single elected director who also serves as the firm's principal manager.

1.2.5 Investor ownership

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

There are other forms of ownership that play an important role in contemporary economies, and other bodies of organizational law—including other bodies of corporate law—that are specifically designed to facilitate the formation of those other types of firms.[25] For example, cooperative corporation statutes—which provide for all of the four features of the corporate form just described except for transferable shares, and often permit the latter as an option as well—allocate voting power and shares in profits proportionally to acts of patronage, which may be the amount of inputs supplied to the firm (in the case of a producer cooperative), or the amount of the firm's products purchased from the firm (in the case of a consumer cooperative). Indeed, business corporations are effectively a special kind of producer cooperative, in which control and profits are tied to supply of a particular type of input, namely capital. As a consequence, business corporations could, in principle, be formed under a well-designed general cooperative corporation statute. But the law provides, instead, a special

[25] For a discussion of the varieties of forms of ownership found in contemporary economies and their respective economic roles, and of the relationship between these forms and the different bodies of organizational law that govern them, see Henry Hansmann, THE OWNERSHIP OF ENTERPRISE (1996).

statutory form for corporations owned by investors of capital ('capital cooperatives,' as we might think of them).[26]

This specialization follows from the dominant role that investor-owned firms have come to play in contemporary economies, and the consequent advantages of having a form that is specialized to the particular needs of such firms, and that signals clearly to all interested parties the particular character of the firm with which they are dealing. The dominance of investor ownership among large firms, in turn, reflects several conspicuous efficiency advantages of that form. One is that, among the various participants in the firm, investors are often the most difficult to protect simply by contractual means.[27] Another is that investors of capital have (or can be induced to have) peculiarly homogeneous interests among themselves, hence minimizing the potential for costly conflict among those who share governance of the firm.[28]

Specialization to investor ownership is yet another respect in which the law of business corporations differs from the law of partnership. The partnership form typically does not presume that ownership is tied to contribution of capital, and though it is often used in that fashion, it is also commonly used to assign ownership of the firm in whole or in part to contributors of labor or of other factors of production—as in the prototypical two-person partnership in which one partner supplies labor and the other capital. As a consequence, the business corporation is less flexible than the partnership in terms of assigning ownership. To be sure, with sufficient special contracting and manipulation of the form, ownership shares in a business corporation can be granted to contributors of labor or other factors of production, or in proportion to consumption of the firm's services. Moreover, as the corporate form has evolved, it has achieved greater flexibility in assigning ownership, either by 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 closely held corporations. Nevertheless, the default rules of corporate law are generally designed for investor ownership, and deviation from this pattern can be awkward. The complex arrangements for sharing rights to earnings, assets, and control between entrepreneurs and investors in high-tech start-up firms offer a familiar example.[29]

Sometimes corporate law itself deviates from the assumption of investor ownership to permit or require that persons other than investors of capital—for example, creditors or employees—participate to some degree in either control or net earnings or both. Worker codetermination is a conspicuous example.

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

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

[28] See Hansmann, *supra* note 25.

[29] 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).

The wisdom and means of providing for such non-investor participation remains one of the basic controversies in corporate law. We shall of course address this subject further in Chapter 3.

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

1.3 What Does Corporate Law Include?

All jurisdictions have a least one statute that establishes a basic corporate form with the five characteristics described above. Nevertheless, corporate law as we understand it here generally extends well beyond the bounds of this core statute.

1.3.1 Secondary and partial corporations forms

First, all major jurisdictions have multiple secondary or partial corporate law statutes. Secondary statutes include separate statutes for special classes of firms such as foreign firms or governmentally owned enterprise. Partial corporate law statutes provide for separately defined statutory entities that have, or at least are permitted to have, some but not all of the five core characteristics described above. Examples include limited partnerships, limited liability companies, and statutory business trusts. To the extent that these forms include the core characteristics of the corporation, our discussion will help to illuminate their role and structure.

We consider close companies—the German GmbH, the French SARL, the Japanese close corporation, the American close corporation, and the British private corporation—to exhibit all of the canonical features of the corporate form. They differ from public companies chiefly because their shares, though transferable at least in principle, do not trade freely in a public market. By contrast, statutes that merely permit business planners to create firms with the legal characteristics of business corporations, such as typical American limited liability company statutes and business trust statutes, are not corporate law statutes. Large scale enterprise, regardless of its statutory origins, tends to exhibit most or all of the core characteristics of the corporation form. But a body of statutory or decisional law belongs to corporate law only to the extent

that it provides for, or at least responds to, these characteristics. It does not belong to the extent that it is merely an empty vessel within which planners may, by contracting, create a contractually-devised corporate form. On the other hand, the analysis offered in this book also offers insight into the interpretation of those bodies of law where they are used to form entities that share the characteristics of business corporations.

1.3.2 Additional sources of corporate law

There are bodies of law that, at least in some jurisdictions, are incorporated in statutes or decisional law that are separate from basic corporate law, and from the alternative forms just described, but that are nonetheless exclusively concerned with particular core characteristics of the corporate form as we define them here.

To begin, the well-known German law of groups, or *Konzernrecht*, qualifies limited liability and limits the discretion of boards of directors in corporations that are closely related through cross ownership, seeking to protect the creditors and minority shareholders of corporations with controlling shareholders. Where subsidiaries are organized under the open corporation statute (*Aktiengesetz*), the rights of controlled companies are delimited by this statute itself, which provides for the regulation of both contractually formalized group relationships and *de facto* control relationships among corporations. Where subsidiaries are organized under the close corporation statute (*GmbH-Gesetz*), the parallel law of corporate groups is judge-made rather than statutory. Either way, however, *Konzernrecht* is clearly an integral part of German corporate law. (We describe the German *Konzernrecht* in greater detail in Chapter 4.)

Similarly, the statutory rules in many jurisdictions that require employee representation on a corporation's board of directors—such as, conspicuously, the German or Dutch 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. American securities law, which applies to large corporations, importantly structures board representation by establishing elaborate election procedures, regulating transferability of shares in various contexts, and imposing detailed disclosure rules. 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 rules on takeovers and mergers.[30]

These supplemental bodies of law are necessarily part of the overall structure of corporate law, and we shall be concerned here with all of them.

[30] 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.

1.3.3 Non-corporate law constraints

There are, of course, many constraints imposed on companies by bodies of law designed to serve objectives that are largely unrelated to the core characteristics of the corporate form, and therefore do not fall within the scope of corporate law as we define it here.

Bankruptcy law, or 'insolvency law,' as it is termed in the UK, is an example. As we have noted, a major contribution of the corporation as a legal form is the ability to partition assets for purposes of pledging them as security to different groups of creditors. Bankruptcy law plays an important role in enforcing the claims that derive from this partitioning. Nevertheless, the problems of bankruptcy presented by corporations are often shared by other types of legal entities, and the elements of bankruptcy law that address those problems are not, in many jurisdictions, confined to entities formed as business corporations.[31] Consequently, we do not treat most aspects of bankruptcy law here as part of corporate law.

Similarly, although the types of firms that typically organize as corporations present particular problems for tort liability—especially when it comes to the liability of the corporation for the acts of corporate employees—these and other problems addressed by tort law are often presented by other types of entities, and we do not address them here directly. Much the same is true, moreover, for the types of issues traditionally considered within the realm of contract law, criminal law, and labor law. While, in each of those areas, firms organized as corporations present, to some degree, particular problems, those problems are not so distinctively connected to the core features of a corporation as to lead us to address them here as part of what we consider basic corporate law.

There are, however, some exceptions. For example, the UK doctrine of 'wrongful trading' in insolvency, while formally an aspect of bankruptcy law, focuses specifically on the duties of corporate directors. The problems of labor contracting presented by large firms are, in some jurisdictions, addressed by specific regulation of the basic elements of the corporate form as we have described them here, such as the composition of the firm's board of directors. The extension of limited liability beyond contract to tort, which has come to be considered a basic feature of the corporate form nearly everywhere, is another exception. In cases such as these, there is a blurring of the boundaries between corporate law and other fields of law—bankruptcy, labor, or tort law—that must be addressed here.

1.4 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

[31] For example, the reorganization provisions under Chapter 11 of the U.S. Bankruptcy Code, while most commonly invoked by companies, are not confined to such entities, but apply as well to partnerships and even individuals.

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[32] of a firm's shareholders, employees, suppliers, and customers without undue sacrifice—and, if possible, with benefit—to third parties such as local communities and beneficiaries of the natural environment. This is what economists would characterize as the pursuit of overall social efficiency.

It is sometimes said that the goals of corporate law should be narrower. In particular, it is sometimes said that the appropriate role of corporate law is simply to assure that the corporation serves the best interests of its shareholders or, more specifically, to maximize financial returns to shareholders or, more specifically still, to maximize the 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 see it, nor do they 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 to be better off themselves as a result. Consequently, the corporation—and, in particular, its shareholders—has 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.

Whether, in fact, the pursuit of shareholder value is generally an effective means of advancing social welfare is an empirical question on which reasonable minds can differ. While each of the authors of this book have 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.

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

To say that the pursuit of aggregate social welfare is the appropriate goal of corporate law is not to say, of course, that the law always serves that goal. Legislatures and courts are sometimes less attentive to overall social welfare than to the particular interests of some influential constituency, such as corporate managers, controlling shareholders, or organized workers. Moreover, corporate law everywhere continues to bear the imprint of the historical path through which it has evolved, and reflects as well various non-efficiency-oriented intellectual and ideological currents that have sometimes influenced its formation. The corporate law of all jurisdictions clearly shows, to a greater or lesser degree, the weight of these various influences.