Economics and the study of company law

Economics plays a fundamental role in companies. A company which does not enjoy monopoly privileges will only be successful if a market exists for its products or services and it offers competitive prices. When a company has its equity listed for trading on an exchange such as the London Stock Exchange, the shares will usually be traded in a market environment encompassing numerous buyers and sellers. In addition, most shareholders, when they purchase equity in a business enterprise, do so on the basis of economic considerations. They usually anticipate receiving cash distributions such as dividend payments from the company and hope that the value of their shares will rise so they can make a profit in the event of a sale. Parties who lend money or extend credit to companies have similar economic motives. Creditors expect to be repaid and charge a price such as interest on a debt in consideration for allowing a company to have use of funds for a stipulated time. A company’s employees also take economic considerations into account. They will keep in mind the salary and benefits offered before joining and then remaining with a company. At the same time, the remuneration package which an employee can expect to receive will be governed in substantial measure by the nature of his skills and the market demand for them. For instance, whereas an elite professional footballer can command a very high wage since few possess his skills, a clerk in a retail store cannot do so since many others could do his job with the necessary training.

Given the dynamics at work in companies, the body of knowledge referred to as economics logically provides valuable insights for those interested in studying corporate activity. Further, for those interested in assessing the impact of alternative legal regimes on companies, economic theory sheds light on important topics. There is indeed a substantial body of literature in which economic models and concepts have been used to examine company law issues. In the United States, economic analysis is arguably the most influential school of thought in the academic study of corporate law. The approach has been used as well by a number of scholars from the United Kingdom, Canada, and Australia. Still, while economic literature

is abundant, there have been no comprehensive surveys of company law from a British viewpoint. This book correspondingly examines in a systematic fashion UK company law from an economic perspective. We begin in this chapter with an overview of a series of key insights that economics can provide. These constitute basic tools with which the reader should be familiar to begin thinking about company law in economic terms.

I. THE PROMOTION OF EFFICIENCY AS A JUSTIFICATION FOR GOVERNMENT INTERVENTION

Economic theory and the rational actor

There is a limited availability of resources to meet unlimited human wants. Therefore individuals are forced to make choices; they must decide what to produce and what to consume. When individuals make choices they forego other opportunities and possibilities. Consequently, every choice made has costs associated with it. There is, in other words, 'no such thing as a free lunch.' Economists refer to the satisfaction or output which an individual would have derived from the best foregone alternative as the opportunity cost of the choice made. For instance, for a highly skilled solicitor who leaves London to pursue a quiet country practice, the opportunity cost of his choice will be the higher salary he would have received if he had continued to work in London.

Economists assume that when individuals make choices this is done rationally. Rational actors, under economic theory, make decisions so as to improve their personal well-being, frequently referred to as their 'utility', 'welfare', or 'wealth.' The rational actor concept has a number of important facets. First, individuals are aware that costs and benefits are associated with different options and take these into account before proceeding. Next, individuals select, among the alternatives available, the one which they prefer. For example, if someone likes apples more than oranges, the individual will choose an apple instead of an orange. Furthermore, individuals make

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4 The precise meaning of these terms is the source of considerable controversy. See, for instance, discussion in G. Lawson, 'Efficiency and Individualism', (1992) 42 Duke LJ 53.
consistent choices. Someone who prefers apples to oranges and prefers 
oranges to strawberries thus will choose apples instead of strawberries. The 
upshot is that the rational actor conducts himself as someone seeking to 
maximize his own welfare.

It is important not to read too much into the economic version of the 
rational actor concept. No attempt is made to explain why individuals pre­
fer particular things nor is there any presumption that choices made by 
rational actors are correct or good. Instead, under economic theory the 
individual is regarded as the best judge of his own welfare and the decisions he 
makes are derived from his own particular set of priorities. In addition, the 
rational actor model does not assume that all people in fact act as 'welfare-
maximizers.' The notional rational actor is in fact a weighted average of the 
individuals under study in which the extremes in behaviour even out. Thus, 
mainstream economic theory allows for individual irrationality while 
assuming that groups will behave as if they are rational. As well, individu­
als do not have to make decisions logically and dispassionately to be ratio­
nal in economic terms. Instead, what matters is that people act as if they 
are maximizing their personal utility. Economists say that if people do this, 
nothing more is required for the rational actor model to be a helpful ana­
lytical tool.1

Exchanges, markets, and allocative efficiency

A key way in which rational actors can increase their joint welfare is 
through voluntary exchange. Assume A owns five apples and the value he 
attaches to his fifth apple is £1. B owns no apples and will pay up to £1.10 
for one. In this situation, both parties will be better off if B buys the fifth 
apple for any price between £1 and £1.10. Economists assume that if A and 
B are rational and are suitably positioned to negotiate and execute the 
transaction, this exchange will occur. They would also assume that if A values 
his fourth apple at £1.10 and B will only pay £1 for a second apple, then 
no further trading would take place. Consequently, a simple equilibrium 
will have been achieved. Furthermore, an economist would characterize the 
outcome as efficient.2 This might seem an innocuous description, but it is 
important to clarify how economists define efficiency. When a company 
manager uses the term, he is probably referring to productive efficiency, 
which involves accomplishing an outcome at the lowest possible cost.3 On 
the other hand, an economist will usually be thinking about allocative

1 See, for example, A. A. Alchian, 'Uncertainty, Evolution and Economic Theory', (1950) 
58 J. of Pol. Econ. 231. For a critical appraisal of this reasoning, see D. A. Farber, 'The Case 
Against Brilliance', (1986) 70 Minn. L. Rev. 917 at 918-24.

2 We are ignoring, for present purposes, externalities, which are costs imposed on third par­
ties not directly involved in a bargaining relationship. On efficiency and externalities, see infra 
n. 76 and chapter three, n. 60.

efficiency, which relates to the distribution of scarce resources. The concern will be whether assets are being employed in their most highly valued use. If they are, then economists say the resources in question are being used efficiently.

Exchanges between individual transactors are potentially an effective medium for increasing allocative efficiency. Parties acting rationally will not agree to enter into a bargain unless each individual involved anticipates being made better off by proceeding. An exchange therefore should increase the personal utility of all concerned and should transfer resources to more highly valued uses. While individual bargains have significant efficiency properties, economic theory has more to say about the aggregate impact of transactions. This occurs through the study of markets. In economic terms, a market is a forum in which those offering to buy and sell products or services interact. The manner in which a market operates can be characterized through demand and supply curves. Buyers are grouped together so as to determine how they respond to various possible prices. This information can in turn be set out in graph form by using a demand curve. The same process can then be carried out for sellers and characterized in a graph as a supply curve. The demand and supply curves are then brought together to demonstrate how price is determined. Fluctuations in the market price in turn are explained by way of changes in the demand and supply curves.

Mainstream economists traditionally model markets by applying a number of assumptions. They postulate that buyers and sellers act rationally, are numerous, have full information about the products on offer, can contract at little cost, have sufficient financial resources to transact, can enter and leave the market with little difficulty, and will carry out the obligations which they agree to perform. Under these assumptions, market participants should continue to trade until no gains can be realized from further exchange. The resulting equilibrium price will be the point at which resources are associated with their highest valued use. In other words, the distribution will be allocatively efficient.

Market failure as a justification for regulation

When characterized in the foregoing terms, voluntary exchanges between individuals and markets have many favourable properties. The best course of action for lawmakers would thus seem to be to leave well enough alone and allow economic choices to be made by private ordering, which is a situation where production and consumption decisions are decentralized so that choices are made by individuals in accordance with their particular

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preferences and incentives. It is often assumed that this sort of 'deregulatory' thinking is the driving force behind the school of thought known as 'law and economies'. This intellectual movement, which is most influential in the United States, provides in considerable measure the analytical foundation for work done on company law from an economic perspective. Many critics of law and economics say that its alleged deregulatory agenda is a key weakness. The thinking is that proponents rely too dogmatically on the efficiency properties of markets in arguing that state intervention is unnecessary and counter-productive. The credibility of the discipline is thereby undermined.

It may well be that many who use economic theories to examine the legal system are not favourably inclined towards regulatory measures. Nevertheless, it is inappropriate to characterize economics as an intellectual discipline in which there is an inherent bias against government intervention. Instead, economic theory can provide a theoretical foundation in a variety of ways for regulation of transactions and markets. The animating principle in most instances is the promotion of allocative efficiency. The theory involved is that government regulation can in various instances help to ensure that assets are assigned to their most productive use, thus fostering increases in aggregate social welfare. Markets under certain prescribed assumptions should yield optimal outcomes. Often, though, such assumptions will not be fulfilled in the real world. Whenever this is the case, it cannot be taken for granted that private ordering will yield welfare-maximizing results. It is possible, therefore, that the government can make improvements. More precisely, public officials may be able to bring about changes which will help to ensure that assets are allocated to their most highly valued use.

One assumption economists make in studying markets is that transactions

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13 Even law and economics scholars recognize the deregulatory dynamic in economic thought; see, for instance, Riley, *supra*, n. 2 at 606 and R. Cooter, 'Law and Unified Social Theory', (1995) 22 *J. of Law and Soc.* 50 at 51.


16 The point can be put more strongly; since the conditions which economists assume are required for efficient outcomes are often not met, economic theory can give government 'carte blanche to intervene': 'An Economic Hero for Tony Blair', *Financial Times*, 25 July, 1994.
can be negotiated on a costless basis and will be performed as agreed thus rendering enforcement difficulties irrelevant. Such a market can be described as 'operationally' efficient. In the real world, this standard is never fully satisfied. Not all transactions are performed in accordance with their terms. The cases which make up the body of contract law are evidence of this; many involve a breach of clauses on which the parties had agreed. Also, typically there will be costs associated with the making of bargains. Fees which have to be paid to individuals who act as advisers or intermediaries are an example. Such individuals will include lawyers, accountants, stockbrokers, and commercial agents. The amounts involved can be appreciable. According to one study, the charges associated with executing a £1,500 transfer of shares in a UK company with publicly traded equity typically are nearly 4 per cent of the value of the transaction. The presence of transaction costs in turn provides scope for government intervention. To the extent that the state can take steps to reduce such costs, conditions will be closer to those which exist in economic models. This in turn implies that welfare-enhancing outcomes should occur more frequently.

An example of a scheme the purpose of which is to reduce transaction costs is one that the Bank of England has been in charge of implementing. The Bank began in 1993 to supervise the creation of CREST, a system designed to deal with the settlement of share transactions. Settlement is concerned with the mechanics of implementing a transfer of shares from one owner to another. Traditionally paperwork has greatly encumbered the process. A sale of shares is not complete until the transferee is entered on the company's register as the holder of the shares. To achieve this, the transferee must obtain from the transferor a signed stock transfer form together with the share certificate which denotes legal ownership of the equity. These documents must then be submitted to officials representing the company who administer and update the share register. CREST, which began operating in July 1996, should reduce much of the paperwork associated with settlement. When equity trades occur through the CREST scheme, share transfers are documented and settled against sterling payments on the basis of electronic messages. If everything works in the manner anticipated, share

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19 Ogus, supra, n. 15 at 16-17.
transactions should be finalized much more quickly and the reduction in paperwork should serve to reduce the transaction costs associated with transfers of equity.\(^{14}\)

An additional assumption economic analysts make concerning market behaviour is that transactors have full information concerning prices, the characteristics of the products available, and so on. Only rarely, though, will market participants in fact be in such a position. Take the example of a sale of a newspaper. Even with this sort of simple transaction a purchaser will not have perfect information since he will not be aware of all of the paper's contents before paying.\(^{15}\) The manner in which stock markets operate also illustrates that there is seldom full awareness of all relevant facts. If prices in a market reflect all pertinent information, then a market is said to be informationally efficient. Studies indicate that if a company's shares are listed on an exchange such as London's Stock Exchange and there is a high trading volume, the prices at which equity is traded will reflect all publicly available information.\(^{16}\) However, the evidence suggests that the prices do not incorporate all relevant facts, such as matters of which only a company's executives and advisers may be aware.\(^{17}\) This indicates that a stock market is not a forum in which all pertinent details are known by those who are trading.

The fact that parties do not have knowledge of all relevant facts provides a potential justification for regulation. An important reason why parties may not have full information is that certain market participants are aware of details of which others are not. To ensure that all parties are better informed, the government can compel those who enjoy informational advantages to disclose what they know. In an unregulated environment, those who run companies have much better access to pertinent facts than others. Compelling companies to disclose key financial data and other important news can help to address this discrepancy and should in a general way enhance the knowledge of those who invest in securities markets. In the United Kingdom, a public company faces substantial disclosure obligations. These are dealt with primarily in the Companies Act 1985\(^{26}\), the Financial Services Act 1986\(^{27}\), and the Stock Exchange's Yellow Book (it sets out the requirements a company must meet before its shares can be listed for trading on the Exchange).\(^{28}\) It may be that such measures, by

\(^{14}\) See, for instance, 'No Certainties About Securities', Financial Times, 21 November, 1995 and 'All Change for the Era of Paperless Investment', Sunday Times, 3 March, 1996. Not all agree that CREST will make improvements (e.g., 'Wasteful and Irrelevant, Crest Should be Stopped', Accountancy Age, 2 December, 1993, 15).

\(^{15}\) Trebilcock, supra, n. 11 at 103.


\(^{17}\) See, for example, Part VII. Chapter 60, see, for instance, Part IV.

\(^{18}\) See The Stock Exchange, Listing Rules, chs. 6, 9 and 12 (hereinafter Listing Rules).
enhancing access to information, foster the transfer of resources to more highly valued uses."

An economist, in addition to assuming that parties do not have to be concerned about transaction costs and have full information, will presume that individuals, as rational actors, will co-ordinate their activities so as to achieve efficient outcomes if they are aware of steps which they can take to increase their joint welfare. However, market participants may not always act in this manner. Instead, rational decisions of economic actors can yield inefficient results and this in turn provides a potential justification for regulation. An analytical device known as game theory, which allows for formal, rigorous examinations of individual decision-making, sheds light on situations where rational conduct will lead to sub-optimal outcomes."

Under game theory, a game is a situation in which the actions of the people involved significantly affect each other's welfare. The individuals working their way through a game are referred to as 'players', their decisions are 'moves' and the results are labelled 'pay-offs'. Sometimes a game is cooperative, which means the players can make credible commitments and enter into binding agreements. If players cannot make such arrangements and thus must act independently, the game is non-cooperative. Another variable is information and knowledge possessed by the players. In some games, the players know little about each other. In these circumstances, a player can only guess about the moves and pay-offs available to others. In other games, each player knows a great deal about his counterparts. For instance, each might be aware of the other players' options, might realize that all involved in the game have similar information, and might know that all other players are attempting to act rationally. When a player is informed in this way, he will be well positioned to anticipate how others will act and can adjust his moves accordingly. If the players are poorly informed, they will find it much more difficult to formulate their strategies on the basis of the moves the others will make.

The 'Prisoners' Dilemma' is a simple scenario which can be used both to illustrate game theory and to demonstrate how rational transactors may fail to reach welfare-maximizing solutions. The two players are suspects who

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See text accompanying chapter three, nn. 18 to 22 and chapter ten, nn. 184 to 186 and accompanying text. Not all are convinced by the reasoning involved, e.g. L. A. Stout, 'The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation', (1988) 87 Mich. L. Rev. 613, especially at 642-4, 696-8. Note as well, that proceeding on a 'piecemeal' basis and introducing reforms which create some but not all of the conditions required to ensure allocatively efficient outcomes may in fact do little to channel resources to more highly valued uses, see Harrison, supra, n. 9 at 53-5 and M. A. Utton, *The Economics of Regulating Industry* (Oxford: Basil Blackwell, 1986) at 16–17 (discussing a line of reasoning known as the 'theory of second best').
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are taken into custody and separated. Each suspect has a choice between
two strategies, these being to co-operate with the other and not confess or
to not co-operate ('defect') and confess. Both prisoners have full infor­
mation about the options which each faces. This is because of the actions of
the prosecutor. The prosecutor is certain that the two prisoners are guilty
of a serious crime, but does not have enough evidence to convict them at
trial. He tells the prisoners that if both do not confess, he can only book
them on a minor charge. Consequently, if the prisoners co-operate with
each other and say nothing to the prosecutor, they will each receive a light
sentence of one year in prison. The prosecutor says further that if both pris­
oners confess to the serious crime, they will be convicted and will receive a
heavy sentence of eight years' imprisonment. Finally, the prosecutor says
that if one prisoner confesses and one does not, the prisoner who confesses
will receive a very short sentence of three months because he has helped.
The one who does not confess will 'have the book thrown at him' and will
receive the maximum prison term of ten years. Consequently, if one prisoner
attempts to co-operate and keeps quiet while the other confesses, the first
prisoner will receive the maximum jail term while the second will receive the
lightest sentence possible. This scenario means that each prisoner is aware
of all of the other's options and pay-offs. The players can thus be charac­
terized as being fully informed. The joint welfare maximizing solution for
the two prisoners is to co-operate with each other and not confess since
between them they will only receive a total of two years in prison. Under
the circumstances, though, the prisoners will not be in a position to make
a binding agreement to keep quiet. Since the game is of this non-coopera­
tive nature, each will remain tempted to defect and confess in order to
receive the lightest sentence of three months. If each reasons in this way,
both may end up confessing. The prisoners will then reach the worst over­
all outcome, which will be spending a total of sixteen years in jail.

Game theory can be used to analyse business enterprises and can high­
light situations where market transactors will, acting rationally, fail to con­
clude mutually advantageous bargains. Take the example of an
entrepreneur who has financial capital and has discovered a potentially
valuable new business opportunity. He incorporates a company to exploit
it. He owns most or all of the shares, thus allowing him to select the
company's directors and otherwise exercise control over the company's

* On games with similar elements see J. S. Johnston, 'Opting In and Opting Out:
Bargaining for Fiduciary Duties in Cooperative Ventures', (1992) 70 Wash. ULQ 291 at
308-10; P. Aghion and P. Bolton, 'An Incomplete Contracts Approach to Financial
Contracting', (1992) 59 Rev. of Econ. St. 473 at 473-6; D. M. Kreps, 'Corporate Culture and
Economic Theory' in J. E. Alt and K. A. Shepsle (eds.), Perspectives on Positive Political
Economy (Cambridge: Cambridge University Press, 1990), 90 at 100-2 and R. D. Cooter,
14 Int. Rev. of Law and Econ. 215 at 218.
The entrepreneur, however, does not have the expertise and connections necessary to develop the business opportunity on his own. Instead, the entrepreneur needs to take on a skilled manager to operate the business. If the entrepreneur takes this step, the potential exists for both him and the manager to end up considerably better off. Nevertheless, the entrepreneur may not hire the manager, even though this would be the efficient outcome. To see why, assume the game, like the Prisoners’ Dilemma, is non-cooperative in the sense that the parties cannot enter into a binding agreement. As well, the game involves a simple decision-making sequence under which one player will move first and the other player will then respond by making his move. This is different from the Prisoners’ Dilemma, where the players act simultaneously when they decide to co-operate or defect. The entrepreneur is to move first and his choice is whether to invest and engage the manager or not invest and give up on his plans. After this, the manager decides whether to co-operate or defect. For the manager, co-operation involves committing himself to the business and using best efforts to ensure it succeeds. If he defects, he will engage in self-serving conduct. He might, for instance, work long enough to find out about the entrepreneur’s plans, appropriate the key elements of the entrepreneur’s scheme and develop the project himself.

A set of hypothetical pay-offs illustrates why the players in this game may well fail to reach the efficient outcome. If the entrepreneur decides not to invest, the pay-off for both him and the manager will be £0. If the entrepreneur invests and the manager co-operates, the total net gain will be £20,000. They will split this, which means that each will receive £10,000. Finally, if the entrepreneur invests and the manager defects, the manager’s pay-off will be £15,000 and the entrepreneur will suffer a loss of £5,000, thus yielding an overall net gain of £10,000. This outcome will be the worst for the entrepreneur because he will have invested time and effort working with the manager and thus will have lost the opportunity to discover and pursue other potentially lucrative commercial ventures. Under the foregoing circumstances, the joint maximizing outcome is investment-cooperation, given the overall profits of £20,000. If, however, the entrepreneur acts rationally and is aware of the choices available to him and to the manager, this result will not come about. The entrepreneur will realize that if he invests, the

On the division of managerial authority in UK companies, see Gower, supra, n. 21 at 47-58. Since 1992 it has been possible for a company to have one member: Companies Act 1985, s. 1(3A), inserted by The Companies (Single Member Private Limited Companies) Regulation 1992, SI 1992/1699.

On introducing time, see Heap, supra, n. 30 at 113-15.

A question which arises at this point is why the net gain is less when the manager carries out the project. The most straightforward explanation for the numbers used is that if the manager defected his conduct would generate costs which would not arise if he followed the co-operative option (e.g., he would expend resources organizing the project and keeping his plans confidential).
manager's best choice will be to defect. This is because the manager will gain £5,000 more from doing this than he would from co-operating. Since an investment/defect result yields the worst overall outcome for the entrepreneur he will decide not to proceed. He will do so even though not investing is the joint minimizing outcome; remember that total profits under these circumstances will be £0.

This entrepreneur/manager scenario, in addition to illustrating that rational transactors may fail to reach an optimal outcome, also indicates how government regulation can provide a solution. Since voluntary agreements which parties reach should usually be mutually beneficial, a step the state can take to increase aggregate social welfare is to use laws to increase the costs associated with breaking promises. Under such circumstances, transactors will have incentives to perform agreements made. Market participants should in turn be more confident that bargains will be carried out as arranged. Correspondingly, they should enter into a wider range of mutually beneficial exchanges than would otherwise be the case. Ultimately the process should foster a more efficient allocation of resources. Contract law is a system of rules which operates consistently with the foregoing rationale for state intervention since it provides incentives for parties to stand by their bargains. The entrepreneur/manager hypothetical illustrates the impact contract law can have. Assume that in negotiations the manager agrees not to use corporate information for personal purposes and promises not to indulge in other competing business activities. The manager then enters into a services contract with the entrepreneur's company and terms are included to reflect the assurances given. Under these circumstances, the entrepreneur via his company would have the right to go to court and obtain an injunction restraining the manager from developing the business opportunity on his own and requiring the manager to return whatever personal benefits he may have obtained in the meantime. The change this would make

A careful reader might wonder why the entrepreneur does not solve the problem by agreeing to take a smaller share under the investment/co-operation option (e.g., he would agree to take £4,500 and let the manager have £15,500). The reason he could not do so is that the manager could not be confident that the entrepreneur would turn over the promised amount since as presently constructed this is a non-cooperative game.


As mentioned, the entrepreneur, by owning most of the shares would be well positioned to run the company and in UK companies the directors usually have the power to make litigation decisions on behalf of the company, e.g., Breckland Group Holdings Ltd. v. London & Suffolk Properties Ltd. [1989] BCLC 100 (Ch. D.).
is dramatic. The presence of an enforceable contract and the possibility of litigation would help to ensure that the manager treated his commitment to the business venture as a binding one. The entrepreneur, now confident of the manager's approach, would have the incentive required to invest. The players therefore would reach the joint maximizing outcome of investment and co-operation.\(^{39}\)

**Clarification of the meaning of efficiency**

While the foregoing discussion indicated that in economics the efficiency criterion relied on to support government intervention is the allocation of resources to more highly valued uses, some further terminological refinements are required. Two different measures of efficiency can be used in assessing whether a proposed change will increase aggregate social welfare.\(^{40}\) One is 'Pareto efficiency', named after its originator, Mr Vilfredo Pareto, a 19th century Italian economist. A transaction or decision is Pareto efficient if the change will make somebody better off while not making anyone feel worse off. Those who advocate state intervention on the basis of efficiency like to be able to discuss their proposals as 'Pareto superior' moves. One reason is that changes which meet the Pareto test must increase societal welfare since some people will be better off while no one loses. Another is that, since there will be no one for whom the costs associated with the change will exceed the benefits, Pareto superior moves have desirable distributational properties.

However, the Pareto standard suffers from a key limitation: few forms of government intervention can meet the requirement of producing no losers. When the state regulates or restricts a particular aspect of human behaviour, usually the policies involved will affect a substantial number of individuals and leave at least some people disadvantaged. Officials who try to overcome this problem will find that progress is very difficult to make. This is illustrated by the problems which befell the London Stock Exchange's TAURUS project, which was the ill-fated predecessor of the CREST system. TAURUS, like CREST, was intended to introduce electronic settlement of share transactions. TAURUS was supposed to reduce dramatically the paperwork involved. While it might seem this would be a universally-supported improvement, this, was not the case. A proposed feature of the TAURUS system was to replace individual company share registers with a centralized system. This caused considerable concern in certain quarters. Some private investors feared that they would either have

\(^{39}\) There are additional complexities involved; these are discussed in chapter three, nn. 70 to 73, 155 to 159 and chapter four, n. 24 and accompanying texts.

to own shares through nominee accounts held by their brokers or incur much higher dealing costs in order to own shares in their own name. Share registrars, who maintain records of shareholdings for UK public companies, opposed the change since they were concerned about being driven out of business by the presence of a central registrar. Finally, many companies wanted to ensure that share registers continued to identify members on an individual basis, fearing that the anonymity likely to be associated with electronic settlement would facilitate hostile takeover bids. The Stock Exchange, in designing Taurus, tried to accommodate all of these concerns. This turned out to be a fatal error. As one observer said: 'Taurus attempted to be all things to all men, to accommodate every desire and anomaly, every quirk and way of doing things. As a consequence, agreement was hard to achieve on anything.' The result was that Taurus was plagued by delays and became a much more costly and technically complex scheme than had originally been envisaged. The Stock Exchange, having failed to accomplish the perhaps impossible task of accommodating all interests, ultimately had no choice but to terminate the project."

Given the restrictions associated with the Pareto standard, when analysts rely on efficiency principles to justify government intervention, they usually use a more lenient benchmark. This is 'Kaldor-Hicks efficiency', which was developed by two British 20th century economists, Professors Nicholas Kaldor and John R. Hicks. Under the Kaldor-Hicks approach, a legal change is efficient if, in aggregate, the benefits associated with the change exceed the costs. In such circumstances, those who gain will obtain enough to compensate fully those who lose. No compensation, however, need take place. Consequently, while a reallocation of resources which leaves someone worse off will not be Pareto efficient, it can meet the Kaldor-Hicks standard of efficiency. The fact that this standard allows for losers means that from an ethical perspective it is less attractive than its Pareto counterpart. Nevertheless, since a change which is Kaldor-Hicks efficient should increase social welfare and since the Pareto test is usually impossible to
satisfy, the Kaldor-Hicks standard is understandably the one which analysts tend to adopt to evaluate proposed changes.44

2. REGULATION CAN GIVE RISE TO COSTS AS WELL AS BENEFITS

Those who employ economic analysis place considerable stress on the idea that choices give rise to costs as well as benefits. This predilection is exemplified by concern about opportunity costs, which represent the satisfaction or output which could have been derived from the best foregone alternative. When the topic is government intervention, the emphasis placed on the need to take costs into account takes on a somewhat different character. The objective is to avoid deception by what some call the 'nirvana fallacy'.45 Analysts who speak favourably about state intervention often seem to assume that government can help to correct matters whenever markets are not operating perfectly. However, such reasoning involves a key logical error. This is that one cannot argue policy B is superior to policy A by simply setting out the problems associated with A. Instead, one must consider policy B's disadvantages as well. This means, in the context of government regulation, one must take into account the costs of legal intervention as well as the benefits. By extension, the possibility exists that regulation may not be justified in circumstances where markets do not cause resources to be allocated to their most highly valued use.

To illustrate the significance of the idea that the costs associated with state intervention need to be kept in mind, it is necessary to introduce two new versions of efficiency, these being ex ante and ex post efficiency. For a transactor, a bargaining arrangement will be efficient ex ante where prior to performance he believes that the benefits associated with contracting will exceed the costs. In contrast, a transactor will only think that a bargain is efficient ex post if he feels he has ended up better off after performance of the agreement. If parties to a contractual arrangement have perfect information, can transact at low cost, can be confident that the bargain will be performed in accordance with its terms, and are fully capable of judging what is in their best interests, the transaction should be efficient both ex ante and ex post. The arrangement should meet the ex ante test since the parties logically would only agree to proceed if they felt that they were going to

end up better off as a result. The contract should also turn out to be efficient after the fact. Under ideal contracting conditions everything should work out as the parties planned. Thus if the transaction was efficient \textit{ex ante} it should necessarily be so \textit{ex post}.

With real world transactions, arrangements under which each party anticipates he will end up better off do not always yield beneficial outcomes for all concerned. Take the example of a situation where transactors do not have perfect information. Under such circumstances an agreement may well often be efficient \textit{both ex ante} and \textit{ex post} for everyone involved. Again, those who purchase newspapers rarely know everything about what they are buying. However, presumably most customers are satisfied with the purchases they make. Otherwise, they would stop buying newspapers. Still, when contracting parties do not have full information, unlikely or unforeseen contingencies can occur which make performance more costly or more difficult. In such circumstances, those who have to bear the losses involved may well feel \textit{ex post} that the costs associated with contracting exceeded the benefits.\textsuperscript{46}

In relation to companies, shareholder voting can give rise to situations where some who viewed arrangements favourably \textit{ex ante} will feel differently \textit{ex post}. A company's members, when they act collectively, usually proceed by way of approving resolutions at general meetings. Only rarely is it required that shareholders act unanimously.\textsuperscript{47} Instead, measures are passed either by a simple majority of the votes cast for an 'ordinary' resolution or by a three-quarters majority for an 'extraordinary' or 'special' resolution.\textsuperscript{48} This is by and large a sensible system.\textsuperscript{49} In a company with a substantial number of shareholders eliciting a response from and obtaining the approval of all members is likely to be a time-consuming process. Also, in a situation where unanimous consent is required, an individual member might try to take advantage of the situation by withholding his consent in order to extract some extra benefit for himself. Because of such considerations, from an \textit{ex ante} perspective all shareholders in a company will usually accept that a voting procedure should be used to approve required changes. A dissenting investor, however, who finds that his fellow shareholders are passing measures with which he disagrees may well subsequently


\textsuperscript{47} The members can arrange for a unanimity rule if they want; see discussion in chapter two, n. 34 and related discussion.

\textsuperscript{48} On types of resolutions, see Gower, \textit{supra}, n. 21 at 518-19.

take a different view. Looking at matters *ex post*, he will find that the voting system is not serving his interests.

Should the state provide relief for individual transactors on the grounds that contractual arrangements have left them worse off after the fact? In other words, should the government seek to ensure that arrangements are efficient for all parties *ex post*? The costs associated with intervention indicate that as a basic proposition the answer should be no. One consideration is that with arrangements where one party is dissatisfied with how things have worked out, assets overall may still be transferred to more valuable uses. This is because other parties will have gained more than the disappointed individual has lost. In such circumstances, the contractual arrangements will, even *ex post*, meet the Kaldor-Hicks standard of efficiency. Regulation in turn might have a counter-productive impact by deterring such efficient changes from occurring. For instance, in a company with a dissatisfied shareholder, the other investors might well have been more qualified or better motivated to judge what was beneficial for the business. In such circumstances, they will likely have been using the voting mechanism to promulgate a series of value-maximizing changes. The state, if it provides the disappointed minority investor with grounds to set aside the arrangements made, might well reverse the efficient outcomes which otherwise would be achieved.

Another reason why providing relief to individuals who are dissatisfied *ex post* might well give rise to more costs than benefits is that this will send a signal to future transactors which might be counter-productive. In a general sense, the problem is that transactors will not proceed with arrangements likely to transfer resources to more highly valued uses because they will fear that a party who is dissatisfied with how matters have worked out will disrupt everything. Assume that the discontented shareholder in the voting scenario was much more astute than his fellow investors and that the changes they were making were ill-advised and detrimental to the business. The company's resources likely would be depleted over time if the minority shareholder was ignored. Nevertheless, disrupting the choices the majority had made would provide a signal to investors generally that only changes supported unanimously were going to be upheld in the event of a dispute. This, in turn, would deter shareholders from relying on voting as a mechanism for approving proposed changes. Since such a regime usually serves investors better than a system based on unanimity principles, the likely outcome would be that investors would be left worse off.

If the legal system provided relief to disappointed transactors as a matter of course, an increase in opportunistic threats of litigation would likely impose an additional set of costs. In a bargaining relationship, a party

behaves in an opportunistic fashion if he seeks to alter unilaterally and in a self-serving manner the agreed-upon formula for sharing the surplus from co-operation. The fact that market participants ordinarily prefer to avoid going to court creates scope for such conduct. The reluctance to litigate is caused primarily by the costs associated with legal proceedings. Litigants have to pay lawyers' fees and expend time and effort preparing for trial. As well, the acrimony which often accompanies court proceedings can undermine otherwise workable business alliances. In a bargaining relationship, an opportunistic individual can take advantage of the circumstances by telling those with whom he is dealing that he will take them to court if they do not offer him a suitable side payment. So long as there is a reasonable prospect that the threatened legal proceedings will succeed, the litigation threat will be a credible one and the strategy has a good chance of working.

If disappointed transactors were entitled to redress, opportunistic individuals would be well positioned to threaten litigation in many circumstances. In all likelihood, the parameters of a 'disappointment' standard would be difficult to define with precision. Correspondingly, there would likely be in many situations a suitable foundation for credible litigation threats. Hence, if the legal system gave a party the right to seek relief on the grounds that he has ended up worse off as a result of a transaction, those involved in companies would regularly have to make otherwise unnecessary side payments to avoid the expenditures of time and money involved with litigation. The overall impact could be highly detrimental. This in turn would increase the likelihood that reforms introduced to ensure that contractual arrangements were beneficial for all transactors ex post would cause the costs of proceeding ultimately to exceed the benefits.

3. THE ECONOMICS OF GOVERNMENT REGULATION

Regulatory measures can be enacted, implemented and administered in a manner which is different from that intended or hoped for by supporters of government action. This phenomenon can increase the costs associated with government regulation. Nevertheless it has often been ignored. Most people who speak in favour of legal regulation of market behaviour adhere if only implicitly to what some have labelled the 'public interest' theory of the state. The fundamental premise of this theory is that government supervision of private ordering is designed to foster the achievement of widely-shared goals in society. Whether such an optimistic appraisal is justified is

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51 On opportunistic conduct generally, see Williamson, supra, n. 46 at 47-50, 64-7.
52 On opportunism and corporate litigation, see Johnston, 'Opting', supra n. 31 at 301-3, 308-10 as well as chapter seven, nn. 158 and 159 and accompanying text.
open to question. The possibility instead exists that because of problems
associated with the formulation and administration of legal rules, steps
taken which are sound enough in theory may not actually yield socially ben­
eficial changes. Key examples of such problems are that interest groups can
have a disproportionate and detrimental influence on the law-making
process and that the bureaucrats charged with administering regulations
may do so primarily in a manner which suits their own agenda.

To place the impact of interest groups and bureaucratic behaviour in
proper perspective, it is helpful to be familiar with a school of thought
known as 'public choice' theory. Despite the similar sounding names, 'public
choice' theory differs significantly from its 'public interest' counterpart.
According to public interest theory, with its reasonably optimistic view of
government activity, public officials seek to promulgate and enforce laws in
a welfare-enhancing fashion because it is their job to do so. Public choice
theorists argue that this characterization is far too simplistic. They say it
is naive to expect officials to work selflessly to promote laudable social goals
and argue instead that one can learn much more by analysing state regula­
tion in a different light. The crucial step is to assume that lawmakers and
the individuals who administer and enforce legal rules act in a manner
designed to maximize their own welfare. For example, a public choice theorist
would say that one can best understand the actions of civil servants and
other government bureaucrats by assuming these individuals are primarily
interested in accumulating power and perks. Along similar lines, according
to public choice theory, legislators are motivated primarily by a desire to be
re-elected and, at least for some, by the ambition to advance within the
ranks of their political party. By extension, government action is a com­
modity which is allocated in accordance with the forces of supply and
demand and the contours of a given law are the result of an intricate web
of implicit, self-interested exchanges among politicians, interest groups, voters,
and regulators.

Economic theory suggests that so long as certain assumptions are met,
market activity yields highly beneficial outcomes. Public choice theorists are
not optimistic that such results will occur with the exchanges involved in the
operation of government. Instead, these scholars usually characterize polit­
ical and regulatory activity in a negative manner. They argue that small,

"On the characteristics of public choice theory see Ogus, supra, n. 15 at 58-63; J. R.
74 Cornell L. Ret. 43 at 45-51 and D. A. Farber and P. P. Frickey, Law and Public Choice: A

"For a (critical) overview of the approach public choice theorists take on this front see
E. L. Rubin, 'Beyond Public Choice: Comprehensive Rationality in the Writing and Reading

"Halper, supra, n. 10 at 239-40 and H. Hovenkamp, 'Legislation, Well-Being and Public
coherent, compact organizations wield a disproportionate influence over the legislative process and consequently are able to secure the enactment of self-serving laws. Also, bureaucrats, being concerned primarily with enhancing their own power and prestige, will tend to engage in 'empire building', thus causing regulatory regimes to expand beyond their optimal size and operate in a dysfunctional manner.  

Public choice theory suffers from some significant limitations. It does not, for instance, seem to explain all political behaviour. People in government do not appear to act in a self-interested fashion at all times; instead they often make personal sacrifices to support their political ideals or to ensure that they do their job well. In addition, public choice theory may portray the law-making process too simplistically. Most political scientists, for instance, say that supply and demand models cannot be used to account for the content of all legal regulation. They argue instead that the political process is unique in many ways and caution that great care must be taken before drawing analogies between markets and politics. An additional limitation is that public choice theorists have not applied their models with equal rigor to all legal decision-makers. Although public choice theorists have studied legislators, regulatory agencies, and similar bureaucracies in some detail, they have, at least until recently, written little about judges.

Public choice theory is further limited by the fact that its models may not be universally applicable. For instance, this school of thought seems more relevant for the United States than for the United Kingdom. Public choice theorists usually assume that legislators are in a position to act as free agents and therefore have substantial scope for individual deal-making. UK legislators, in the ordinary course, do not enjoy such freedom.

This is because the executive branch of government, composed of the Cabinet and the civil service, has much more control over the nature and content of legislation than do individual politicians in the House of Commons and the

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59 For an overview of this line of thinking see Farber and Frickey, supra, n. 54 at 17-21.


House of Lords. The legislative process usually starts when civil servants within a Department, either on their own initiative or at the suggestion of the responsible Minister, formulate a reasonably detailed policy proposal. If the Department’s officials can persuade the Minister that the proposal is meritorious and should be implemented as legislation, the Minister will try to win over Cabinet and ensure that the matter is placed on the Government’s programme of bills. The Department’s lawyers will then prepare instructions for Parliamentary Counsel, which is the office within the civil service which drafts legislation. This is a vital stage, because once a bill is drafted, its form is usually substantially determined. One reason is that the drafting process ordinarily causes the Government’s policies on an issue to become much more fixed and rigid. Furthermore, the party in Government, by virtue of the majority it enjoys in the House of Commons and the strictures of party discipline, will usually be able to deter backbenchers from suggesting wholesale changes. The upshot is that while parliamentary debates often give rise to some additions, amendments, and deletions, in usual circumstances, most elements of proposed legislation survive intact.

In the United States the process associated with the preparation of statutes is much more decentralized. The executive branch has substantially less control over legislation than is the case in the United Kingdom. Correspondingly, individual legislators are far more likely to initiate the legislative process by introducing a bill than are their UK counterparts. As well, because party discipline is weak in the United States, legislators have much more scope for voting in accordance with their personal preferences than do UK parliamentarians. Furthermore, while there are federal and state legislative counsels which will assist with drafting, no one is obliged to use them or rely on their advice. Consequently, a legislator who proposes a bill will often rely on his own research staff or interested outside observers to draft a measure. In light of all these circumstances, elected officials in the United States clearly have more scope to act as the free agents envisaged by public choice theorists than do UK parliamentarians.

Still, while public choice theory has its limitations, the dynamics on which it focuses do have an impact on the enactment and administration of UK laws. On the legislative front, even though British legislators have less influence over the content of statutes than their US counterparts, lobbying does occur and can in certain instances have an appreciable impact on enactments. Consider a bill introduced to Parliament by the Government of
Mrs Margaret (now Lady) Thatcher in the mid-1980s. The proposed legislation stipulated that all directors of insolvent companies should be disqualified from serving on company boards for three years, subject to relief from the courts. The Confederation of British Industry and other groups representing the business community lobbied heavily against the legislation, and their efforts paid off when the House of Lords blocked the Government's plan. Ultimately, Parliament did enact the Company Directors (Disqualification) Act 1986, which expanded the grounds for disqualification. Nevertheless, by virtue of interest group pressure, the legislation did not go as far as the Government had originally intended.

According to some accounts of the performance of the Serious Fraud Office (SFO), this organization has acted in a manner consistent with public choice characterizations in terms of bureaucratic behaviour. The Criminal Justice Act 1987 set up the SFO to investigate and prosecute large scale commercial fraud cases. The SFO's work is relevant in the company law field because its most prominent cases involve dubious market practices affecting large business enterprises. The press has been highly critical of the SFO's performance. One feature which has been the focus of much attention is that the SFO has failed to secure convictions in a substantial portion of its high-profile cases. An alleged cause of this pattern has been that the SFO, anxious to establish a reputation as a 'serious player', was too keen to prosecute in the wake of widely publicized company scandals. The SFO, due to its impatience, may well have pursued cases when it was imprudent to proceed. To the extent that the responsible officials were in fact concerned about enhancing the SFO's status, the behaviour bears a considerable resemblance to the 'empire building' to which public choice theorists refer. Furthermore, the SFO's miscalculations may well have needlessly embroiled defendants and the criminal justice system in trials which were long, complex, and expensive.

66 1986, c. 46.
68 1987, c. 38, s. 1.
70 For a summary of these cases, see M. Levi, The Investigation, Prosecution, and Trial of Serious Fraud (London: HMSO, 1993), App. B. See also 'Trying Times', Economist, 27 January, 1996, discussing acquittals of Kevin and Ian Maxwell on charges of conspiring to defraud pension funds in their father's business empire.
71 For anecdotal evidence supporting this view, see B. Wildlake, Serious Fraud Office (London: Little, Brown, 1995) at 48-9, 53, 61-2, 236.
4. THE IMPACT OF LEGAL RULES ON PRIVATE TRANSACTIONS

Professor Ronald Coase and ‘The Problem of Social Cost’

Traditionally, legal scholars have taken it for granted that the law matters. The conventional wisdom has been that most members of society attempt to comply with legal rules and alter their behaviour when laws are changed. The manner in which academics are characterizing the impact of law is, however, changing. Increasingly, scholars are recognizing that the effect which the legal system has on social and commercial activity is often marginal. ‘The Problem of Social Cost’, an article written in 1960 by economist Professor Ronald Coase, has played a key role in this process. The article, which has also been credited with providing much of the impetus for the development of law and economics as an intellectual discipline, discussed negative externalities. A negative externality arises when people who are not parties to a consumption or production decision are adversely affected by the decision. For example, if railroad engines generate sparks which set fire to crop fields adjoining the tracks, the railway company imposes a negative externality on the farmers.

If firms do not take externalities into account, society’s resources may end up being inefficiently allocated. Firms which are free to disregard social costs will be able to set lower prices. This will mean demand will be higher than it otherwise would be, which in turn will lead to the supplying of larger quantities. The ultimate result will be over-production from the perspective of society. The government arguably can solve the problem by taxing or making liable those market participants who cause negative externalities. Such steps should cause transactors to internalize the costs involved, which in turn should foster a socially optimal production of resources. Hence, with the crop example, the policy prescription would seem to be that the state should tax railway companies or make them liable for crop damage in order to foster the efficient use of trains.


" (1960) 3 J. of L. and Econ. 1; see on this point Schwab, supra, n. 14 at 1191.


This line of reasoning may well place too much emphasis on legal rules. Professor Coase pointed out in his article that when economic activities conflict, if those involved are well-informed and can bargain at low cost, these individuals will likely adjust their production levels to a mutually advantageous and socially optimal level. Furthermore, this will occur no matter what the law is. This point can be illustrated by considering the railway/farmer scenario. Assume the profits generated by running trains are greater than those yielded by raising crops close to the tracks. In this situation, so long as the railway company and the farmers can bargain with minimal fuss, the engines will run regardless of the relevant liability rule. The fact that this will occur if the railway company is not liable is not surprising since the company will be acting consistently within its legal rights. More startling is the fact that the result will likely not change if the liability rule is reversed. The railway company, in these circumstances, will likely negotiate with the farmers for permission to run its trains and the farmers should agree if they are offered at least enough to compensate them for the profits foregone by not growing the crops. The result, in turn, would be efficient since all parties would be better off than if the trains did not run.

Professor Coase’s reasoning posed a strong challenge to the assumptions that people usually made about legal rules. Prior to ‘The Problem of Social Cost’, it probably would have been taken for granted that a liability rule would affect the operation of trains and that any attempt the parties made to bargain around the law would be counter-productive from a social perspective. Professor Coase’s work indicated this may not be so. His reasoning suggests that whenever people encounter legal rules which do not suit their interests, they may well negotiate around those rules and formulate a mutually advantageous and socially optimal solution. Work done since ‘The Problem of Social Cost’ has confirmed that the role the law plays is often marginal. A series of studies have been carried out which indicate, for instance, that many commercial transactions are arranged without lawyers becoming involved. Furthermore, in situations where transactors do obtain legal advice, they often substantially complete their negotiations before consulting their lawyers. The role of the legal advisers is then simply to structure the transaction so that legal rules do not pose a problem.

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77 This is only one of a number of insights which Coase’s article provided. The literature on ‘The Problem of Social Cost’ is voluminous; for an overview of the issues it brings to light see Duxbury, supra, a. 44 at 387-8 and F. Parisi, ‘Private Property and Social Costs’, (1995) 2 Eur. J. of L. and Econ. 149.


Also, commonly parties to a contract do not worry whether there has been full compliance with everything in writing. They instead rely on informal undertakings and the reputation of those with whom they are dealing as assurances of satisfactory performance. It might seem, to lawyers at least, that this sort of behaviour is imprudent and even reckless. Still, it can be expensive and time-consuming to obtain and follow legal advice and to perform agreements strictly in accordance with all terms. Consequently, even commercial actors who are generally cautious and deliberative may well decide that it is not cost-justified for them to attempt to achieve a particular legal position and to follow contracts to the letter.

Examples of the limited role law can play in companies
Like other areas of commercial endeavour, the law's role in company affairs is often a marginal one. Examples arise in a variety of contexts. Individuals who decide to incorporate a business are often more concerned with saving money on professional fees than they are about the precise legal structure of the company. Consequently, it is reasonably common for incorporators to pay a company formation agency to set up their company using a 'standard form' corporate constitution rather than relying upon a solicitor. They act in this way because they believe it is not worthwhile to pay for the specialized advice which a lawyer might provide.

Another situation where the law is very much in the background is prior to an offering of shares for sale to the public by a company which is obtaining a listing to have its equity traded on London's Stock Exchange. This process, commonly referred to as 'going public' or a 'flotation', is regulated by a combination of statutory provisions and Stock Exchange rules. Nevertheless, a significant aspect of the procedure can occur outside this elaborate legal framework. There is usually a considerable gap in time between the publication of the documentation which supports a flotation and the commencement of official trading on The Stock Exchange. During this hiatus, a 'grey market' can develop in the shares. The trading which
occurs usually takes place on a verbal basis only and is not conducted through The Stock Exchange. Such dealings are not subject to the safeguards which the Exchange's regulations offer, which means that investors may be subject to an increased risk of deals being dishonoured or not settled promptly. Grey market transactions are legally enforceable under the law of contract, but most dealers are very hesitant to resort to formal court proceedings. 85

The limited role which the law plays is also illustrated by the fact that when company participants encounter a legal doctrine which conflicts with their needs and expectations, they often neutralize the law's effect by making some contractual adjustments. For instance, in the ordinary course, a company's shareholders and managers are not personally responsible for its debts.86 They correspondingly enjoy what it is commonly referred to as limited liability. Creditors, when they lend money to a smaller company, often want the firm's operators to bear some personal financial responsibility if the company collapses. Limited liability poses a problem in this regard, but the difficulties involved can be overcome in a straightforward manner. A creditor who wants to contract around limited liability can require as a condition of lending that the company's operators provide a personal guarantee for corporate debts. Similarly, contractual planning has frequently been used to reduce the impact of what is known as the ultra vires doctrine. In the United Kingdom a company's capacity is defined by the powers and objects stated in its memorandum of association. Corporate activities which are not within the specified capacity are ultra vires. Though the situation has been modified somewhat by statute, traditionally when the ultra vires doctrine applied, its effects were harsh.87 Most notably, if a company entered into a contract which was not authorized by the memorandum, that contract was void and consequently could not be enforced by any of the parties. As a practical matter, however, the ultra vires doctrine only rarely interfered with corporate transactions. Individuals forming companies usually prevented problems from arising by arranging for the memorandum to include lengthy and highly comprehensive powers and objects clauses.88


86 See, for example, Salomon v. Salomon [1897] AC 22 (HL) and Companies Act 1985, ss. 1(2) and 2(3).

87 The modifications were introduced by s. 108 of the Companies Act 1989, c. 40, adding s. 35A to the Companies Act. For an overview of the changes and the previous state of the law see Gower, supra, n. 21 at 166-93.

This meant that only in exceptional circumstances would companies engage in activities which exceeded their capacity.

One further pattern of behaviour which illustrates that the law’s impact is often marginal in company affairs is the approach which company participants take towards litigation. As mentioned, court proceedings are usually costly and disruptive. Individuals involved in companies therefore prefer not to resolve disagreements by litigation. Disputes between factions of shareholders are reasonably common in companies. Nevertheless such matters rarely actually go to trial.90 Also, when a company has breached an executive’s service contract by dismissing him before the term has expired, the matter will almost invariably be settled out of court.91 As well, even if company participants do litigate, the manner in which they ultimately deal with the matter may well not be consistent with the judge’s order. Instead, the victorious party might treat the court’s ruling as a bargaining chip and the parties will ultimately reach a different outcome from that which the judge had specified. This is indicated by a study of US cases where a shareholder had applied for an order to wind up a company on the grounds that those in control of corporate affairs had acted improperly.92 The usual result in such cases was that the company continued to do business and its operators agreed to buy the applicant’s shares. This pattern prevailed regardless of whether the application for winding up succeeded. It seems the only difference a winding up order made was that successful applicants could negotiate the sale of their shares on more favourable terms than their unsuccessful counterparts.

Situations where the law matters

The foregoing discussion illustrates that contrary to what might have been expected, the law’s impact on company affairs is often insubstantial. One should not go to the opposite extreme, though, and assume that the law’s role is always marginal or peripheral. A situation where the law has a significant impact is where a legal scheme prevents company participants from structuring their affairs in the manner they want. In Germany many managers and investors are unenthusiastic about laws in that country which mandate worker participation in the governance of larger enterprises. Some German businesses have indeed tried to escape the effects of the legislation

by forming subsidiary companies or by making use of a non-corporate business organization, such as a limited partnership. Still, the bulk of the worker participation rules have been designed so that they cannot be avoided by choice of business form; thus the legality of these strategies is open to doubt. As a result, large German businesses usually refrain from using evasive techniques and provide for worker participation in the manner the relevant legislation specifies.

Another situation where company participants ascribe considerable importance to the rules which govern their affairs is where they are seeking to achieve a particular legal position by way of detailed contractual planning. Take the example of venture capital arrangements. Venture capital consists of equity sold by an emerging business to sophisticated investors. The money which the investors pay for their shares provides the company with financial backing and gives the firm’s managers useful credibility when they approach banks to obtain a loan. Venture capital negotiations are usually lengthy and the supporting documentation is almost invariably detailed and comprehensive. This suggests that the parties to such arrangements think it is important to achieve a particular legal position.

One reason why market participants sometimes structure their affairs by way of comprehensive planning pertains to financial resources. Individuals will be more inclined to rely on complex contractual arrangements when they have substantial assets and thus can afford to pay for the professional advice required to engage in and conclude detailed and costly negotiations. With venture capital negotiations, for instance, those who provide the financing as part of such arrangements will usually have access to the funds necessary to pay for the legal advice they require. Company participants will also take steps to achieve a particular legal position where the relevant legal regulations do not suit their needs and the situation can be dealt with

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93 K. J. Hopt, 'Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe', (1994) 14 Int. Rev. of Law and Econ. 203 at 206. For more detail on the German legislation and managerial attitudes toward the regime, see chapter twelve, nn. 119 to 122, 138 and accompanying text.


readily by contractual terms. With venture capital arrangements, tax legis-
lation can motivate those involved to act in this manner. A common
arrangement in venture capital schemes is a 'ratchet', which is a mechanism
designed to provide incentives to the managers of the emerging business by
ensuring that the proportion of equity they own varies in accordance with
the success of the business.⁷ Such performance-related rights, however, can
trigger adverse tax consequences if proper precautions are not taken.
Usually it will be sufficient to ensure that the corporate constitution has set
out the relevant terms in a comprehensive fashion before the venture capital
investors take up their shares.⁸

Company participants may also rely on legal planning where certain oth-
erwise reassuring factors are missing. Transactors tend not to worry much
about formalizing matters on a contractual basis when all the parties con-
cerned have a sound commercial reputation. On the other hand, a more
legalistic approach is often taken when parties know little about each other.
Again, the venture capital example is instructive. Usually, the people oper-
ating companies which require an injection of venture capital do not have
much of a track record. Those providing the funds consequently will be
sceptical of the level of expertise and degree of commitment possessed by
those operating the business. This means the investors will rely more heav-
ily on contractual documentation for protection than they otherwise would.
For instance, to motivate the managers to run the business in the share-
holders' interests there will usually be a ratchet arrangement or an analo-
gous incentive scheme. As well, there will likely be detailed clauses requiring
those in charge to make timely and regular disclosures and allowing
investors to abandon the project on short notice if the prospects look dim.

A final situation where the law’s impact can be highly significant is in dis-
putes between company participants. To understand why this is the case, it
is necessary to be familiar with the 'gap-filling' function which the legal sys-
tem plays. Only very rarely will contractual documentation deal with all
potentially relevant issues in a bargaining relationship. The reasons can
include the failure to pay for sophisticated legal advice, the occurrence of
events which even the highest-paid lawyer could not have anticipated and
the emergence of altered dynamics as circumstances change over time.
When issues have not been dealt with by express contractual clauses, statu-
tory measures and principles established by way of precedents in judicial
decisions will govern. The law, in such circumstances, will be filling the
'gaps' in the relevant contractual material.

When legal doctrines act as 'gap fillers' they can have a significant impact

⁷ On how ratchets can be structured, see C. Hale and S. Beddow, 'Preference Shares: In a
Class of Their Own', PLC, October 1995, 11 at 16, 18.
⁸ Finance Act 1988, c. 39, discussed by J. Blake, 'Tax Considerations' in Practitioner's
Guide, supra, n. 94, 277 at 292-5.
on the outcome of disagreements. For instance, the applicable rules can help to shape the parties' negotiating strategies and can have an important influence on whether cases settle or go to trial. Furthermore, if a dispute ends up in court, the judge will rely on the relevant statutory and case law principles in reaching a decision. This is significant because, while a court order will not always be complied with in the precise manner which a judge has specified, it can have an effect on any post-litigation bargaining which takes place. The US study of winding up cases discussed earlier indicates this. Again, the applicants who were successful were apparently able to use their orders for dissolution of the company to demand more favourable terms than those who were not.

To sum up, the law's role in company affairs is complicated. Clearly, legal rules do matter sometimes. Nevertheless, they are certainly not always of fundamental importance. Often, company participants pay little attention to the state of the law. Furthermore, when they do, they are just as likely to be contracting around legal rules as complying with the applicable doctrines. It is thus unrealistic and unhelpful to assume that the law dictates how companies are run. Instead, the law is only one factor which influences corporate activities, and in many circumstances it is not the key one.

5. THE COMPANY AS A NEXUS OF CONTRACTS

We have now considered a series of insights which economic theory can provide for those interested in company law. None of the basic points considered thus far has been relevant solely for corporate behaviour. Instead, in each instance, the concepts discussed have potentially been relevant for a variety of types of activities regulated by law. Game theory, for instance, has been used to study fields as diverse as civil procedure, labour law, and tort law. Also, public choice models have been used to analyse a wide range of legislative behaviour and regulatory activities. Furthermore, contractual theorists have recognized that a wide range of commercial transactions is governed as much by informal undertakings and implicit commitments as by legal documentation, legislative provisions and judicial rulings. There is, however, an insight which economics provides that is of

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" For a similar appraisal of the role which contract law plays in a business context, see S. Deakin, et al., 'Trust' or Law? Towards an Integrated Theory of Contractual Relations Between Firms', (1994) 21 J. of Law and Soc. 329, especially at 337.


" See, for instance, the topics discussed in Farber and Frickey, supra, n. 54.

" See, for example, the overview of relational contract theory provided in S. Wheeler and J. Shaw, Contract Law: Cases, Materials and Commentary (Oxford: Clarendon Press, 1994) at
relevance primarily in the context of corporate activity. This is that a company is a network of explicit and implicit bargains, or a nexus of contracts.

The nexus of contracts characterization is at odds with the legal conceptualization of a company. From a legal perspective, a company is a distinct entity and an artificial person. This has a variety of implications. Though a company's members are described as the owners, when a business is conducted through the medium of a corporate vehicle, the company in fact owns the assets of the business. As well, a company, as a legal person, can take action to enforce its legal rights. In contrast, shareholders typically cannot act on a company's behalf in this regard. Also, the fact that a company's shareholders and managers enjoy limited liability is consistent with the principle of corporate personality; the company, not these individuals, is responsible for its debts. Still, despite a company's legal status, it is helpful to deconstruct the corporate entity and examine directly the relationships between the key participants. When this is done, it becomes evident that individuals associated with companies become involved in corporate affairs voluntarily and interact on the basis of reciprocal expectations and behaviour. Correspondingly, thinking about the company as a nexus of contracts is a valuable analytical exercise.

The role of the firm in economic activity

A firm encompasses any association of people formed to carry on business. The incorporated company is an important example of a firm, though others exist, such as the unincorporated partnership. To gain a better understanding of why a company is a nexus of contracts, it is helpful to start by considering why economic activity takes place through the medium of firms. A firm typically has a staff of permanent employees who work together in assembling products and delivering services. In such an environment people can be assigned the tasks at which they are most effective. Reliance on specialization allows for discovery and exploitation of situations of 'comparative advantage', which exist where individuals have, relative to each other, different sets of skills and talents. Correspondingly, larger output can be achieved than would be the case if one person was doing everything. This consideration will be of particular importance


... See generally Gower, supra, n. 21 at 85-96.

... See Foss v. Harbottle (1843) 2 Hare 461 and discussion of exceptions to the rule in this case in Gower, supra, n. 21 at 643-6.


... On the use of the words 'firm' and 'company' in this context, see text accompanying Introduction, nn. 7 and 8.

Key Participants in Companies

The nature and character of the bargaining relationships within each company will be in some respects unique. Nevertheless, it is possible to identify common elements which assist in analysing corporate affairs and in evaluating the role which law plays. This chapter examines the fundamental characteristics of the different types of participants involved with companies. Chapter one introduced the format we will use. We saw that bargaining relations involving company participants can be described in terms of six concepts. These again are the duration of contracting, the return parties anticipate receiving, the risk of loss, the degree of control a transactor has, the existence of conflicts of interest, and the extent to which parties can deal with potentially contentious matters through explicit contractual arrangements. These are the topics we will consider.

This chapter discusses five classes of company participant: shareholders, creditors, employees, directors, and managers. One reason we focus on these categories is that all play a crucial role in either financing or carrying out the economic activities which companies undertake. Also, each category can have a significant influence on corporate decision-making. Furthermore, shareholders, creditors, employees, directors, and managers choose to become associated with companies on a voluntary basis, which helps to ensure that focusing on bargaining relations is a suitable analytical step. Taking these reasons into account explains why some important groups are not analysed. Customers, at first glance, appear to be a suitable topic for discussion. They enter into contractual arrangements with the businesses from which they purchase goods and services. In addition, a business cannot prosper unless there is a demand for its products and services. Still, a dissatisfied purchaser, while probably wanting redress from a company which sells him defective products, is unlikely to be interested in influencing its managerial policies. Similarly, customers do not usually play any sort of ongoing role in financing business enterprises. The upshot is that

1 See 'Troubles Caused by a Lack of Legitimacy', *Financial Times*, 3 November, 1995 (article by Professor John Kay), arguing that there should be greater recognition of the ties between a company and its customers.

2 An exception might be supporters of professional football clubs, which typically carry on business via a limited company. Supporters are usually reluctant to switch allegiances, tend to view their team as a community asset, and often express their dissatisfaction in a vocal manner if team success is sacrificed for the sake of profit. Balancing the interests of shareholders and fans has been likened to 'galloping around a circus ring riding two horses bareback', 'Fancy Footwork Takes Team Top of the League', *Financial Times*, 10 February, 1996.
customers do not take a sufficiently direct part in the organization or operation of companies to merit analysis at this juncture.

Another group this chapter does not deal with is public officials. By virtue of various legislative and regulatory schemes, governmental institutions have an important impact on how companies operate. It is not particularly helpful, however, to characterize relations between government and business in contractual terms. Admittedly, dealings between companies and government sometimes involve bargaining and exchange, such as when cities, regions, and countries compete for major industrial plants by offering financial assistance, favourable tax treatment, and other similar benefits. Overall, however, the dynamics involved in business-government relations are significantly different from those which shape the interaction between private individuals. Market participants will usually be motivated primarily by monetary or other material gain. Government officials, on the other hand, are usually much more concerned with political and institutional pressures. Also, governmental institutions can rely on legislative power to shape behaviour in any bilateral negotiations, which is something that usually cannot occur in dealings between private actors. As a result, the analytical framework we are using in this chapter does not readily accommodate many aspects of the relationship between companies and government.

I. SHAREHOLDERS

In analysing the bargain elements which are relevant for shareholders, a key consideration to keep in mind is that a company can be classified as closely held, widely held, or somewhere in between. It is impossible to define with precision what constitutes a closely held or widely held company since within each category every individual business will have some distinctive features. However, certain prevalent characteristics can still be identified. A closely held company will have a small number of members (the term used by the Companies Act 1985 to refer to shareholders). A widely held company, in contrast, will have many shareholders and the company’s equity will usually be listed for trading on a stock exchange. In a closely held company, the members usually take a hands-on role in running the business. For instance, the authors of one British study found that in approximately four out of five small companies, individuals serving on the board of directors owned 90 per cent or more of the shares. In contrast, with a widely held or public company, a clear dichotomy often exists. Executives in a public company usually only own a small fraction of the equity and the mem-

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3 On the use of the term 'member', see Introduction, n. 5.
KEY PARTICIPANTS IN COMPANIES

bers tend to shy away from becoming involved in the day-to-day running of the business.'

English company law has, since early in this century, made some allowances for the differences which exist between companies with publicly traded shares and their closely held counterparts. The process began when the Companies Act 1907 gave legislative recognition to the concept of the private company. At this point the Act stipulated that a private company was one which had fewer than 50 members, had not raised capital from the public, and had a clause in the corporate constitution restricting the transfer of shares.' The primary reason that Parliament introduced the private company concept was because companies legislation imposed obligations on incorporated entities to file publicly prescribed financial information. It was thought appropriate to excuse smaller businesses from complying with the bulk of such disclosure requirements. A similar pattern exists today. The Companies Act 1985 provides certain registration and filing exemptions for firms categorized as 'small' and 'medium-sized'.'

While UK companies legislation has provided some special treatment for smaller companies in terms of filing financial information, traditionally no distinctions have been made with rules that govern relations between shareholders. This is the case even though members in closely held companies usually deal with each other on a less formal and structured basis than do their counterparts in public companies.' In 1989 Parliament made a modest departure, however, from the traditional pattern. At this juncture, UK companies legislation was amended to permit private companies to dispense with certain formalities concerning the conduct of business which usually must be carried out at a general meeting of the shareholders.' Despite Parliament's cautious approach, we will see now that the differences which exist between widely held companies and their closely held counterparts have a significant impact on relations between shareholders within these enterprises.

Duration

The duration of a shareholder's investment is almost always open-ended. This distinguishes those who own shares from some other participants in companies, such as creditors. A debt contract will have a specified term which can expire and create the opportunity for renegotiation. In contrast, the relation of shareholders with a company does not automatically come up for periodic renewal and it is very rare for the corporate constitution to

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1. On executive share ownership, see infra, n. 305.
2. 7 Edw. 7, c. 50, s. 37.
3. See Part VII, ch. II of the Act; exemptions for small companies are discussed in more detail in chapter eleven, nn. 77 to 89 and accompanying text.
4. Some argue that correspondingly a different legislative approach is required, e.g., L. Sealy, 'Small Company Legislation', Law Society Gaz., 8 December, 1993, 16.
5. See, for example, Companies Act 1985, c. 6, as amended, ss. 381A, 381B.
Still, while share ownership rarely operates for a prescribed period, a company's members will frequently not own their equity throughout the company's lifetime. Instead, investors commonly acquire shares after incorporation and dispose of their equity at some time prior to a company being wound up.

The approach which individual shareholders take towards the investment they have in a company will vary depending on the circumstances. With closely held businesses, investors usually anticipate and expect that they will help to run the company and thereby contribute to its growth and development. Indeed, many people become involved in such enterprises because they seek the independence and challenge associated with operating their own business. The connection which exists can be reinforced over time if a member, carrying out managerial duties, develops skills and training which are uniquely suited to the business and thus have much less value elsewhere. Family ties can also create a link between a company and its shareholders; it is common for those who own equity in smaller businesses to be related. The upshot is that those who own equity in closely held companies usually have little interest in selling their shares and regard their investment as being long-term in nature. However this is not a hard and fast rule. Under certain circumstances members in closely held companies will be looking to liquidate their investment quickly. Reasons why a shareholder might want to sell his equity are that he has decided to start work in a different line of business or that he has had a disagreement with his fellow investors.

An investor who is seeking to liquidate his investment in a closely held company may find that he will remain a shareholder longer than he would prefer. This is because selling shares in such enterprises is often not a straightforward process. Part of the problem will be transfer restrictions. Shareholders in closely held companies frequently agree to these so they can screen potential transferees to ensure that the new individuals will be suitable business partners. Another complicating factor is that buyers will often be hard to find. Individuals who have no existing connection with the company will usually not be interested since they will not want to take the time and trouble to become involved in the operations of a small business. Even with those who are curious, they will likely walk away if they discover the departing shareholder felt compelled to leave because of acrimonious rela-

10 O. Williamson, *The Economic Institutions of Capitalism* (New York, The Free Press, 1985) at 304 and L. C. B. Gower, *Principles of Modern Company Law*, 5th ed. (London: Sweet & Maxwell, 1992) at 765, n. 58 (author saying he was unaware of a limited company with articles of association fixing the duration of the company, which is a circumstance under which a company can be wound up under the Insolvency Act 1986, c. 45, s. 84(1)(a)).
tions with others in the company. A shareholder looking to sell will thus usually have to turn to his fellow investors to buy him out. This will not always be a straightforward solution. Unless a shift in the balance of power in the company is in prospect, the remaining investors are unlikely to see much advantage in purchasing additional shares on their own behalf. Also, while a company has the power to repurchase its own shares if certain procedural requirements are met, those in charge are likely to have in mind preferred uses for cash on hand, such as financing an expansion of the business."

Shareholders who own equity in a company with publicly traded shares tend not to be tied to the business in the same way as their counterparts in closely held firms. A key difference is that individuals who buy equity in a public company rarely develop any links to the business by participating in management. As well, when investors decide to terminate the relationship and sell their shares they can usually do so readily. In the United Kingdom, the fact that certain financial institutions act as market-makers for listed companies (essentially those with shares listed for trading on London’s Stock Exchange) helps to ensure that this is the case. Market-makers undertake to buy and sell the equity of various companies in all but the most difficult market conditions. They will use their own capital if necessary to complete deals and The Stock Exchange offers them certain privileges which make it more attractive for them to trade on their own account. Listed companies thus should almost always have a liquid market for their shares, which means investors have an exit option whenever they want to dispose of the equity they own.

A commonly held perception is that investments in a listed company are usually transitory in nature. This is often thought to be the situation with equity owned by institutions such as insurance companies, pension funds, and unit trusts. Institutional investors, which own some 70 per cent of the equity in Britain’s public companies, are often accused of being

On the power to repurchase shares, see Companies Act 1985, Part V, ch. VII; for more details see chapter five, nn. 28, 35 to 41, and accompanying text.

On listed companies, the term can encompass any company with shares listed with an exchange recognized under the Financial Services Act 1986 (c. 60) but at present the London Stock Exchange is the only one with this status which carries out a listing process. An alternative trading system called Tradepoint has also been recognized, but it only allows for dealing in shares of companies already listed on The Stock Exchange.

On marketmakers, see 'Exchange Looks to a New Order', Investors Chronicle, 19 January, 1996, 38 as well as chapter eight, nn. 30 and 180 and accompanying text. The Stock Exchange proposed in 1996 scrapping the marketmaking system for the 100 largest listed companies and replacing it with a new regime under which a ‘registered principal trader’ would carry out much the same functions as a marketmaker but would not be required to take as many risks with their own capital, ‘LSE Plans Shift from Marketmaking System’, Financial Times, 29 April, 1996.

preoccupied with current performance and near-term prospects and are criti-
cized for not being sufficiently patient to wait for higher earnings to emerge
in the future." Trading patterns provide some support for such criticism. A
typical institution will on average sell during a year equities which by value
compose one-quarter of its share portfolio." The primary cause of the 'short-termist' myopia from which institutional investors allegedly suffer is
the manner in which the performance of fund managers, the individuals
who make most of the decisions to buy and sell shares, is evaluated. The
standard pattern is that a fund manager's track record is compared with
those of his peers on a quarter-to-quarter and year-to-year basis. A fund
manager therefore may well want to generate favourable results promptly
and thus has an incentive to buy and sell shares as quickly as necessary to
achieve this."

Though allegations of insufficient patience are common, it is unlikely that
institutional investors focus unduly on short-term factors." Paying atten-
tion to current trends and the next expected set of results does not demon-
strate a disregard for future developments. Instead, near-term profitability
can be consistent with good long-term performance; the two indeed are
more often associated than not." Also, when fund managers make invest-
ment choices concerning the buying and selling of a company's shares they
will rely on the advice of professional company analysts, who give substan-
tial weight to considerations which will have an impact over time. These
individuals act as the 'eyes and ears' of institutional investors by studying
the affairs of listed companies." In making recommendations, company

" D. Goodhart and C. Grant, 'Making the City Work' (London: Fabian Society, 1988) at
17-22 and the summary of the literature provided by P. Marsh, Short-Termism on Trial
(London: IFMA, 1990) at 4-7. See as well Trade and Industry Committee, Takeovers and
public companies over 90% said financial institutions focus unduly on the short-term).

" E. V. Morgan and A. D. Morgan, The Stock Market and Mergers in the United
Kingdom', Hume Occasional Paper No. 24 (Edinburgh: David Hume Institute, 1990) at 12, 60.
This statistic conceals variations depending on the type of institutional investor. Turnover with
investment and unit trusts is considerably higher than for pension funds and insurance com-
Governance Role of Financial Institutions in Their Investee Companies (London: Certified
Accountants Educational Trust, 1995) at 59-60.

" M. Lipton and S. A. Rosenblum, 'A New System of Corporate Governance: The
Monkhouse, 'Corporate Investment and Short-Termism' in T. Clarke and E. Monkhouse

" Marsh, supra, n. 17 at 11-15, 28-40 and CBI Industry City/Industry Task Force, Report

" See, for example, J. R. Woolridge, 'Competitive Decline and Corporate Restructuring: Is
a Myopic Stock Market to Blame?' in D. H. Chew (eds.), The New Corporate Finance: Where

" The 'eyes and ears' phrase comes from 'City Shudders Over Mackie Case', Financial
Times, 13 April, 1993.
analysts will take into account a variety of factors which are relevant over the longer term, including the quality of management, research and development expenditures and the introduction of new product lines. As well, the trading patterns of institutional investors are not necessarily evidence of a short-term perspective. Circumstances change and knowledge develops, which means that a fund manager should continually evaluate his share portfolio and sell shares which he thinks have become overvalued. Furthermore, regardless of the rate of turnover in shares, institutional investors have recently begun to work more actively towards promoting the long-term operating success of companies. Fund managers have become more keen to meet with company executives, to voice their dissatisfaction with board decisions with which they disagree and to support managerial shake-ups in underperforming companies.

Irrespective of how committed institutional investors might be to the companies in which they own equity, an investment in a public company is most likely to be treated as a long-term proposition by an individual or members of a family who own a substantial block of shares in that company. Such a situation typically arises when an entrepreneur has started a business and then either he or his children have arranged for the company's shares to be sold by way of a public offering, often called a 'flotation'. It is reasonably common in such circumstances for the founder and subsequent generations to retain an appreciable percentage of the equity. When a founder and his family continue to own a substantial stake they can be highly possessive of their investment, which will mean they will be reluctant to sell the shares they own and will be unenthusiastic about having the company issue new equity to the public if this will dilute the family's holdings. So long as financial considerations do not dictate a change of approach, the relationship between the company and the family will thus often be of considerable significance and duration. For instance, with J. Sainsbury plc, which operates a leading supermarket chain, the Sainsbury family owns nearly 45 per cent of the shares and for many years has played a key role in the running of the company. Also, Great Universal Stores plc, a major financial services and property company, remains tightly controlled by the Wolfson family. Overall, however, the general tendency in recent times

Sir M. Jacomb, ‘Shareholders are the Owners’ in Creative Tension (London: NAPF, 1990), 53 at 55-6.
Institutional Muscles Being Flexed More Often, Financial Times, 17/18 December, 1994; Institutions Flex Muscles in Public, Financial Times, 19 June, 1995 and discussions of institutional investor activities in infra nn. 71 to 73 as well as chapter thirteen, nn. 78 to 81, 127 to 129, 166, 172 to 178, 186 to 195, and chapter fourteen, nn. 268 to 276, and accompanying texts.
See also 'Loadsamoney Returns', Sunday Times, 24 December, 1995 (identifying individuals and families with substantial stakes in companies).
Return

A company’s shareholders are the ultimate beneficiaries of whatever success it enjoys since they are entitled to what is left over after other claims the company is obliged to meet have been satisfied. The members are thus the company’s ‘residual claimants’. The total return which a company’s equity yields for investors is a function of the net cash flow the business generates over time. The members will receive the return by way of distributions the company makes throughout its life. These can take the form of dividend payments, offers to repurchase equity for cash and any final payment made to shareholders upon liquidation of the business.

While the total return shares will yield will be composed of all distributions a company will ultimately make, individual members tend to view return somewhat differently. Since investors buy and sell equity at various junctures throughout a company’s life, most think of their return as being a combination of cash distributions made by the company while they own their equity together with the gain or loss involved when they sell their shares. However, the fact that equity is traded between investors does not change the total return, which shares yield over time. Instead, the gains or losses of individual shareholders merely constitute transfers of wealth as between themselves. Similarly, the rate at which a company distributes cash by dividends or share repurchases should not affect total shareholder return during the lifetime of the business. A company’s aggregate net profit flow should instead be unaffected by whether earnings are retained or distributed so long as the company’s ability to raise funds by issuing new shares or by borrowing money is not affected by the approach taken towards dividends and share repurchases. Individual shareholders, however, can have strong preferences about whether a company should retain earnings or distribute cash. The tax treatment of dividends versus capital gains can have an important impact on investor attitudes. Also, if share-
to 'beat the market' by trading on the basis that stock returns were going to be on average higher in January than in other months. Similar 'calendar effects' which academics have identified relate to trading which occurs on the day before a holiday and the last day of the month."

Despite these studies, the proposition that one can only earn higher than average returns at the expense of greater risk retains substantial vitality. A number of academics have published work that at least partially contradicts Professors Fama and French's conclusions and indicates that risk is positively correlated with return. As well, there is a considerable body of evidence which indicates that even though pricing irregularities might exist and even persist over time, putting into practice strategies which provide abnormal profits for investors over the long-term is very difficult. For instance, in the early 1980s academics studying US stock markets noticed that small corporations had consistently outperformed larger companies in previous decades. Investors who tried to exploit this 'small-firm effect' were promptly treated to a number of years of under-performance by the supposedly inefficient market. Also, while market professionals may believe it is possible to 'beat the market', few fund managers can do it consistently. According to one study, three-quarters of all unit trusts investing in UK shares do worse than the FT-SE Actuaries All Share Index and only one in five of the funds in the top-quarter of a five-year performance table remain in the top-quarter over the next five years. In sum, while there is clearly room for debate, it remains likely that an investor who seeks to obtain an above-average return on his share portfolio does so primarily at the expense of greater risk.

*Control*

Under UK company law the shareholders determine the content of the memorandum and articles and can use these documents to allocate responsibility for running the company to those whom they choose. Almost invariably, the power to manage the company is delegated to the board of directors. Nevertheless, the members will in most circumstances retain the authority to select who sits on the board. Consequently, in legal terms,

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53 For a summary see Fama, *supra*, n. 45 at 1586-7. In the UK, April is the month in which share prices behave in an anomalous fashion, Keane, *supra*, n. 35 at 12.


57 See chapter one, n. 130 and accompanying text.

58 Companies (Tables A to F) Regulations 1985, SI 1985/805, Table A (hereinafter Table A), art. 73 and Gower, *supra*, n. 10 at 141. In smaller companies, the power to appoint new directors is frequently given to the board, Wainman, *supra*, n. 30 at 252.
shareholders have substantial control over corporate affairs. Still, an observation which has often been made about shareholders is that the extent of their actual involvement does not correspond with the important legal role which they have. The Modern Corporation and Private Property, written in the early 1930s by Mr Adolf Berle, a law Professor and Mr Gardiner Means, an economist, provided this line of thinking with a powerful intellectual boost. The authors asserted that while the law treated shareholders as a company's owners, investors in public corporations usually did not act in the manner one would expect of an owner. Instead, shareholders tended to leave it to management to deal with all matters of importance. The upshot was that there was a separation of ownership and control.

In the years after Professor Berle and Mr Means outlined their separation of ownership and control thesis, many commentators have bemoaned shareholder passivity. In so doing, these observers have tended to gloss over the fact that in many ways it can be fully rational for investors in a public company to be apathetic about managerial issues and to leave it to corporate executives to run the business. One reason this is so is that corporate executives, by virtue of their knowledge and expertise, are usually better qualified to make managerial decisions than are shareholders. Also, for an investor who owns shares in a large number of companies, participating in the affairs of one typically will not be worthwhile since any improvement in the overall value of his portfolio is probably going to be trivial. In addition, if mismanagement does become a serious concern, an investor who is aware of the liquidity the stock market offers may well think that selling the equity is a much quicker and less costly solution than trying to turn a company around by taking a 'hands-on' approach. The fact that a company's members enjoy limited liability further reinforces the indifference to corporate decision-making. Investors know that because shares in a company offer this feature, the most they can lose is what they have paid. They correspondingly have less of an incentive to intervene in managerial affairs than they would if they were fully accountable for corporate financial obligations and thus had their personal wealth at risk.

Despite limited liability and the other factors which indicate why shareholders will often be 'rationally apathetic' about the day-to-day decision-making which occurs in companies, shareholders do not always shy away from playing a role in managerial matters. The dynamics in closely held

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companies are typically much different. In such enterprises, the members usually are part of the management team and help to run the company on an ongoing basis.\textsuperscript{63} This should not be surprising. Those who own equity in a closely held company typically have a substantial portion of their wealth invested in the firm and thus do not benefit greatly from diversification.\textsuperscript{64} Also, as mentioned, an ownership stake in a closely held company is ordinarily not a liquid investment. Consequently, participating in corporate decision-making will often be the only way for a shareholder to protect his interests.

In a listed company where an individual or the members of a family own a substantial block of the shares, the same sort of circumstances will exist. Usually, such 'blockholders', instead of owning a fully diversified portfolio of shares, will have a disproportionate percentage of their wealth invested in the company. They may face as well some problems selling their shares if they are dissatisfied with their company's performance since liquidating a large stake in a single company without a fall in the price can be difficult.\textsuperscript{65} Such considerations help to explain why blockholders often take considerable interest in corporate affairs.\textsuperscript{66} However, it is difficult to generalize about the degree of influence which they will have. When a single individual or a cohesive coalition of shareholders owns a majority of shares, exercising influence over management will be relatively straightforward. This is because the dominant shareholder(s) can choose who sits on the company's board and the directors in turn can select executives the dominant shareholders) thinks are suitable. Otherwise, the degree of influence will depend on the circumstances. Important factors will be the number of other investors with a substantial stake in the company, the blockholder's ability to form voting coalitions, and the voting rules in effect for a particular decision.

Institutional investors comprise another category of shareholder for which it is difficult to generalize about the extent of control exercised in relation to companies.\textsuperscript{67} Traditionally, institutions owning shares have...
preferred to leave it to management to run companies and have responded to poor corporate performance by selling their stake rather than by intervening in order to try to rectify matters. Many fund managers continue to use this strategy today, a fact which the reasonably high rate of turnover of equities held by institutions illustrates. Furthermore, institutional shareholders tend not to vote on resolutions put forward at shareholder general meetings and when they do, this usually occurs by way of a written document known as a proxy which enables management to vote in the manner instructed. Since institutional investors own some 70 per cent of the shares in UK public companies and since the typical general meeting is carried out without fund managers or other representatives being present, the exercise has been labelled 'Hamlet without the prince'.

Despite the approach which has traditionally been taken, institutional investors have in recent years become considerably more willing to take corrective action in relation to companies in which they own shares. On a general level, according to a 1995 report based on interviews with fund managers, institutions regularly intervene and influence governance issues, albeit usually on a quiet, 'behind the scenes' basis. More specifically, chief executives in a number of leading UK and US companies have in the past few years resigned in response to institutional pressure. Indeed, it has been said that the fund managers based in London's financial district 'have become the king-makers and king-breakers of the corporate jungle' and thus are the 'Caesars of the City'. Institutional activism has also prompted numerous listed UK companies to make changes to executive pay packages, with the primary emphasis being on attaching more stringent performance conditions to incentive schemes and reducing the size of pay-offs being made to departing corporate executives.

**Conflicts of interest**

The conflicts of interest which can affect shareholders can be divided into two basic types. First, shareholder interests can diverge from those of another set of company participants, such as managers or creditors. Such conflicts will be considered at various junctures later in this chapter. Secondly, friction can arise between a company's members. A situation where this is likely to occur is when a single individual or a cohesive coali-
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Shareholders who anticipate potential sources of conflict and disagreement may choose to bargain with each other in order to agree upon specified rights and remedies. A member in a closely held company has for instance a strong incentive to contract for protection. Again, an investment in a closely held company is usually an illiquid one. Therefore, in the event of a falling out, a minority shareholder’s stake in the business will effectively be under the control of people with whom he no longer gets along. Contractual protection may serve to address the problems this creates for such an individual and a number of documents can be relied on to establish specified legally enforceable rights and obligations. The most obvious are the company’s memorandum and articles of association. Other possibilities are a shareholders’ agreement and a service contract entered into by a member in his capacity as director or employee. Through proper drafting, a minority shareholder can be given a seat on the board, a designated salary, the power

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74 For an overview of the types of problems which can arise, see F. H. O’Neal and R. B. Thompson, O’Neal’s Oppression of Minority Shareholders, 2nd ed. (Deerfield, Ill.: Callaghan & Co., 1985)), especially ch. 2.

75 See cases discussed by M. Bowen, Fox and Bowen on the Law of Private Companies, 2nd ed. (London: Sweet & Maxwell, 1995) at 221-3.

76 See, for example, ‘Survival in a War of Succession’, Financial Times, 22 February, 1994.

to veto major corporate changes, the right to demand the purchase of his investment at fair value, and other important rights. In such circumstances, the member should have the leverage required to have a continuing influence on the company and should be well-positioned to negotiate favourable terms for his departure in the event that relations have become irredeemably acrimonious.

While shareholders in closely held companies have incentives to bargain and have devices upon which they can rely to secure contractual protection, in many such businesses little negotiating about conflicts of interest actually takes place. Information gaps are part of the explanation. The foundation for a closely held business will usually be a fluid long-term relationship between a handful of shareholders. Under such circumstances, the parties will inevitably be unaware of important contingencies that may affect their dealings. As well, transaction costs can preclude negotiations between shareholders. People who invest in closely held companies frequently place a high priority on saving money. Correspondingly they will often not be prepared to pay legal advisers to draft comprehensive supporting contractual documentation. An additional consideration is that individuals often commence a small business in an atmosphere of heady optimism and mutual good will, in part because the participants are often related or are friends. Under such circumstances, the parties may be reluctant to raise and confront potentially contentious issues since doing so will put everyone in a pessimistic frame of mind and perhaps cause them to walk away from a viable business opportunity. One other factor which can deter bargaining in closely held companies is that the shareholders may misjudge what is in their interests. It is reasonably common for people starting their own business to lack commercial experience. As a result, the possibility exists that they will decline to make special arrangements for the types of contingencies for which a more worldly individual would provide.

When participants in closely held companies do choose to bargain for express rights and obligations, they can typically do so quite readily since they can negotiate with each other face-to-face and, with the assistance of their professional advisers (if any), work their way through the essential parameters of the bargain struck. Matters are different with shareholders in companies with shares listed for trading on a stock exchange. Investors in such enterprises ordinarily only get the opportunity to buy equity on a 'take it or leave it' basis since negotiating about the terms of the corporate constitution prior to buying shares will usually be impracticable.

O'Neal and Thompson, O'Neal's Oppression, supra, n. 74, paras. 2.17-2.20. See, as well, chapter ten, nn. 62 and 63 and accompanying text.

Some who question the premise that relations between shareholders constitute a 'nexus of contracts' argue that this illustrates it is misleading to characterize what is going on in contractual terms: V. Brudney, 'Corporate Governance, Agency Costs, and the Rhetoric of Contract', (1985) 85 Colum. L. Rev. 1403 and C. Bradley, 'Contracts, Trusts, and Companies'
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Nevertheless, while equity in a public company will typically be purchased 'as is', a potential investor still has choices available. An investor who is dissatisfied with what is on offer can buy shares in different individual companies, purchase a diversified portfolio of shares via a collective investment vehicle such as a unit trust or forego the equity market entirely in favour of fixed income securities. Also, even though an investor in a limited company is unlikely to get the opportunity to haggle over the combination of rights and restrictions attached to his shares, what is purchased is unlikely to be in any sense a one-sided arrangement biased against shareholders. Instead, the relevant terms will normally have been scrutinized with some care to ensure that they meet investors' needs and expectations. For instance, The Stock Exchange will not list shares for trading unless the company's articles of association meet specified criteria. In addition, individuals responsible for co-ordinating a public issue of shares (generally an issuing house or a sponsoring broker) will seek to deal with matters that might cause investors concern so as to ensure that the sale of the equity goes well.

As mentioned, because of information gaps and transaction costs, the incorporators of a closely held company will not always agree on explicit contractual terms which deal with all issues that affect them. Similar dynamics exist in public companies. Investors, managers and other interested parties will never have perfect information about a business when they become involved with it. Also, since neither time nor resources is unlimited, negotiations which occur about matters thought to be of significance will always be affected in some measure by transaction costs. It is therefore inevitable that the memorandum and articles of association will contain some gaps. The fact that companies are long-living entities which function in an ever-changing environment compounds the problem. New needs, unanticipated situations, and additional information can make different arrangements more desirable than those initially established. Hence, even when the corporate constitution, as initially drafted, provides the best arrangement at the time of incorporation, there will be potential for improvement over time.

Whenever transactors feel that a contract they have entered into does not address properly an important issue or does not deal adequately with changed circumstances, they can respond by varying the terms. Under contract law, conventionally all parties must agree to any such variation. At first glance, one might expect that the situation would be the same with companies. This is because of the statutory contract provided for by section in J. McCahery et al. (eds.) *Corporate Control and Accountability: Changing Structures and the Dynamics of Regulation* (Oxford: Clarendon Press, 1993), 217 at 218-19.


14 of the Companies Act 1985. Section 14 stipulates that the memorandum and articles of association bind a company and its members as though the documents had been signed and sealed by each member and contained covenants on the part of each member to observe all provisions. Despite the corporate constitution's contractual nature, however, alterations typically do not require unanimous approval. Instead, a three-quarters majority of votes cast by shareholders either present at a meeting or voting through the medium of a proxy is usually all that is required to make alterations.  

The fact that unanimous consent is not required for varying the terms of the corporate constitution does not undermine in any significant way the idea that relations between shareholders are contractual in nature. Instead, each of a company’s members can be taken to have elected to allow the ground rules to be varied subsequently in a manner with which he might disagree. Most investors when they buy shares are aware that companies operate on a basis of some form of majority rule rather than a unanimity standard.  Also, if a company’s members want to provide for a unanimity rule they can always choose to do so. The methods available include entering into an independent contractual arrangement (usually a shareholders’ agreement), stipulating in the memorandum of association that particular rights in the articles cannot be altered, and using share class rights in the articles of association to give a member of the company a veto over prescribed changes.  Still, despite having the option to introduce a unanimity requirement, in most instances shareholders continue to resolve matters affecting their rights by voting.

It should not be surprising that shareholders take this approach. When a unanimity requirement is in place, it can be very difficult for a company’s members to make value-increasing changes. One reason is that it will often be costly and inconvenient to elicit a response from each and every shareholder, especially in companies with a large number of members. Furthermore, under a unanimity rule a shareholder who is otherwise indifferent to a change might well act in a strategic manner and withhold his consent so as to extract some extra benefit for himself. Such an individual,

“Companies Act 1985, ss. 378(2) (definition of special resolution), s. 9 (requirement for amending articles of association) and s. 4 (example of statutory provision authorizing amendment of memorandum of association). See, however, Companies Act 1985, ss. 2(7) and 17 (special rules pertaining to variation of the memorandum of association) and ss. 125-7 (additional requirements for variation of rights attached to classes of shares). For further discussion, see Gower, supra, n. 10 at 532-43.


by acting in this sort of opportunistic fashion, would potentially have considerable bargaining leverage and thus could make matters highly inconvenient for the investors who wanted to carry out changes that would benefit the company’s members. Use of the voting mechanism alleviates such problems substantially. With matters put to a vote at a general meeting, all shareholders are usually bound by the result, regardless of whether they attended or voted in a manner different from the majority. Consequently, changes can be made without ensuring that each and every member of the company has taken the trouble to make his views known. Also, there is significantly less scope for an investor to engage in hold-out behaviour and withhold his consent since with voting rules only those shareholders who own a substantial percentage of the equity will have sufficient leverage to veto proposed changes. The voting mechanism has defects and these might provide a justification for legal regulation concerning the matters on which shareholders vote. Nevertheless, it should be evident that it is possible to reconcile the proposition that relations between shareholders are contractual in nature with the fact that the terms of the corporate constitution can be varied without unanimous approval.

2. CREDITORS

A wide variety of individuals and commercial entities become creditors of companies. We will focus on three types of particular importance. One is trade creditors, who supply goods and services to companies and then advance credit by not requiring immediate payment. The second class consists of institutional lenders, with banks being the most important providers of finance of this type. A key method of bank lending is the overdraft, which allows a company to borrow by overdrawing on a bank account. The company will reduce the money owing by periodically making deposits in the account. The third class is composed of creditors whose right to payment is evidenced by a certificate a company has issued. The debenture is an important example of such an arrangement. The standard way in which a company borrows money by way of debentures is to arrange to have them issued to a substantial number of investors through the medium of a trustee under a single instrument. When debt is aggregated in this fashion, it is often referred to as loan stock.

Duration

Invariably, contracts creating debt obligations specify some form of repayment date. This means that it will always be possible to determine the maximum legal duration of a debt. In the United Kingdom, much corporate
borrowing is done on a short-term basis. Suppliers, for example, usually grant credit for periods of 30 or 60 days.70 Also, since the overdraft is relied on so heavily, much bank lending can be categorized as being short-term in character.71 An overdraft constitutes short-term finance because the bank can, at its discretion, demand immediate full repayment of the overdrawn balance. In practice, banks rarely exercise their right to do so, assuming a company is in reasonable financial health and is conducting business in a proper fashion. This means that a company which relies on overdraft financing can end up dealing with the same bank for many years. Nevertheless, the short-term character of such arrangements remains relevant. When business exigencies or changes in government policy require banks to restrict lending, overdrafts are a primary target. Typically, some companies will have their overdraft facilities withdrawn and many others will have their overdraft limits reduced. Concerns about such possibilities lead some companies to borrow from asset finance companies since such lenders will offer a debt contract which allows funds to be used for a designated minimum period of time (e.g., one year).72 Still, the risk of withdrawal or reduction associated with an overdraft is one which many businesses are prepared to bear. This method of financing is attractive for UK companies because such an arrangement usually operates in a flexible and informal manner and because committing to long-term debt has been an unattractive option in an economic environment where high interest rates have until recently been the norm.73

The overdraft is not the only sort of arrangement where short-term lending arrangements can provide the foundation for a relationship of considerable duration. This type of situation can exist as well with trade creditors. While suppliers usually only grant credit for a particular transaction for a short period, they are often keen to foster an enduring commercial relationship with the customer.74 A supplier which incurs substantial expense tailoring its product to meet the needs of a particular buyer will often be

87 J. S. Ziegel, et. al., Commercial and Consumer Transactions: Cases, Texts and Materials, 3d ed. (Toronto: Emond Montgomery, 1995) at 442 (discussing situation in Canada). Trade creditors often have to wait for a considerable time after payment is due before actually receiving what is owing, e.g., 'Late-Payers Keep Small Firms Waiting 77 Days', Times, 15 February, 1996.
thinking in terms of a lengthy commercial relationship. Indeed, he may face financial ruin if the customer terminates its dealings on short notice.

While debt contracts with a short repayment period can be the foundation for long-term dealings, conversely a loan which does not mature for a considerable period of time may not involve a creditor in a lengthy relationship with the borrower. This is often the case, for instance, with debentures. Such arrangements often provide for repayment over a period of years. Still, the relation between individual debenture holders and a company can often be transitory in nature. One reason is that debentures can be traded on markets in much the same way as the equity of a listed company. When this occurs, a debenture holder can readily terminate the relationship with the debtor company by selling the debt to a new buyer. Another consideration is that debentures often do not simply mature and get repaid. A company may instead orchestrate an exchange, which generally involves the issuance of debentures with new terms to existing holders. Alternatively, the borrowing company may ‘recall’ the debt by relying on contractual terms which authorize the borrower to discharge the debt obligation by paying the principal and accrued interest.

Return

The rate of return which a lender earns if the borrower repays the principal and interest on time is commonly referred to as the yield. The yield will be an amount which is fixed by the debt contract. For example, if a lender advances £5,000 to a fledgling company which is to be repaid in one year with £500 to be paid as interest, the yield on this debt obligation will be 10 percent. Furthermore, unless there is a renegotiation, the lender’s return will not change, regardless of how the company performs. This is a standard feature with debt obligations; a creditor’s return typically will not vary with the fortunes of a company in the same manner as a shareholder’s does. The fixed nature of the yield on a debt can be distressing for a lender when a corporate debtor is highly successful. As one banker has said: ‘It has always frustrated me that if a company did well, the bank was repaid and the shareholders went off with big amounts of money.’ Conversely, however, creditors can benefit from having a fixed claim. When a company is performing poorly, the value of a company’s shares will decline but so long as the company does not renegotiate or default, its creditors will receive the return for which they contracted.

While the yield on a debt obligation is usually based on the applicable interest rate, calculating with precision a creditor’s return can be a complex exercise. One consideration is the fact that a creditor will not be repaid for


duration. Furthermore, a lender can bargain for security. This usually entails contracting for the right to proceed against designated assets of the debtor on default and will often leave a lender well-positioned to recover at least some of what is owing. Finally, a creditor may be able to purchase insurance to address the risks he faces. For instance, private insurers offer cover to suppliers and manufacturers for losses arising from default by trade debtors.\footnote{See, for instance, A. H. Swash, \textit{Credit Control} (Wantage: Shaws Linton Publications, no date), ch. 13 and \textquote{Safeguard for the Good Times}, Survey on Credit Management, \textit{Financial Times}, 6 March, 1995.}

\textbf{Control}

One other possible strategy a lender can employ to reduce the risks associated with debt obligations is to exercise some measure of control over the business affairs of the debtor company. Such involvement can take a variety of forms. Banks, for instance, will frequently provide financial counselling and make referrals to those able to offer technical or managerial assistance. Also, bank officials will check developments at a company by requesting sales forecasts, making quarterly visits and monitoring financial statements prepared on a month-by-month basis. Furthermore, if a bank has lent money by the medium of an overdraft, staff can monitor continuously the corporate debtor's financial position by watching movements in the balance owing.\footnote{\textquote{Business Adjusts to Tighter Credit}, \textit{Financial Times}, 27/28 February, 1993 and \textquote{Banks Reward Small Firms for Sharpening Their Skills}, \textit{Independent on Sunday}, 26 June, 1994. On creditor monitoring generally, see R. E. Scott, \textquote{A Relational Theory of Secured Financing}, (1986) 86 \textit{Colum. L. Rev.} 901 at 946-50 and G. G. Triantis and R. J. Daniels, \textquote{The Role of Debt in Interactive Corporate Governance}, (1995) 83 \textit{Calif. L. Rev.} 1073.}

Still, while creditors clearly can take steps to keep an eye on the running of debtor companies, in the ordinary course, a lender will not find it worthwhile to become actively and closely involved in corporate decision-making. The fixed nature of the return for which creditors contract is an important reason for this.\footnote{F. H. Easterbrook and D. R. Fischel, \textquote{Voting in Corporate Law}, (1983) 26 \textit{J. of L. and Econ.} 395 at 403.} As we have seen, while shareholders might benefit greatly if a company is successful, the return creditors receive typically remains constant. Since a lender gains nothing extra, it makes little sense for him to try to improve the profitability of his corporate debtors. A creditor will be further deterred from becoming actively involved in corporate affairs if he has lent money to a large number of companies. The presence of numerous debt contracts is significant in two respects. As mentioned, a creditor who deals with numerous customers diversifies away much of the risk of loss stemming from default by any one company. The reduction of risk should concomitantly mute a creditor's incentive to take an active managerial role with any single corporate debtor. As well, resource considerations come into play.
For a creditor who deals with a large number of debtors, becoming involved in a detailed manner in the affairs of each company is going to be an extremely time-consuming and costly exercise.

An additional factor which mitigates against creditor involvement in corporate governance is expertise. Staff at a lending institution may be very good at evaluating credit risks and detecting signs of trouble with debt contracts which are in place. It is doubtful, however, whether such individuals will have the background required to contribute in a positive fashion to the ongoing management of companies. UK banks have always been lenders rather than investors and taking a different approach would probably require the retraining of thousands of branch managers. With trade creditors, while those in charge can draw on the experience they have from running their own business, their expertise in a specific business sector (e.g., manufacturing) may well be of limited value in improving managerial performance in another (e.g., retailing).

While creditors are normally content for a variety of reasons to leave the running of companies to others, the situation can change dramatically when a corporate debtor encounters serious financial problems. With a company that is in a sound financial position, creditors are protected by its equity cushion, which represents the residual value of the enterprise and is composed of the value of assets left over after all liabilities have been taken into account. As a company’s financial situation worsens, this cushion erodes. If steps are not taken to address the problem, the company’s liabilities will ultimately exceed its assets and the company will correspondingly be unable to repay all of those to whom it owes money. This prospect will be of concern to creditors and may well provide the impetus for them to take corrective action.

The incentive to intervene is enhanced by the fact that shareholders in financially distressed companies will be tempted to implement high-risk business strategies to rescue the company. As a company falls more deeply into debt, projects will have to generate progressively greater amounts of net revenue to cover the existing debt obligations and leave something over as residual profit. Business strategies promising the required returns will likely be accompanied, however, by higher risks. With such ventures the

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110 For a more detailed analysis see G. Triantis, 'The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment', (1993) 43 *UULJ* 679 at 680-90 (illustrating the points involved by drawing from financial economic theory concerning the pricing of share options).
likelihood thus increases that assets which would otherwise be available for unpaid creditors will be dissipated. Another reason shareholders in a failing company will be tempted to pursue high-risk, high-return strategies is that by virtue of limited liability, they typically stand to lose only what they paid for their shares. The consequences of failure will therefore not be brought home fully to them. Thus, in a sense they will be gambling with creditors' money more than their own.

To illustrate the incentives which shareholders have as financial problems mount, suppose a company is deeply in debt. In such circumstances, the creditors will likely have the power, either under terms in debt contracts or under legislation, to take charge of the business or ensure that the company is shut down and the assets are sold. Our company, however, has developed a new product which will clearly have some degree of success in the marketplace. Two approaches can be used in marketing it. One is to have the company proceed conservatively and sell the product at a price which will secure modest sales and a comfortable profit on each unit sold. The company, by playing it safe, will pay off a considerable portion of what is owing but the creditors will probably still seek to close the business down in order to recover the remaining debt. The other alternative is to undertake an aggressive advertising campaign and sell the product at a discounted price in order to achieve high sales volume. It is far from clear that the product will be sufficiently popular to make this approach profitable. Nevertheless, if everything works out the company will be able to pay off its outstanding debts and its continued existence will be secured. The company's creditors will probably prefer that the company implement the conservative strategy. Part of the reason is that use of this approach should ensure that the amount owing is reduced. As well, the company will end up considerably deeper in debt if the gamble on high sales volume works out badly. The shareholders, on the other hand, will favour the aggressive strategy since success will mean the equity will have some value. Also, if things do not work out, by virtue of their limited liability they should not be personally responsible for the additional debts the company has incurred. Given such dynamics, those owed money by the company have an incentive to intervene.

If creditors choose to take a proactive role with a company in financial distress, the first step they will likely take will be to ensure that the situation does not deteriorate further. A helpful first step, often relied on by banks, will be to appoint an investigator, such as a specialist firm of accountants, which will find out the cash requirements of the business and recom-

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Creditors who have a security interest in the assets of a company commonly contract for the right to appoint a receiver to enforce the security; see R. M. Goode, Principles of Corporate Insolvency Law (London: Sweet & Maxwell, 1990) at 77-8. Creditors can apply for a winding up order under s. 124 of the Insolvency Act 1986. See Goode, ibid, at 13.
mend possible long-term solutions. On completion of the investigation, the bank might negotiate with incumbent management to make changes needed to reverse the financial difficulties. Alternatively, if the bank has lost faith in those in charge, it will seek to take control of the business. This typically will be done pursuant to contractual clauses, common in lending arrangements involving banks, which allow for the appointment of a receiver.

Once a receiver has been appointed, a bank or similar institutional lender typically has some options. One possibility is to shut down the company and liquidate it, which involves selling the assets for cash. Another is to try to turn matters around and rescue the business. This in some circumstances will be done by continuing to work with the incumbent management team. Alternatively, the creditors might orchestrate the replacement of those in charge and bring in new managers, either on a permanent basis or with a troubleshooter known as a 'company doctor'. If the rescue succeeds, the creditors might benefit because the company will be in a position to pay, over time, what it owes. The business could also be sold as a going concern to new owners for a price sufficient to discharge existing liabilities. Still, while a successful rescue offers such possibilities, the standard practice in the United Kingdom in fact is liquidation. Major financiers such as banks have been criticized for relying on this approach on the grounds they are insufficiently creative in dealing with failing companies. Such criticism may be unfair. UK banks have recently shown an increasing willingness to refinance businesses that merit saving and have even taken a minority equity stake in some instances to facilitate the rescue effort. Likewise, in the United States, where the best-known vehicle for reviving bankrupt companies is Chapter n of the Bankruptcy Code of 1978, many view the process involved as being time-consuming and wasteful.

\[\text{\textsuperscript{113}} If the receiver is appointed pursuant to floating charge (a debt instrument which provides security over corporate assets) and has responsibility for substantially the whole of the company's property, the individual in question is known as an 'administrative receiver' and is regulated by Part III of the Insolvency Act 1986 (see s. 29(2)).\]
\[\text{\textsuperscript{114}} See, for example, 'Doctors in at the Deep End', Independent on Sunday, 6 September, 1992 and 'Business Healers Under Spotlight', Independent on Sunday, 16 April, 1995. Some question, however, whether in the future there will be much demand for the services provided, 'Company Doctors are a Dying Breed, says James', Sunday Times, 21 January, 1996.\]
\[\text{\textsuperscript{116}} M. Bose, 'From Lenders to Owners?', Director, December 1993, 45; 'Taking an Interest Can be the Best Option', Financial Times, 30 August, 1994 and 'UK Banks Frequently Play Critical Role in Corporate Rescues' (letter), Financial Times, 9 February, 1995.\]
Correspondingly, there is no consensus on the best possible approach to company rescues.\textsuperscript{118}

\textit{Conflicts of interest}

Whenever a company is successful and is generating profits on a consistent basis, disagreements between its shareholders and creditors should be rare since the value of the equity will be increasing and the chances of default should be minimal. On a more general level, it will usually be counter-productive for shareholders if those running a business antagonize creditors. A company which gains a reputation for surprising lenders and gambling with their money will probably find it difficult to obtain credit on standard terms in the future. Under such circumstances, new lenders will demand special concessions to compensate for the risk of suffering the same fate.

While the interests of creditors and shareholders can be congruent, the possibility of conflict also exists.\textsuperscript{119} One situation where this will be the case is where a company transfers corporate assets to shareholders for inadequate consideration. With such a transaction, the shareholders in question will clearly benefit and creditors will potentially be prejudiced since the company will be on a less sound financial footing. Another way in which the same result can occur is if a company adopts a highly generous dividend policy. The members are likely to be pleased since they will have the cash in hand. On the other hand, the equity cushion which protects the creditors will be eroded in some measure, thus increasing the risk of default and potentially diminishing the value of the assets available if liquidation occurs.

Another area of possible creditor/shareholder conflict involves the issuance of new debt. New borrowing is something which shareholders may well view favourably. With access to such funding, the company may not need to seek additional financing from the members. The company, in addition, may be in a position to pursue potentially lucrative business opportunities which would otherwise be beyond its means. Existing creditors will take a different view of new borrowing. Since the return on debt contracts is usually fixed, the possibility of higher profits will not hold much attraction. At the same time, the new loans will increase a company's debt-to-equity ratio.\textsuperscript{120} This will dilute the claim of incumbent debt-holders against

\textsuperscript{118} We will leave it to others to canvass the issues further. See, for instance, the articles set out in section II of J. S. Ziegel (ed.) \textit{Current Developments in International and Comparative Corporate Insolvency Law} (Oxford: Clarendon Press, 1994), 63 ff.


\textsuperscript{120} The debt-to-equity ratio is one method for ascertaining what is known in the UK as 'gearing'. See Holmes and Sugden, \textit{supra}, n. 90 at 26-7, 177-8.
the company's cash flow and assets. As well, since repayment obligations are a fixed cost that do not diminish in the event of adversity, an increased debt load could end up being a crippling burden for a company which suffers a downturn in its fortunes.

An additional potential source of disagreement between creditors and shareholders is one we have already considered. This is that shareholders have an incentive to gamble with creditors’ funds. We have already seen this is a problem when a company is in financial distress, but the dynamics involved are relevant in other situations. Take the example of a business opportunity that potentially will yield a large return but also may give rise to losses which threaten the overall financial viability of the firm. If everything works out, the debtors will be repaid what they are owed, but the members will reap most of the benefit, given the residual nature of their claim. If the venture fails, the risk of default by the company would increase but the shareholders, by virtue of their limited liability, stand to lose nothing more than what they paid for their equity. For shareholders, then, high-risk, high-return ventures can be a ‘heads we win, tails creditors lose’ phenomenon.

Shareholders aside, other conflicts of interest can affect those who lend money to companies. We will see later in the chapter that a company’s managers frequently pursue a different agenda from that of a lender. As well, with employees, if creditors decide to close down a company and liquidate the assets, this will have an adverse impact on the workforce. There can also be conflicts between classes of creditors. The factors at work are similar to those which affect the relationship between shareholders and lenders.

When a company is in financial distress, creditors with claims which are in a poor priority position will, like shareholders, support risky business strategies. This is because a successful gamble could yield enough funds to satisfy all debt obligations. Conversely, a well-positioned creditor, such as a bank which can rely on security it has taken against assets to assert priority over other claimants, has an incentive to cut its losses and get out what it can by shutting down the business and selling what it can. Priority conflicts between creditors give rise to topical and interesting problems but we will leave it to others to discuss the issues involved.

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121 The extent to which this will be a concern for a creditor will depend on his priority position. If a lender has contracted for a security interest in a company’s assets and has priority over others with a similar claim, dilution should not be a major concern.


123 Infra, n. 348 and discussion following n. 355.


Bargaining

Creditors can rely on the debt contract to take a number of precautions to deal with the possibility they will be adversely affected by the manner in which a company is run. One approach is to bargain for security against corporate assets. Also, to address problems posed by new borrowing, lending agreements can require a debtor company to obtain the creditor's permission before issuing additional debt. Furthermore, creditors can rely on the debt contract to enhance their monitoring capabilities. This can be done, for instance, by requiring the debtor company to submit specified financial information on a regular basis. An additional possible precaution is to impose contractual restrictions on various types of conduct in which a debtor company might engage. Clauses can be used which curtail the distribution of funds to shareholders by way of dividend payments or share repurchases. Along similar lines, loan covenants can be included which deal with a company's 'gearing' and require a company not to exceed a prescribed ratio of debt to shareholder equity. As well, a debt contract can stipulate how borrowed funds are to be used, require the debtor to remain in the same line of business and make lender approval a condition to be met prior to the selling of major assets.

Still, bargaining is not a perfect solution for creditors. The types of conduct which might adversely affect their interests cannot all be addressed since some will be very difficult to anticipate. Even with predictable contingencies, drafting provisions which deal effectively with the risks involved can be difficult and expensive. In addition, since it is costly to monitor compliance and take enforcement measures, extensive contractual rights are often of limited practical use. Furthermore, pressing for contractual protection can be a counter-productive strategy in a competitive environment. Those running a company may well take their business elsewhere if they think that other lenders will require markedly less restrictive terms. Competitive pressures therefore exist which can cause creditors to forego protective measures which they ideally would prefer to see in place.

The position of trade creditors illustrates the limitations involved with bargaining for protection. They do not usually attempt to tailor contractual

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"Clauses of this nature are more common than covenants which restrict directly dividends or other types of cash distributions. J. Day and P. Taylor, 'Accounting Aspects: Room for Improvement?', *Accountancy*, June 1994, 129. See further chapter eleven, nn. 210 and 211 and accompanying text.

terms on a transaction-by-transaction basis to address the risk of default.\textsuperscript{129} One reason is that they know that being too pedantic about contractual provisions will cost them business.\textsuperscript{130} As well, a trade creditor who has a large customer list will usually find it too time-consuming to negotiate each agreement in detail and will know that monitoring contractual compliance effectively will be very difficult. Trade creditors nevertheless are protected in various ways. If they have a large customer list, they will benefit from diversification of risk.\textsuperscript{131} If market conditions permit, they will seek to pass along some of the risk they face in the form of higher prices.\textsuperscript{132} Since the likelihood of default is reduced with debt obligations of brief duration, trade creditors benefit from the fact that they typically only grant credit for a short period of time (again, usually 30 or 60 days).\textsuperscript{133} In addition, some trade creditors rely on retention of title clauses to retain a security interest in the goods they sell and thereby achieve priority over these assets against competing claimants.\textsuperscript{134} Furthermore, if the risks involved with trade credit cannot be dealt with or accommodated satisfactorily by any of these other means, the possibility of taking out credit insurance exists.

3. \textsc{Employees}

An essential characteristic of the relationship between employees and a company which employs them is the authority of the employer. Workers, when they agree to work for a company, expect to follow directions about how they do their work. In other words they accede to a 'zone of acceptance'.\textsuperscript{135} Another key feature of the employment relation is that its parameters are set by law.\textsuperscript{136} As a witness told a committee investigating UK company law (albeit in a slightly different context): '... when trade is bad. The supplier will take a risk, he will say 'I want to sell these goods'...'.\textsuperscript{137} Minutes of Evidence Taken Before the Company Law Committee, 1960-1 (Lord Jenkins, chair) (London: H.M.S.O., 1961) at 472.


\textsuperscript{130} As a witness told a committee investigating UK company law (albeit in a slightly different context): '... when trade is bad. The supplier will take a risk, he will say 'I want to sell those goods'...'.\textsuperscript{137} Minutes of Evidence Taken Before the Company Law Committee, 1960-1 (Lord Jenkins, chair) (London: H.M.S.O., 1961) at 472.

\textsuperscript{131} supra, n. 101 and related discussion.

\textsuperscript{132} See T. C. Halliday, 'The Legal Construction of Organizational Mortality (sic): The Structure of Security and the Politics of Corporate Reorganization in Britain and the United States', (1992) unpublished, quoting a banker as saying 'the profit margins of the ordinary trade creditor are commonly pitched at levels of such height as to enable them to take into account the risk of a customer's insolvency', at 36. See also Bolton Committee, \textit{Small Firms}, supra, n. 90 at 183, 185 (noting that financing a business by trade credit is more expensive than relying on bank loans).

\textsuperscript{133} See T. C. Halliday, 'The Legal Construction of Organizational Mortality (sic): The Structure of Security and the Politics of Corporate Reorganization in Britain and the United States', (1992) unpublished, quoting a banker as saying 'the profit margins of the ordinary trade creditor are commonly pitched at levels of such height as to enable them to take into account the risk of a customer's insolvency', at 36. See also Bolton Committee, \textit{Small Firms}, supra, n. 90 at 183, 185 (noting that financing a business by trade credit is more expensive than relying on bank loans).


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Meters are determined, at least on a day-to-day basis, by the firm’s internal administrative system rather than by formal negotiations or market forces. Some argue that by virtue of these circumstances employment arrangements differ in fundamental ways from conventional market transactions and thus cannot be analysed by relying on the precepts of conventional economic theory. The thinking is that, because of the existence of employer power and the presence of administrative structures, the hallmarks of an arms-length bargaining relationship are absent. Instead, coercion, bureaucracy, and domination are the central themes underlying dealings between companies and their workers.  

While employment relations may have some distinctive characteristics, the dynamics involved nevertheless can be examined usefully from an economic perspective. An important consideration is that forces of supply and demand remain relevant. Employers have to be aware of labour market conditions because they need to know what terms will have to be offered to retain highly valued staff and to hire able new recruits. Workers will monitor developments as well, either to look for a better job elsewhere or to find alternative employment in the event that they lose their existing position. Hence, while employment issues will be dealt with via an internal administrative system, on a day-to-day basis the norms of the labour market always have some bearing on dealings between workers and companies. Also significant is the fact that the authority present in employment relationships can be explained plausibly on the basis of efficiency considerations rather than power dynamics. Heavy reliance on market-based contracting can be a costly and time-consuming means of co-ordinating and organizing business activity. Firms potentially are a better alternative since they offer predictability and order in the workplace. The advantages which firms provide could not arise if management did not have the authority to monitor and issue directions to the staff.

Another reason to examine the position of employees from an economic perspective is that employment contracts, instead of being instruments of coercion, can fairly be characterized as voluntary arrangements which have attributes that are beneficial for workers. In a free society, an individual ultimately makes the choice to agree to work for a company. Also, the law

137 See chapter one, n. 109 and accompanying text as well as 'Subcontractors and Temporaries Take Over', Financial Times, 2 June, 1995.  
138 For a more intricate defence of the role of authority in employment relations see Williamson, supra, n. 10 at 215-33.  
will not compel an individual to do any work for an employer.” Admittedly, an individual who accepts a job offer may not be satisfied fully with the terms and may feel pressured by external circumstances such as the absence of alternative opportunities to accept a position.” Still, an employee will see advantages in agreeing to work for a company. An individual who does not have a permanent job faces the prospect of having to find new customers on a regular basis to contract for his services. This can be a process fraught with uncertainty. A company’s workers, on the other hand, are usually paid a fixed wage at predetermined and regular intervals. An employee thus will be able to organize his financial affairs with some degree of certainty. The mere fact that the employment relation can be characterized in economic terms in no sense implies that employers will always exercise the authority which they have in a manner that corresponds with the preferences of the workforce. Employers can act in a manner that has an extremely prejudicial impact on workers; plant closings are an obvious example. Nevertheless, since the employment relation is influenced by economic dynamics, insights can be gained into the role workers play in companies by focusing on the bargain elements of duration, risk, return and control, and conflict of interest.”

**Duration**

It is possible for the employment contract of a rank-and-file worker to have a fixed term but the standard practice is that, unless some sort of probationary period is involved, there will be no specified duration.” Consequently, the bargaining relationship between an employee and a company will typically continue to operate until the worker resigns or retires, the company ceases to operate or the company dismisses the worker from his position. Formerly, under case law principles, when a business was sold, this had the effect of terminating all employment contracts. However, statutory measures now ensure that employment contracts in place at the time of a transfer become binding on the transferee and any dismissal connected with a transfer is unjustified unless it is for an economic, technical, or organizational reason.”

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142 See *Stone, supra, n. 139 and A. Wolfe, The Modern Corporation: Private Agent or Public Actor?*, (1993) 50 *Wash. and Lee L. Rev.* 1673 at 1690-1 (arguing that employment relations can be analysed by focusing on contractual dynamics).


When a company takes the initiative in terminating an employment contract, as a matter of basic principle, the company can simply declare that the arrangement is at an end. English courts, however, have implied terms in employment contracts requiring an employer to provide a worker with reasonable (but usually short) notice prior to the dismissal taking effect. Furthermore, the entire area is now regulated in some detail by statute. By virtue of legislation, an employee with more than two years of service can require a written statement of reasons for dismissal and minimum notice periods are imposed. Similarly, an employee who qualifies on the basis of the length of his service to a company is entitled to a remedy for unfair dismissal if the employer did not have a substantial and valid reason for terminating the employment contract. In addition, if the reason for dismissal is that a worker has become surplus to the employer's current requirements, the employer must make redundancy payments.

The legal regime aside, a variety of considerations influence the duration of employment. Workers who are just entering the employment market will usually be actively considering alternatives and will have few skills which are specifically related to the needs of their current employers. Consequently, they will be able to move easily between jobs and companies will be able to secure replacements at low cost. For some workers the situation never changes. The skills they develop are readily transferable and when they decide to switch jobs their employers can find substitutes readily. Janitors, security staff, and restaurant waiters are examples of individuals often falling within this description. For other workers, however, their mobility decreases over time. Sometimes this occurs because an individual builds his life around his job and makes important personal investments in the community where he works. For example, his spouse may be employed in the same area, his children may be accustomed to the local school system and his entire family may have developed ties with other members of the community. In other situations, the lack of mobility may arise because of actions of the employer. An employee may accept a job offering a lower salary than was available to him elsewhere in the expectation

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"" Davies and Freedland, supra, n. 143 at 24.
"" Employment Protection (Consolidation) Act 1978, c. 44, s. 49 (notice) and s. 53 (written reasons), as amended by Employment Act 1989, c. 38, s. 15. The constitutionality of this regime has been cast into doubt by a judgment of the Court of Appeal, R. v. Secretary of State for Employment, ex. p. Seymour Smith, [1995] IRLR 464.
"" Employment Protection (Consolidation) Act 1978, ss. 54-80.
that when he proves himself to be skilled, productive, and loyal he will be rewarded in the form of promotions and a salary that exceeds the going rate.\textsuperscript{151} Such an individual will be reluctant to quit since he will forego the anticipated deferred compensation. Furthermore, a company which has tasks that require knowledge and skills that are unique to the firm will select employees to engage in specialized training and 'on the job' learning. Workers who acquire such firm-specific knowledge may have their mobility reduced since their skills and values have been so finely tuned that they will be of little value to other employers.\textsuperscript{152}

An individual who finds that his job mobility is significantly circumscribed will take considerable comfort in having a reliable expectation of continued employment. Such an expectation may now be unrealistic in many circumstances. It is often said that while formerly companies would provide in practical terms a 'job for life' for satisfactory employees, the chances of building a secure career with one business are now considerably diminished. Companies, after engaging in successive waves of 'downsizing', allegedly now have only a small core of full-time employees and assign much of the work to a periphery consisting of self-employed individuals, firms hired on short-term contracts, and 'portfolio workers' who hop from job to job and seek continuing education when they are out of work.\textsuperscript{153} Statistics indicate that this characterization of employment trends is somewhat misleading. The average length of time that British workers spend with one employer has not changed markedly in recent years and a substantial fraction of the workforce continues to have a 'lifetime' job lasting 20 years or more.\textsuperscript{154} A possible explanation for different perceptions concerning job security is that change is now less likely to be the result of choice. It appears that it is becoming more common for employees to leave work because of involuntary redundancy rather than the offer of a better job elsewhere.\textsuperscript{155}


\textsuperscript{153} On this characterization, see Blyton and Turnbull, supra, n. 136 at 53, 56-7; 'Career Opportunities', supra, n. 152; 'Destructive Dismissal', Independent on Sunday, 15 October, 1995 and 'Off With Their Overheads', Independent on Sunday, 10 December, 1995.


\textsuperscript{155} 'Life, Jobs', supra, n. 154 and 'Whistling While They Work', Economist, 28 January, 1995. Still, the statistics on redundancy are not fully consistent with this interpretation; see Blyton and Turnbull, supra, n. 136 at 51-2.
Return

The return workers receive is usually in the form of wages with the rate of pay being set at a prescribed sum per hour or as a predetermined annual salary. Benefit packages (e.g., pension and health) also make up a significant component of the total remuneration package. Wage and benefit levels usually do not vary to reflect the contribution an individual employee is making to a company or fluctuate in accordance with the degree of success the business is enjoying. Because of this, companies may well be foregoing an opportunity to use employee remuneration as a motivational instrument. With the arrangements companies are typically using, workers have no direct financial incentive to work effectively since they know their level of pay will not be affected dramatically by the quality of their work or their contribution to corporate success. Employers who seek to motivate staff to work carefully, diligently, and effectively thus have to rely on sanctions such as dismissal and inducements such as a promotion.

Arguably, corporate performance could be improved if the return employees received fluctuated in a manner which reflected the degree of success which their employers were enjoying. Under such a regime, staff would have a financial incentive to work harder on a firm's behalf. On a more general level, there might be greater identification with the company, a new awareness of the importance of saving costs, and more interest in the company's financial status. Politicians in Britain and other countries have been sufficiently persuaded by such arguments to enact measures designed to foster the use of employee share ownership and pay arrangements which offer rewards that vary in accordance with corporate performance. In the United Kingdom a variety of share ownership schemes attract tax advantages, both for the company and the employee. Also, payments to employees can qualify for tax relief if they are based on profits attributable to a company or other relevant employment unit and meet a variety of other criteria. The Income and Corporation Taxes Act 1988 together with the Finance Act 1989 set out most of the tax-related rules, though other legislation, such as the Financial Services Act 1986 and the Companies Act 1985 can be relevant depending on the nature of the scheme involved.

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157 Weiler, supra, n. 149 at 138.  
160 Ch. 1.  
161 Ch. 39.  
162 Ch. 60.  
163 Ch. 6.  
Risk
As mentioned, workers who are paid in accordance with the profitability of their corporate employers are more vulnerable to risk than are employees who receive a fixed wage. Nevertheless, all workers face risk. Leaving aside the possibility of physical harm which exists with some occupations, the primary risk an employee faces is losing his job. The costs involved when this occurs can be significant. An employee will have to come to terms in his own mind with what may well be a surprising and traumatic event. He will probably suffer some loss of expected lifetime earnings since he will be out of work for a period of time. He may have to expend considerable time and effort finding other work. He might have to make time-consuming and inconvenient adjustments in order to take a new job, such as moving to a different city. Finally, he may well take a pay cut when he starts; the average seems to be a reduction of 10 to 15 per cent.

The magnitude of the costs an individual worker endures after losing his job will depend in considerable measure on his personal circumstances. If a worker has to move in order to find a new job, the costs involved will be influenced significantly by his housing arrangements (e.g., does he own or rent?) and by the extent of the connections he has made in the community in which he was living. Another significant consideration will be whether the employee had taken up his former position in anticipation of receiving deferred compensation upon proving himself over time. If an individual has done so and has demonstrated his capabilities, an abrupt dismissal means that he will forfeit the salary and benefits which he was expecting to receive later in his career. Also significant is whether a worker has, during his tenure, acquired training, patterns of behaviour and expertise which are primarily firm-specific. A worker who has done so to a substantial extent may be unable to fit in elsewhere and his training, to the extent it is transferable, will be valued at a significant discount. Someone, on the other hand, who has developed general purpose skills should be well-positioned to switch jobs and secure another comparable position.

Control
There are two basic ways in which employees can take an active role in shaping and determining the content of managerial decisions. First, workers can be a company’s owners. This would mean that the employees would be in much the same position as that which the shareholders presently occupy. Hence, the workers would receive distributions the company made


*** On the psychological stages that a worker is likely to pass through upon becoming redundant, see Salamon, supra, n. 172 at 632.

on the basis of net earnings and would be entitled to select those empow-
ered to make managerial decisions. Secondly, employees can retain the posi-
tion they presently have in companies but nevertheless have an influence via
worker representatives who meet and deal with management. For example,
in Germany legislation gives employees participation rights of this
nature. Most notably, German companies with a large number of staff
are obliged to provide for worker representation on the board of directors.

Many observers speak enthusiastically about worker control and ownership of companies. Advantages are said to be that employees will have the opportunity they deserve to participate actively in decisions which affect their economic welfare and that workers will be more productive since they will feel a strong sense of commitment to their companies. Employee ownership of companies is nevertheless uncommon. Worker ownership, to the extent that it does occur, tends to arise in different types of business organizations, such as non-profit co-operatives and partnerships made up of professionals such as lawyers and accountants. It is also not standard practice for employees to influence and shape managerial policies by communicating and co-operating with corporate executives. In UK companies, one explanation for this is that the legal system does not provide substantial scope for worker consultation. Even in Germany, though, with its significant formal employee participation rights, the role played in corporate policy-making is modest. Worker representatives concern themselves primarily with warding off changes damaging to the staff and with obtaining compensation if such changes cannot be avoided. Chapter twelve will consider in more detail why employees have traditionally played only a minor role in controlling and owning companies.

Conflicts of interest

Conflicts of interest are in some measure inevitable between workers and other corporate participants. A key reason is that shareholders and creditors rely on a company's staff to work diligently, skilfully, and honestly. This means that in economic terms, the workers will be in the position of agent and the shareholders and creditors will be in the position of principal. Workers will be tempted to relax and perform tasks in a perfunctory manner or perhaps engage in more egregious self-serving conduct such as

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See for example text accompanying chapter three n. 121 and chapter twelve, nn. 12, 19 to 21, 94 to 102.

Hansmann, supra, n. 150 at 1784-96 and chapter twelve, n. 10 and accompanying text.

On the matters where consultation is required, see chapter twelve, nn. 91, 176, 177 and 204 and accompanying text.

Lane, supra, n. 174, ch. 9.

Gospel and Palmer, supra, n. 141 at 6-7.

On the economic concept of principal-agent relations, see chapter one, n. 152 and accompanying text.
abusing corporate perks or carrying out petty theft. To the extent that employees act upon such preferences, they will impose agency costs on shareholders and creditors.

The situation can work in reverse as well. Take the example of steps designed to enhance employee productivity. Such measures can improve corporate performance and thereby benefit shareholders and creditors. At the same time, however, the impact on the workers may be detrimental. For instance, an employer may think that extensive supervision is required to keep the staff focused on the tasks which have been assigned. However, rigorous monitoring will tend to produce a negative workplace atmosphere since no one likes to be watched on an ongoing basis. A similar source of conflict will be the introduction of labour-saving new technology. The company's shareholders and creditors will be in favour since the company's profit flow should improve but many employees will fear that they will lose their jobs.

While the possibility of conflict cannot be ignored, workers' interests also often coincide with those of other corporate participants. In the case of a company with high profits, shareholders will own equity which should be increasing in value and creditors will face a minimal risk of default. Workers should also benefit. A successful company will typically be increasing output, which should enhance the job security of existing employees and lead to the hiring of new staff. Another situation where the interests of shareholders, creditors, and employees may all coincide is where management obtains the active co-operation of the workforce rather than mere compliance or coerced consent. A possible way those in charge can reach such an outcome is to consult regularly with the workers, provide increased training, and offer reliable assurances of job security. Such changes will potentially make individual members of the staff more flexible and adaptable and may well help management to harness the creative abilities of the employees. Investors and lenders in turn could benefit from such a work environment since for a business being competitive and successful in the marketplace may well depend increasingly on employees working 'smarter' rather than just harder.

In some circumstances, determining whether the interests of employees are in harmony or conflict with those of other corporate participants is difficult. An acquisition of one company by another is a transaction which falls into this class. Such deals are most likely to have an adverse impact on employees if the acquirors plan to increase the profitability of the target by

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For examples of such conduct, see 'Sabotage Their Systems and Steal Their Stationery . . .', *Independent on Sunday*, 10 March, 1996.


way of mass dismissals and wage reductions. Furthermore, even if this sort of radical restructuring does not take place employees will feel uncertain since they have to deal with a new management team whose main business could lie in other spheres of activity. Still, a number of empirical studies indicate that corporate acquisitions typically do not result in substantial reductions in the size of the workforce. In addition, with the dismissals and wage reductions that do take place, the possibility exists that they might have occurred anyway in the face of natural competitive pressures. As well, a change in ownership can be beneficial for the workforce since new management may revive what was a declining company.

Bargaining

Conflicts between employees and other corporate participants in theory can be addressed by bargaining. Take the example of corporate acquisitions. An employment contract can be drafted so as to deal with the impact which such transactions have on employees. For instance, in the United States it has recently become common for employment contracts to include 'tin parachute' clauses which entitle rank and file workers to severance pay if they lose their job as a result of a takeover. Nevertheless, the express terms of an employment contract are ordinarily not highly detailed and the focus is usually on a few issues, such as wages, work hours, and holidays. The relevant documents will correspondingly not deal in any detail with numerous key issues, such as specific worker responsibilities and anticipated levels of performance.

The approach that is used has advantages, since too precise a specification of obligations will preclude both employer and employee from responding effectively to changing circumstances. Furthermore, mechanisms exist which address gaps in employment contracts. The presence of a union can, for instance, play a significant role. Collective agreements reached between unions and employers are usually considerably more intricate than conventional employment contracts. Topics dealt with that are unlikely to be addressed in individual contracts of employment can include physical working conditions, redeployment within the organization, and redundancy.

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issues. It is standard practice for individual employment contracts to incorporate the terms of any pertinent collective agreement. If the practice is not followed the terms in question will not be binding against individual employees. This requires an act of the parties since it does not occur automatically by operation of a rule of law.

The legal system also addresses the problem of gaps in employment contracts. English courts have, in order to resolve disputes between workers and employers, developed an intricate set of implied terms. One of these, as mentioned, is a duty on the part of employers to provide notice prior to dismissal. Another example is an obligation imposed on workers to obey reasonable orders.

Furthermore, while the UK Parliament has traditionally adopted a policy of abstention with employment relations, a variety of statutory measures now regulate the area. For instance, pursuant to the Employment Protection (Consolidation) Act 1978 an employer must provide to a worker a written statement of the particulars of his employment contract. Items to be specified include the place of work, hours, remuneration details, pension arrangements, any applicable disciplinary rules, and the title of the job to be done. As well, a number of important employment topics are now directly regulated by statute. We have already seen that dismissal is dealt with in some detail by legislation. Other matters governed by statute include health and safety issues and race and sex discrimination in the workplace.

4. DIRECTORS

In UK companies, the almost universal practice is for the articles of association to vest the power to manage the company in the hands of the board of directors. Nevertheless, day-to-day corporate decision-making is not usually carried out at board meetings. In the ordinary course, a company's articles of association will authorize the board to delegate its powers to

Addison and Siebert, supra, n. 169 at 361.
Wedderburn, supra, n. 140 at 329-30 and Davies and Freedland, supra, a. 143 at 19-20.
On Parliament's approach and how it has changed, see Davies and Freedland, supra, n. 143, especially chs. 1, 4, 8, 11.
Ss. 1-6, most recently amended by Trade Union Reform and Employment Rights Act 1993.
Equal Pay Act 1970, c. 41; Sex Discrimination Act 1975, c. 65; Race Relations Act 1976, c. 74; Health and Safety at Work Act 1974, c. 37, and Management of Health and Safety at Work Regulations, SI 1992/2051. One should not infer from the foregoing that the state has simply been seeking to fill gaps which have been too troublesome for employers and employees to address; the anti-discrimination legislation was an example of the agenda no longer being set by the concerns of industrial parties, Davies and Freedland, supra, n. 143 at 55, 653-4.
Chapter one, n. 130 and accompanying text.
individuals holding executive offices within the company. Correspondingly, decisions about hiring and firing, assigning work, launching product lines, and setting prices are ordinarily made outside the boardroom. Indeed, in small, closely held enterprises, board meetings are little more than legal formalities, when they are held at all. Key investors are usually both directors and full-time managers and will make most important decisions as part of their day-to-day management of the company rather than as members of the board.

In companies that have publicly traded shares, the board will operate on a more formal, structured basis. A number of senior full-time executives will sit on the board and most often they will be joined by a group of individuals who are not involved with the affairs of the company on a day-to-day basis. Those falling into the latter category are commonly referred to as outside or non-executive directors. The number of non-executive directors varies from company to company, but survey evidence indicates that the average proportion in a listed company is greater than two out of five and that this ratio has been growing in recent years.

Outside directors fulfill two key functions. One is providing full-time executives with support and assistance as they carry out their managerial tasks, which entails offering specialized advice and fostering links with other organizations. The other is monitoring executive decision-making. This will involve reviewing the performance of management to ensure that those in charge are running the company in the shareholders' interests and are complying with the legal duties, regulatory requirements, and ethical imperatives associated with the operation of a public company. In situations where corporate performance is markedly sub-standard, the outside directors may seek to orchestrate the removal and replacement of key executives.

UK company law does not recognize non-executives as a separate class of director. Though some allowances may be made for differences in knowledge and experience, all directors owe the same legal duties and are equally

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202 Table A, art. 72.
responsible for decisions taken by the whole board.\textsuperscript{207} Still, increasingly it is being recognized that executive and non-executive play different roles. Some judges have accepted that the distinction should be taken into account.\textsuperscript{208} Furthermore, in 1992 a prominent committee on UK corporate governance chaired by Sir Adrian Cadbury singled out non-executives in a number of instances when it issued a series of recommendations concerning the proper role of the board in public companies.\textsuperscript{209} In addition, following recommendations made in 1995 by a study group on executive pay chaired by Sir Richard Greenbury, The Stock Exchange altered its rules to require a listed company to disclose whether managerial remuneration policy was being determined by a committee composed entirely of outside directors.\textsuperscript{210}

We will follow the pattern which has developed and analyse non-executive directors separately from those who carry out managerial functions. Non-executive directors will be discussed in this section and the individuals who run companies on a day-to-day basis will be dealt with in the next. A brief note about terminology is needed, however, before proceeding further. The type of directors we will discuss are variously referred to as 'non-executive', 'outside', and 'independent'. Often these terms are used interchangeably and this will occur to a certain extent here. Still, some potentially relevant differences do exist. The term 'non-executive' should encompass anyone who is not a member of the management team. An 'outside' director will be anyone who is not currently employed by a company on a full-time basis.\textsuperscript{211} According to this terminology, the outside director category is somewhat more restrictive in nature because in the admittedly unlikely event that a rank-and-file employee has a post on the board, he will be a non-executive director but will not qualify as an outside director. On the other hand, an individual who has recently retired as a senior executive from a company should qualify under both categories, as would someone who is acting as a company's solicitor or accountant.


\textsuperscript{209} Committee on the Financial Aspects of Corporate Governance, Report (hereinafter Cadbury Report) (London: Gee and Co., 1992), particularly at 22-4. On the Committee’s background, see chapter eight, n. 52 and accompanying text.


\textsuperscript{211} The term ‘non-executive’ is more accepted in the UK and ‘outside’ is the prevalent US usage. Still, some UK observers prefer the ‘outside’ label, A. Cadbury, ‘Thoughts on Corporate Governance’, (1993) 1 Corporate Governance — An International Review, 5 at 6.
The term ‘independent’ is the most restrictive of the three categories. To meet this standard, an individual should, apart from his seat on the board and shareholdings (if any), have no connection with the company. The idea is that he should be free from any business or other relationship which could interfere with the exercise of independent judgement. Hence, the recently retired executive and the solicitor or accountant would likely not qualify, given the connections they will have to the company and its management team.

Sir Adrian Cadbury’s corporate governance committee and Sir Richard Greenbury’s executive pay committee both recognized the significance of being ‘independent’. The Cadbury Committee recommended that a listed company should have three non-executive directors and stipulated that two of these should be individuals whom the board can define as ‘independent’. The Greenbury Committee recommended that all individuals sitting on a remuneration committee should be independent in the sense that they do not have any personal financial interest in the deliberations.

Duration

An individual’s term as a director begins when he is first selected. In UK companies, the standard practice is for the articles of association to stipulate that the members are to elect the directors by way of an ordinary resolution.

In public companies shareholder voting on this issue is usually a formality since in most circumstances only one slate of candidates is offered. Thus, the key to becoming a director is to be nominated. Until recently, the individual leading the board known as the chairman had responsibility for choosing the candidates. In companies where the top executive (we will frequently use the term chief executive officer or CEO) was someone other than the chairman, he also often had an important say in the process. It is becoming increasingly common in UK companies, however, for a nominating committee composed of a number of incumbent directors to carry out the task of finding new members of the board. Such committees may in turn rely on recruitment agencies (‘headhunters’) or consult with PRO NED, an organization that seeks to promote the role of non-executive directors in corporate governance and specializes in identifying suitable candidates for company boards. The emergence of the nominating committee has not,

For instance, in 1995, there were complaints that the newly appointed chairman of BTR pic was not independent since he had just resigned as a senior partner of Ernst & Young, BTR’s auditors, ‘Independence of New BTR Questioned’, Independent on Sunday, 1 October, 1995.


P. Loose, et al., The Company Director: Powers and Duties, 7th ed., (Bristol: Jordans, 1993), ch. 2.3. See also Table A articles, art. 78 and Companies Act 1985, s. 292.

The title, imported from the US, is becoming more commonly used in the UK than managing director, which used to be the prevalent term, Charkham, supra, n. 97 at 264-5.
however, displaced fully the role played by the chairman of the board or the CEO. As a practical matter, the individuals in these posts continue to play a significant role in finding and selecting nominees. For an individual who has been selected as a director, the company's articles of association will usually deal with the term he is to serve. A common format is one under which one-third of the directors are to retire at each annual general meeting. If retirement does occur in accordance with this sort of rotation, a director will, in the ordinary course serve for a term of three years. At the end of this time, he will be eligible for re-election. Since only one slate of candidates is usually nominated, if he is on good terms with the CEO, the chairman of the board, and any other individuals who have a strong influence on the deliberations of the nominating committee, there is a good chance he will be selected to serve a new term. The length of time which non-executives actually serve is not entirely clear. One study of UK companies indicates that outside directors stay in office for an average of about six years but another suggests they typically do so for twice as long.

An elected director may leave office during his term. One way this can occur is if he is removed by the shareholders pursuant to a procedure established by section 303 of the Companies Act 1985. Another is if a director falls within the scope of measures in the articles of association or in legislation which disqualify him from continuing to serve. One statutory provision of this nature is section 293 of the Companies Act 1985, which provides that a director of a public company must vacate his office after he attains seventy years of age. The shareholders can, however, pass a resolution allowing such an official to retain his position.


217 Table A, arts. 73 and 74. See Loose et al, supra, n. 214 at 434-5.

218 Engaging non-executive directors by a letter of appointment for a period of three years is the most widely adopted practice, PRO NED, supra, n. 216 at 7.

219 See also Table A, art. 75, which deems an director who stands for re-election to be re-elected unless another person is elected or a resolution not to fill the vacancy is passed.


221 On this measure and some limitations associated with it, see J. Dine, 'The Role of the Non-Executive Director' in S. Sheikh and W. Rees (eds.) Corporate Governance & Corporate Culpability (London: Cavendish Publishing, 1995), 199 at 202-4.

222 On the impact of the articles of association, see Loose et al, supra, n. 214 at 433-4.

223 Another example is the Company Directors Disqualification Act 1986, c. 46, pursuant to which an individual can be disqualified on a variety of grounds (e.g., persistent breaches of companies legislation, fraudulent conduct, 'unfitness'). The Act is discussed in more detail later in the book (see, for example, text accompanying chapter three, nn. 143 to 146, chapter seven, nn. 68 to 70 and chapter eleven, n. 287 to 294).
An additional way in which a director can leave office prior to his term expiring is by resigning. While this can occur for purely personal reasons, often other circumstances will be involved. A director may quit because he feels that he can no longer get along with the chairman/CEO. If voting control in a company has shifted after a bidder has made a successful offer to purchase the company's shares, the existing directors will usually resign to make way for the new regime. Furthermore, outside directors often leave office when their company is in dire financial trouble. If a company's operations are terminated and the assets are liquidated, then all members of the board necessarily lose their positions. Even without liquidation, however, outside directors will quite often step down. For instance, a study of US public corporations which were forced by financial troubles to restructure their debt found that only about half of the non-executive directors in office one year before restructuring still held their directorships three years later.

Directors, including non-executives, are usually given fees for attending meetings and carrying out related duties. A non-executive will also sometimes be paid an annual retainer and may agree with the company that he can claim reasonable expenses, such as travel and accommodation. Furthermore, he might charge on a per diem basis for time spent on company business which is not closely related to his activities as a director. The actual recipient of fee income will not always be the non-executive. In circumstances where an outside director works on a permanent basis for another company or institution, the fees are frequently paid directly to the primary employer as reimbursement for allowing the individual to spend time acting as a non-executive. In any case, the amounts involved are usually not particularly large. For a director who works approximately fifteen days per year, the amount he will be paid annually will vary from about £7,000 for smaller listed companies to something over £20,000 for larger business enterprises.

Most companies' articles of association require a director to give written notice of resignation, Coopers & Lybrand, Being a Director: What You Need to Know (London: Gee, 1993) at 142.


Charkham, supra, n. 97 at 272.


See Loose et al., supra, n. 214 at 389-91, who notes that Table A, art. 82 is not suitable for making such arrangements. On director pay see generally Clutterbuck and Waine, supra, n. 225 at 99, 146-9.

Clutterbuck and Waine, ibid, at 148.

Ibid, at 147; 'Non-Executives Paid £14,400 for 15 Days’ Work', Times, 15 February, ’95; ‘Overwrought, Overworked and Over Here’, Financial Times, 17 March, 1995 and
mentioned, non-executives face risks on this front of which they need to be increasingly aware. At first glance, a solution could be to rely on contractual documentation to displace or modify the duties which such individuals owe. Section 310 of the Companies Act 1985, however, declares void any provision in a contract or a company's articles of association that operates as an exculpatory clause in relation to director liability.  

Another strategy is for a company to take out on a director's behalf an insurance policy that will reimburse him if he incurs personal liability while acting on the company's behalf. This type of insurance has been available in the United Kingdom since the 1930s, though it was only in 1989 that an amendment to the Companies Act 1985 established beyond doubt that such insurance was permitted. This change in the law and the growing awareness of the liabilities which directors face have provided the impetus for a significant increase in the purchase of insurance in the United Kingdom. Indeed, the market has become sufficiently lucrative for at least one insurer to offer policies specially tailored for non-executive directors. Still, insurance is not going to address all the concerns a director will have about litigation. Such policies usually stipulate that a claim cannot be made if environmental liabilities are involved or if a director has been fraudulent or dishonest. Also, losses incurred in respect of criminal liability cannot as a matter of public policy be insured against. Finally, having insurance does not spare a director the inconvenience and adverse publicity associated with litigation.

5. MANAGEMENT

Larger businesses have a wide range of individuals who are categorized as managers, ranging from workplace supervisors to top executives. Our focus is on the latter. The managers who are at the apex of the corporate decision-making hierarchy act as central organizers, establish the future direction of the business, and make the key strategic and administrative decisions.

264 Section 310(3) does establish an exception for clauses which indemnify a director (the terminology actually used is officer) against costs incurred in i) successfully defending himself in judicial proceedings, 2) obtaining, under prescribed provisions, relief from the courts. On s. 310, see further chapter five nn. 51 to 53 and related discussion.


decisions. This means they will determine which markets the company should try to exploit, decide which products and services the company should offer, and formulate the company's basic organizational structure. In smaller, closely held companies, the individuals in question will usually be key shareholders as well as directors and officers. In public companies, on the other hand, investors rarely play a 'hands-on' role in managerial matters. Instead, decision-making will be carried out by a management team made up of a group of professionally trained executives. One individual, the CEO, will ordinarily act as chief co-ordinator, policy-maker, and motivator. Other top managers will have more specialized duties, such as dealing with finance, marketing or personnel, or will control company operations in a particular geographic area. The primary responsibility of these individuals will be to perform their assigned function. Still, they will also play a significant role in setting company policy and co-ordinating the operation of the business.

**Duration**

An executive will be in a contractual relationship with the company for which he has agreed to work. In the absence of specific agreement, both parties must give notice which is 'reasonable' before terminating the relationship. The meaning of 'reasonable' varies depending on the circumstances. Since certainty is usually desired, it is standard practice for an executive's service contract to have a clause dealing specifically with duration. One arrangement which can be used is to specify a period of notice which either party can give to terminate the agreement. Another possibility is a fixed period contract. With this type of arrangement, the employment relationship is formally at an end when the specified period of time has elapsed. The time when the term is approaching its end is an awkward one since the executive does not know if his contract will be renewed. This generates uncertainty both for him and others at the company and the executive. Correspondingly, companies quite often set up a 'rolling' or 'evergreen' contract. Such an agreement in effect constantly renews itself. Hence, a three-year rolling contract is always three years from expiry, which means the awkward problem of renewal never arises.

Sometimes a top manager will be pressured to leave his company during the term of his service contract. If he succumbs to the pressure, he will usually depart immediately rather than continue to work until his contract expires. This does not mean, however, that the terms dealing with

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""" Loose et al, supra, n. 214 at 408. 
""""Ibid.
""" For an example of such a clause, see ibid, at 459 (the clause also contains a notice provision).
"""" See generally 'Service Contracts'. PLC, July 1993, 14.
""" If an executive is in possession of highly confidential and strategic information, in order to have the terms of employment relating to confidentiality and fidelity continue, he may be placed on 'gardening leave', which means he is not released from his employment contract but
duration will be irrelevant. In the event that the manager sues for breach of contract, the damages to which he will be entitled will depend in large measure on how long the agreement still has to run. Litigation in such matters is rare, but if the time remaining is substantial, he will be well-positioned to negotiate a generous severance payment. Lucrative 'golden handshakes' have in fact become the subject of some controversy in recent years. Until recently in listed companies three-year rolling contracts for senior executives was the norm and five-year terms were reasonably common. In the early 1990s, such arrangements accounted in considerable measure for a series of generous, well-publicized pay-offs made to senior executives departing after indifferent corporate performance. Institutional investors, disturbed that companies were 'rewarding failure', pressed for the use of shorter contracts. This campaign had a significant impact and it soon became much more common for executive contracts in listed companies to be of one or two years' duration. The move in this direction was given a further boost in 1995 when the Greenbury Committee on executive pay recommended that the best practice was for contracts to have a one-year term.

Contractual arrangements aside, the relationship between companies and their managers tends to be one of substantial duration. We have already seen that in closely held companies the individuals who own shares in and run such enterprises usually have a financial investment in the business which cannot be liquidated easily. Also, they will often have developed firm-specific skills which will be of limited value elsewhere. As a result, those in charge will usually not be well-situated to leave their positions on short notice, even if they were so inclined.

spends his time at home: F. Younson, 'Terminating Senior Executives', PLC, November 1994, 32 at 35.

K. N. Dierden, 'Directors' Service Contracts' in Tolley's Company Law, issue 13 (July 1993), (Croydon: Tolley Publishing, i99off.), D50 at D50/5, D50/7. The rule of thumb is that a departing executive will get at least half of what he would have earned on the employment contract (e.g., an executive will get about one-and-a-half years' worth of salary under a three year rolling contract): 'Fat Pay-Offs Feed on Investor Inertia', Independent on Sunday, 13 June, 1993. See also M. Ingle, 'Terminating Senior Executives', PLC, December 1994, 37.

Chapter one, n. 90.


See 'Stopping the Gravy', supra, n. 278; 'Adding Up the Sacks of Gold', Independent on Sunday, 13 June, 1993 and 'The Higher They Go The Softer They Fall', Independent on Sunday, 21 August, 1994 as well as discussion in chapter fourteen, nn. 273 to 276 and accompanying text.


Executives in public companies do not face the same constraints as their counterparts in closely held firms. They will usually be able to dispose quickly of whatever investment they have in their companies since the shares will likely be listed for trading on an exchange. They can, in addition, have expertise and talents which will be attractive to an alternative employer. For instance, a successful finance director, with his knowledge of capital budgeting, credit control and accounting, will usually be very much in demand.\textsuperscript{282} Furthermore, if one looks beyond those in top managerial positions to individuals in a company who can be classified as aspiring executives, inter-firm mobility has been increasing.\textsuperscript{283} Part of the explanation for this is that in many instances some moving around is required to rise through the corporate ranks.\textsuperscript{284} Inter-firm mobility is increasing as well because ‘delayering’, a process by which a company streamlines its internal corporate hierarchy, has been occurring more frequently. Often, numerous managers lose their jobs in such reorganizations, thus forcing them to look for work before they would otherwise choose to leave.\textsuperscript{285}

While executives in public companies are not tied to their firms in quite the same way as the individuals who run closely held companies, those in top managerial posts do usually spend a considerable amount of time working for the same employer. For instance, a 1994 survey of 100 leading UK companies revealed that just over half of the CEOs had joined their current company before 1980.\textsuperscript{286} One reason for this pattern is that many senior managers are not particularly well-positioned to change jobs. While a finance director may have the sort of expertise and training which other companies will value highly, other top managerial personnel can have skills which are largely specific to their companies or the industries in which they work.\textsuperscript{287} This is likely to be the case, for instance, with an executive in charge of research or of product development. Another reason senior managers often end up spending a considerable amount of time with one company is that for someone who aspires to a top position, staying at a firm will at a certain point often help him to get ahead. This is because, despite increases in inter-firm mobility, most executives at the apex of the

\textsuperscript{283} G. Bamber and E. Snape, ‘Britain in Roomkin, supra, n. 270, 17 at 32-7.
corporate hierarchy are ultimately selected by way of internal promotion, not by external appointment."

An additional factor which ensures that a typical top manager spends a considerable amount of time with his company is that, unless some sort of special circumstances are involved, the likelihood of dismissal is usually low." Correspondingly, there are some instances where a single individual has been CEO at a UK listed company for a period of 25 years or more." The amount of time which top executives should spend with their companies has become the matter of some controversy. In 1995, two British academics proposed the introduction of legislation establishing a system under which a listed company's chief executive would be appointed for a fixed four-year period but could only serve a maximum of two terms." This suggestion elicited a mixed response with one concern being that establishing a maximum amount of time an individual could serve would impose an arbitrary strait-jacket on truly exceptional people who would be forced to leave prematurely."

Return

Individuals who are in top management positions in larger businesses are usually well paid. A 1994 study of just under 1,000 leading UK companies found that the average total remuneration of chief executives was £351,000." This is over 20 times the annual salary of the typical rank-and-file worker (approximately £16,500)." The same 1994 survey indicated that


"'No 1, Your Time is Up', Independent on Sunday, 27 August, 1995 (examples cited included Mr Stanley Kalms of Dixons pic and Lord Weinstock of GEC pic, who announced his intention to resign soon after).


Автор статьи отстаивает тезис об отсутствии у юридического лица каких-либо собственных интересов. Интерес юридического лица — категория ситуативная, подлежащая установлению каждый раз применительно к тому или иному правовому институту корпоративного права. Для определения интересов юридического лица и его участников необходимо ответить на вопрос: ради защиты чьих интересов конкретный институт однажды был введен позитивным правом или судебной практикой? Лишь после этого можно утверждать, что для целей применения данного института интересы юридического лица тождественны интересам бенефициаров, получающих некоторые выгоды от введения соответствующего института. Как это ни парадоксально, но не интерес юридического лица порождает те или иные механизмы защиты, а, напротив, введение в корпоративное право защитных инструментов артикулирует интерес той или иной группы участников корпоративных отношений, который начинает отождествляться с интересом юридического лица. Наконец, политико-правовые дискуссии, обосновывающие введение какого-либо нового института корпоративного права, не могут базироваться на понятии интересов юридического лица, а должны основываться соображениями защиты интересов отдельных участников или групп участников корпорации.

Ключевые слова: интерес юридического лица, интерес участника корпорации, принцип большинства, предпочтения, принятие решений группой, теорема невозможности Эрроу, парадокс голосования

* Правовые позиции, приводимые в настоящей публикации, являются частным мнением автора и не отражают позицию Адвокатского бюро «Егоров, Пугинский, Афанасьев и партнеры», а также не могут использоваться как предпосылки для составления представления о возможных правовых позициях названного Адвокатского бюро в будущем. Автор выражает благодарность за ценные комментарии и замечания, высказанные в ходе доработки статьи, Н. Ермаковой, Я. Зубареву, Д. Чуприкову, при этом все ошибки и спорные суждения, конечно же, остаются на совести самого автора.
Dmitry Stepanov  
PhD in Law

**Interests of Corporation and Its Shareholders**

Legal entity as an artificial creature made by law has no own interests and the only interest that matters in corporate law is the interest of legal entity participants. Since shareholders have heterogeneous interests varying from one group to another and those interests may change in the course of time the author argues that the notion of interests of any legal entity is case-specific and may change dramatically over the lifetime for any given corporation. Moreover, there are no universal interests to be protected by corporate law, instead courts and law-makers tend to introduce narrowly tailored protective mechanisms which may protect minority shareholders in one instance and negatively affect them in others. The only one reason to employ the term «interests of legal entity» is to highlight whose interests are protected by a given rule of corporate law mechanism and how this rule should be enforced. Finally, in any policy related debates (e.g. in what extent, who and how should be protected by corporate law) we cannot rely on the interests of any specific group of shareholders: since most people of groups of three and more face voting paradox and unable to aggregate their preferences without any dictator (in Arrowian sense of social welfare function), law makers tend to make their choices based on Pareto efficiency criteria and constrained by current political environments.

*Key words: interest of corporation, shareholders' interests, majority principle, preferences, Arrow’s impossibility theorem, voting paradox, preferences aggregation, cyclical preferences*
Свободная трибуна

зия подхода, предполагающего отождествление интересов юридического лица с интересами какой-либо группы участников юридического лица. При этом как с позиций экономического анализа права, так и в процессе рассмотрения частных, сугубо прикладных вопросов, которые возникают в практике применения норм корпоративного законодательства, обосновывается тезис о том, что интересы юридического лица — категория довольно подвижная, сложно или почти не поддающаяся какой-либо раз и навсегда текстуальной формализации, фиксации, даже применительно к конкретному юридическому лицу, если в нем присутствуют как минимум три лица (участника). Тем более сложно дать какую-либо нормативную привязку к тому, что понимать под такими интересами или как их определять универсальным образом, для любого юридического лица.

Как будет показано ниже, интересы юридического лица имеют практическое, прикладное значение лишь для одной цели: понять, допустима ли в принципе защита того или иного интереса конкретного участника юридического лица, а не самой организации исходя из наличного правового регулирования (положений закона при его буквальном прочтении или позитивного права, как оно понимается в практике его применения). И если допустима, то насколько право должно защищать такой интерес. Никакого иного, самостоятельного значения категория интересов юридического лица не имеет. В этом моменте предлагаемая вниманию читателя работа принципиально расходится с превалирующей в настоящее время в российской науке гражданского права тенденцией поиска и подведения под категорию интересов юридического лица и (или) его участников любой темы, хоть сколько-нибудь связанной с защитой прав участников корпоративных образований, когда тот или иной механизм защиты явно или имплицитно предполагается направленным на защиту некоторого абстрактно описанного интереса юридического лица или интересов некоторых групп его участников, например миноритарных участников или контролирующего лица1. Соответственно, если только интерес участников, но не самого юридического лица может иметь хоть сколько-нибудь значимую практическую ценность, крайне проблематично обосновывать те или иные притязания на защиту ущемленного интереса или нарушенного права — в рамках корпоративного права — ссылками на то, что были нарушены интересы юридического лица. Однако ущемление интересов отдельных участников — тема еще более скользкая, а потому в практическом плане ссылки на ущемление интересов участника могут иметь правовое значение лишь в случае, когда соответствующее средство право-

вой защиты *expressis verbis* предусмотрено позитивным правом либо (в исключительных случаях) дозволено через судебное правотворчество. Какими критериями определяется введение таких средств правовой защиты в налличное право — об этом в самом общем виде будет сказано в завершении настоящей статьи.

I. Постановка проблемы

Поскольку предметом настоящей публикации не является исследование того, что такое интерес в материальном праве\(^2\) (охраняемый законом интерес, или законный интерес — терминология, скорее, уже науки процессуального права), то для целей последующего изложения под интересом будет пониматься категория максимально общего свойства, т.е. материально-правовая конструкция, неразрывно связанная с субъективным гражданским правом, причем связь эта обычно проявляется по линии защиты нарушенных прав, в данном случае прав, касающихся корпоративных отношений и всего того, что связано с созданием и последующим функционированием юридического лица\(^3\). Интерес — категория в праве довольно устоявшаяся, хотя о ее содержании продолжаются споры. Вместе с тем подложкой интереса, когда от правовой действительности мы переходим к сфере жизнедеятельности отдельного индивида или когда используем терминологию иных социальных наук, оказываются предпочтения, соответственно, далее обе эти категории (интерес и предпочтения) используются как синонимы.

Об интересе в праве обычно вспоминают тогда, когда есть противопоставление интересов, т.е. как минимум два так или иначе противостоящих друг другу интереса (необязательно жестко непримиримых, это может и слабо артикулированное противопоставление, однако такое «разведение» интересов так или иначе предполагается). Там, где есть только один интерес и ему никто или ничто не противостоит, потребности в обсуждении проблематики его защиты просто нет. Так, одним из наиболее типичных примеров противопоставления интересов участников

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\(^3\) Таким образом, в настоящей работе, если иное специально не оговарено, корпоративное право понимается в самом широком смысле: не только как право корпораций, т.е. основанных на членстве, как правило, коммерческих организаций, но любых иных юридических лиц — как корпоративных и унитарных, так и коммерческих и некоммерческих организаций. Аналогично под участником корпорации будет пониматься участник любого корпоративного образования, вне зависимости от того, как он специальным образом именуется в законе (участник, акционер и т.п.). Соответственно, основной тезис, отстаиваемый в настоящей работе, а равно и прочие соображения, даже если они иллюстрируются исключительно или преимущественно ссылками на проблематику коммерческих корпораций, могут быть применены как к некоммерческим организациям, так и к унитарным предприятиям (организациям). Там, где это необходимо в силу специфики иных организаций, не относящихся к коммерческим корпорациям, делаются соответствующие отступления.
корпоративного образования является имплицитно присутствующей практиче-
ски в любой корпорации конфликт интересов мажоритарного и миноритарных
участников.

На эту особенность корпораций — наличие противостоящих интересов двух групп
акционеров — уже неоднократно обращал внимание КС РФ, который отмечал не-
обходимость установления в законодательстве баланса интересов мажоритарного
акционера и миноритариев; например, для целей института принудительного вы-
kупа акций ОАО. В случае с консолидацией акций, когда в отсутствие институ-
ta дробных акций миноритарии фактически вытеснялись из АО, Суд пошел еще
дальше: он не только отметил противопоставление интересов владельцев круп-
ych пакетов акций и миноритариев, но указал, что в случае с консолида-
цией мажоритарий оказывается в более выигрышном положении, но также впер-
вые в полный юридический оборот — по крайней мере на официальном
уровне — смысловую конструкцию, которую он обозначил как „интересы акцио-
нерного общества в целом“. При буквальном прочтении судебного акта высшей
судебной институции обнаруживается, однако, что в рассматриваемом деле «ин-
teresы акционерного общества в целом» были отождествлены с интересами вла-
дельцев крупных пакетов акций, которые обеспечили фактическое вытеснение
миноритариев за счет принятия решения о консолидации акций.

5 См. п. 3 определения КС РФ от 03.07.2007 № 681-О-П «По жалобам граждан Ю.Ю. Колодкина и
Ю.Н. Шадеева на нарушение их конституционных прав положениями статьи 84.8 Федерального зако-
на «Об акционерных обществах» во взаимосвязи с частью 5 статьи 7 Федерального закона «О внесении
изменений в Федеральный закон «Об акционерных обществах» и некоторые другие законодательные
акты Российской Федерации».
6 См. п. 5.2 постановления КС РФ от 24.02.2004 № 3-П «По делу о проверке конституционности отдель-
ных положений статей 74 и 77 Федерального закона «Об акционерных обществах», регулирующих по-
рядок консолидации размещенных акций акционерного общества и выкупа дробных акций, в связи с
кадетами граждан, компании «Кадет Истеблишмент» и запросом Октябрьского районного суда города
Пензы».
7 В науке гражданского права России подобный общий интерес АО был детально описан и научно обо-
снован несколькими годами позже. См.: Николаевская Е.И. Гражданско-правовая характеристика ин-
teresов акционеров и акционерного общества и их баланса: дис. ... канд. юрид. наук. М., 2008. С. 9,
64–85 (общий корпоративный интерес АО — это «определяемый стратегическими целями законный
интерес АО, направленный на достижение блага для всех субъектов акционерного правоотношения и
устанавливаемый пределы осуществления их прав», причем такой интерес должен соответствовать за-
кону, быть направлен на достижение блага для всех акционеров, а не некоторой части из них, наконец,
такой интерес имеет приоритет над законными интересами других субъектов акционерного правоотно-
шения, условно говоря, выступает неким знаменателем, под который подводятся интересы всех прочих
участников корпоративных отношений, их интересы не должны по общему правилу отклоняться от
общего интереса АО).
8 Пункт 5.2 постановления КС РФ от 24.02.2004 № 3-П.
9 Так, в п. 5.2 постановления КС РФ от 24.02.2004 № 3-П Суд отметил следующее: «...основанием для
отчуждения у части акционеров принадлежащего им имущества могут быть интересы акционерного об-
щества в целом, в той мере, в которой они действуют для достижения общего для акционерного общества
блага. При этом необходимо иметь в виду, что в результате консолидации акций в интересах акционер-
ного общества в целом в лучшем положении оказываются акционеры, владеющие крупными пакетами
акций, в то время как неблагоприятные последствия консолидации, как правило, несут миноритарные
акционеры.»
Количество дел, в которых артикулируется конфликт интересов мажоритарных и миноритарных участников либо выделяются интересы самого юридического лица, измеряется сотнями, если уже не тысячами, поэтому, видимо, нет нужды приводить здесь ссылки на судебно-арбитражную практику рассмотрения корпоративных споров. Однако два момента, которые ассоциируются именно с развитием такой практики, точнее, судебного правотворчества, все же стоит отметить специально.

Во-первых, именно в практике арбитражных судов противопоставление интересов мажоритарных и миноритарных участников впервые в российском корпоративном праве было разрешено не в пользу мажоритария, как это ранее традиционно делалось в позитивном праве или практике КС РФ, т.е. приоритет в защите интересов, пусть в довольно специфичном институте, исключении участника ООО из такого общества, был отдан миноритариям. Так, по правилам ст. 10 Федерального закона от 08.02.1998 № 14-ФЗ «Об обществах с ограниченной ответственностью» (далее — Закон об ООО) миноритарии, если они обладают минимум 10% уставного капитала ООО, вправе требовать исключения мажоритарного участника ООО, обладающего долей более 50%, правда, только в случае, если уставом соответствующего ООО не предусмотрено право выхода (ст. 26 Закона об ООО) участников из общества.

Во-вторых, ВАС РФ еще до изменения ГК РФ в части, посвященной юридическим лицам, базируясь на довольно лапидарно изложенном законодательном материале, создал детальный путеводитель для судов по концепции так называемых фидуциарных обязанностей членов органов управления юридического лица, в основе которой лежит допущение о наличии именно у юридического лица, а не у его участников некоторых объективных интересов, охраняемых через запрет нарушения обязанности заботы (требование действовать разумно) и добросовестности (недопустимость конфликта интересов). При этом, что интересно, лицо, осуществляющее функции единоличного исполнительного органа, может быть привлечено к ответственности перед юридическим лицом даже тогда, когда есть решение участников такой организации, одобряющее совершение конкретной сделки или действия, т.е. интересы тех, кого можно было бы отождествить с носителями агрегированного интереса, отождествляемого с интересом юридического лица, мало чем могут помочь директору, привлекаемому к ответственности за нарушение фидуциарных обязанностей. Тем самым стараниями судебно-арбитражной практики был обособлен — по крайней мере, в виде общего допущения — не только тот факт, что признано, что признано, что определение о взыскании с директора убытков может быть приведено к ответственности перед юридическим лицом даже тогда, когда есть решение участников такой организации, одобряющее совершение конкретной сделки или действия, т.е. интересы тех, кого можно было бы отождествить с носителями агрегированного интереса, отождествляемого с интересом юридического лица, мало чем могут помочь директору, привлекаемому к ответственности за нарушение фидуциарных обязанностей. Тем самым стараниями судебно-арбитражной практики был обособлен — по крайней мере, в виде общего допущения — не только тот факт, что признано, что признано, что определение о взыскании с директора убытков может быть приведено к ответственности перед юридическим лицом даже тогда, когда есть решение участников такой организации, одобряющее совершение конкретной сделки или действия, т.е. интересы тех, кого можно было бы отождествить с носителями агрегированного интереса, отождествляемого с интересом юридического лица, мало чем могут помочь директору, привлекаемому к ответственности за нарушение фидуциарных обязанностей.

См. п. 11 информационного письма Президиума ВАС РФ от 24.05.2012 «Обзор практики рассмотрения арбитражными судами споров, связанных с исключением участника из общества с ограниченной ответственностью».

См. п. 7 постановления Пленума ВАС РФ от 30.07.2013 № 62 «О некоторых вопросах возмещения убытков лицами, входящими в состав органов юридического лица» («не является основанием для отказа в удовлетворении требования о взыскании с директора убытков несмотря на то, что действие директора, повлекшее для юридического лица ущерб, было одобрено решениям коллегиальных органов юридического лица, а равно его учредителей (участников), либо директор действовал во исполнение указаний таких лиц, поскольку директор несет самостоятельную обязанность действовать в интересах юридического лица добросовестно и разумно»).

Справедливости ради следует заметить, что в п. 7 постановления № 62 не говорится о том, каким образом было принято решение об одобрении сделки или действия. Однако если такое решение принимается некоторым большинством участников (хотя бы минимумом голосов, требуемым по закону для принятия соответствующего решения): в таком случае интересы юридического лица могут быть
абстрактный интерес юридического лица, который может существовать в отрыве от интересов участников организации.

Наконец, если обратиться к позитивному праву, т.е. законодательству о юридических лицах, то там можно обнаружить нередкие ссылки на интересы юридического лица, которые обычно упоминаются в связи с вопросами ответственности участников корпоративных отношений. Не случайно, что позитивное право вроде бы не упоминает интересов всех или отдельных групп участников юридического лица — так, как это делается в доктрине или судебной практике, однако, по сути, каждый раз, когда диспозиция нормы права содержит указание на интерес юридического лица, не составляет особого труда выяснить интерес участника или группы участников, который на самом деле защищается соответствующей нормой.

К примеру, правила об ответственности членов органов управления юридического лица за действия, совершенные в противоречие интересам представляемого юридического лица (п. 3 ст. 53 и ст. 53¹ ГК РФ), по сути, оказываются направленными на защиту незаинтересованных и, как правило, миноритарных участников такого юридического лица, хотя ответственность конструируется в законе как нарушение обязанностей, которые лицо несет перед юридическим лицом, а не в пользу участников такого лица, и возмещение ущерба также осуществляется в пользу организации, а не участников. Понятно, что, хотя убытки, возмещенные организацией, напрямую не идут в карман иных участников такого юридического лица, тем не менее косвенно подобное возмещение позитивно отражается на отождествлены с интересами всех или части несогласных с принятым решением участников, а потому места для некоего интереса самого юридического лица нет, его интерес может быть отождествлен с интересами фактически бесправных миноритарий. Другое дело, когда решение об одобрении сделки санкционируется всеми участниками единогласно (от общего числа всех участников, а не от присутствующих при голосовании), т.е. места для какого-либо иного голоса внутри этого конкретного юридического лица не остается, а значит, нет места и для интереса, противоположного выраженному в решении участников об одобрении сделки. В последнем случае, если допустить, что юридическое лицо может быть носителем самостоятельного интереса, не сводимого к сумме интересов всех его участников, выраженного в решении собрания участников по конкретному вопросу, а равно интереса, выраженного директором при совершении сделки от имени юридического лица на основании названного решения, получается, что ВАС РФ впервые в отечественной судебной практике описал самостоятельный интерес юридического лица, не сводимый к интересу всех его участников. К сожалению, подобное прочтение вряд ли стоит воспринимать всерьез как то, что хотелось сказать в таком случае авторам подобного разъяснения. Если это так, то даже здесь интерес юридического лица оказывается участвованием с интересом отдельных участников — всех или части тех участников юридического лица, которые в силу незначительности принадлежащего им объема корпоративного контроля в принципе не могли повлиять на принятие решения об одобрении сделки или действия, а равно инициатора, предостаточно совершенному директором от имени такого юридического лица. Соответственно, указание на интересы юридического лица в данном случае — это прием юридической техники, который позволяет уравновесить производ мажоритарных участников и дать правовую защиту интересам миноритарий.
них участниках. Во многом именно поэтому соответствующие этой категории иски называют косвенными. Другой пример — исключение участника ООО (ст. 10 Закона об ООО), а с недавних пор также и участника непубличного акционерного общества (абз. 4 п. 1 ст. 67 ГК РФ) из такого общества. Вроде бы исключение если и возможно, то только за то, что участник юридического лица своими действиями (бездействием) причинил существенный вред самому юридическому лицу либо «инным образом существенно затрудняет его деятельность и достижение целей, ради которых оно создавалось». Однако кто инициирует такое исключение? Кто от него в итоге выигрывает? Ответы на все эти вопросы более чем очевидны: те участники, которые не желают видеть исключаемого участника в своих рядах. Поэтому опять-таки ссылка на интересы юридического лица оказывается не более чем уловкой юридической техники, которая прикрывает истины интересы, защищаемые рассматриваемой нормой.

Наконец, тот же самый подход — маскировку позитивным правом интересов одних участников юридического лица в противовес другим под видом интересов юридического лица — можно обнаружить в иных институтах корпоративного права: 1) крупные и заинтересованные сделки (интересы неконтролирующих и незаинтересованных в совершении сделки участников); 2) ответственность головной компании по правилам ст. 67 ГК РФ перед дочерней компанией за сделки, совершенные дочерней компанией с согласия головной компании, или за убытки, причиненные иным образом в связи с ее действиями или бездействиями, а равно ответственность любого иного контролирующего лица на основании п. 3 ст. 53 ГК РФ (интересы участников дочернего юридического лица и участников, не обладающих таким объемом контроля, как контролирующее лицо). Таким образом, постулирование интересов юридического лица позитивным правом как предпосылка для наступления ответственности или как идеальная основа корреспондирующего средству правовой защиты на деле оказывается отсылкой к интересам всех или некоторой группы участников корпорации. Далее уже су-

дам в ходе применения конкретной нормы права приходится решать, обоснованно или нет давать ход соответствующему средству защиты. Суды вольно или невольно проводят взвешивание на невидимых весах интересов одних участников в противовес другим. Однако, когда суды подходят к этому моменту, мы опять возвращаемся к проблеме не интереса юридического лица как такового, а к неким совокупным интересам участников корпорации, как правило их отдельной группы. Тут возникает вопрос: как в таком случае определить эти интересы, как их формализовать, «писать на бумаге», с тем чтобы сделать по отношению к ним нормативную привязку?

Сегодня у одного участника одни интересы, а завтра, в том числе из-за столкновения с интересами иных участников, они могут стать прямо противоположными. Сегодня в юридическом лице один состав участников, а завтра он может измениться до неузнаваемости, а значит, и интересы, приписываемые юридическому лицу, меняются кардинальным образом. Подобная подвижность интересов проявляется тем сильнее, чем больше участников внутри юридического лица и чем выше обращаемость его акций (долей в уставном капитале). В экстремальных случаях коллективный интерес участников может быть настолько размытым, что единственным выразителем интереса юридического лица оказывается его менеджмент — лица, формально вообще никак не участвующие в акционерном капитале, что, в общем, не новость для публичных корпораций с так называемой дисперсной, т.е. высоко распыленной системой корпоративной собственности, где наблюдается разделение собственности и контроля — феномен, впервые описанный почти столетие назад.

Таким образом, попытка опереться на интересы участников юридического лица, точнее, некоторую «сумму» подобных интересов или их «среднее арифметическое» тоже приводит к неутешительным выводам. Даже если допустить, что интересы юридического лица действительно отличны от интересов его участников (что само по себе более чем спорно даже в указанном выше единственном примере из области судебно-арбитражной практики), закономерно возникают вопросы. Что


Аналогичные рассуждения см.: Николагорская Е.И. Указ. соч. С. 72; Плешков Д.В. Указ. соч. С. 24, 29.


См.: Михайлов С.В. Категория интереса в российском гражданском праве. М., 2002. С. 156.
взять за основу при определении интереса юридического лица? Где заканчивается сфера интересов юридического лица как такового и начинаются интересы только его участников, если всерьёз допускать подобное разграничение? И напротив, если уравнивать интересы юридического лица с интересами его участников, то как можно полагаться в этом вопросе на последнее, коль скоро они подвижны? На что в таком случае вообще можно опереться? Далее, если интерес корпорации фиктивен и статичен, а интересы конкретных акционеров всегда подвижны20, как уравнять нечто, постоянно меняющееся и текущее (интересы конкретных акционеров), с некой абстракцией, однажды закрепленной и описанной как интерес юридического лица — будь то общий интерес коммерческой корпорации или общий интерес некоммерческой организации? Как описать критерии выявления интересов участников юридического лица, а через них — фиктивных интересов самой организации?

Очевидно, здесь можно сформулировать ключевую проблему в рамках рассматриваемой темы. Понятно, что сначала нужно определить предмет рассмотрения, задать границы того, что следует решить, а уже затем попытаться понять, как подойти к решению проблемы. Итак, какие исследовательские вопросы стоят в связи с заявленной темой?

Во-первых, судя по всему, юридическое лицо как правовая абстракция, смысловая фикция, лишенная физического существования, никаких собственных интересов — так как они понимаются применительно к субъектам, имеющим собственную волю, — не имеет и иметь не может. Любое указание на интересы юридического лица есть не более чем вмененный интерес, присвоенный фиктивному субъекту права, каковым является юридическое лицо. В таком случае интересы юридического лица по факту просто отождествляются с интересами того, кто стоит за таким лицом, т. е. с интересами его участников или учредителей21. Поскольку интересы участников юридического лица могут быть не только гетерогенными, но и меняться со временем, то нередко фиктивный общий интерес юридического лица будет описан как, скорее, желаемый или декларативный интерес, однако все же в перспективе он должен отвечать интересам максимально широкого круга участников корпорации (стремление к максимизации утилитарности от участия

20 Д.В. Плешков предлагает примирить статичность общего интереса АО как некой условной категории с подвижностью интересов реальных акционеров через ссылку на стремление акционеров к максимизации прибыли. См.: Плешков Д.В. Указ. соч. С. 29 («…интерес общества совпадает по содержанию с интересом акционеров, вытекающим непосредственно (и исключительно) из акционерного статуса. В реальной жизни интересы акционеров динамичны, в то же время интерес общества (получение прибыли, рост капитализации) остается неизменным»).

21 Если в число лиц, интересы которых должны приниматься во внимание, включаются не только участники юридического лица, а, скажем, и его работники или кредиторы, то в таком случае интересы указанных «внегодноабрентателей» от деятельности юридического лица также могут уравниваться с интересами юридического лица. При подобном подходе пропоненты соответствующей точки зрения должны совершить два теоретических допущения: (1) обосновать, что во внимание корпоративным правом должны приниматься интересы не только участников корпорации, но и иных субъектов, так или иначе признаваемых корпоративным правом как лица, имеющие право требования к корпоративному образованию; (2) тем или иным образом отождествить — пусть и не всеобъемлющим для деятельно- сти корпорации, а хотя бы для тех или иных частных целей — интересы юридического лица с интересами указанных субъектов, причем «подвинув» в таком случае участников корпорации (полностью или в части). Иными словами, интересы участников корпорации, как следует из подобного хода мысли, должны уступить место интересам перечисленных иных лиц, интересы работников, кредиторов и т. п. в таком случае получают приоритет над интересами участников корпоративного образования.
в корпоративном образовании). Вместе с тем если интересы юридического лица тождественны некоему превалирующему среди участников интересу или сумме интересов всех либо значительной доли участников, то как в таком случае определять этот агрегированный интерес, чтобы его можно было отождествить с интересом юридического лица?

Во-вторых, возникает самый сложный вопрос: интересы каких именно участников корпорации и определяемые на какой момент времени могут быть обозначены как интересы, которые можно было бы отождествить с интересами самого юридического лица? Как только мы найдем ответ на этот вопрос, далее легко выйти на формулирование того самого превалирующего интереса или «суммы интересов» участников, которую можно было бы условно отождествлять с интересами соответствующего юридического лица.

Как будет показано ниже, поиск ответа на второй вопрос представляет серьезную проблему, причем не только для корпоративного права или права вообще (шире — юридического знания как такового), он имеет под собой более фундаментальную составляющую.

Интересы участников юридического лица — если речь не идет о компании одного лица — крайне сложно поддаются фиксации, юридической формализации. Более того, интересы реальных, живых, физических лиц, в отличие от мифических интересов корпораций, вполне реальны и подвижны (поскольку их предпочтения могут меняться сколько угодно часто), причем интересы живых людей, объединяющихся в группы, могут становиться подвижными именно из-за создания групп и коалиций. Тем самым даже однажды описанный в договоре, законе или судебном прецеденте интерес отдельного участника или группы участников внутри юридического лица, формально зафиксированный в документе для того, чтобы потом к этому интересу привязать те или иные правовые последствия, может оказаться нестабильным, изменениями с течением времени, а потому правовая конструкция, направленная на защиту интереса, в конечном счете также оказывается неустойчивой, хлипкой. Подобная конструкция, покоящаяся на негодном фундаменте, рано или поздно начинает восприниматься сомнительной с политико-правовой и (или) формально-юридической точки зрения. Иными словами, из-за изменчивости интересов участников юридического лица, проистекающей как раз из специфики группового образования (коалиции, равно любой группы, в которую входят три и более индивидуума), любая правовая конструкция, направленная, как может сначала показаться, на защиту легитимного интереса, при последующем изменении интересов одного или нескольких участников группы может порождать совершенно неприглядные с точки зрения права последствия. Пока это утверждение звучит довольно абстрактно, но как будет показано далее, именно в этом состоят ключевая проблема всего корпоративного права. По этой же причине корпоративное право, несмотря на то что оно является, вне всякого сомнения, частью гражданского права, не укладывается, по крайней мере на уровне интуитивного понимания, в логику традиционного договорного права, построенного по модели договора — двусторонней сделки, равно и классической сделочной теории: обычное договорное право имеет дело либо со стабильным интересом (постоянными предпочтениями), например односторонние сделки, либо с четким противопоставлением интересов, точнее, жестким конфликтом, как в любом дого-
воре — двусторонней сделке. В корпоративном же праве общей моделью является образ сделки многосторонней, а в ней на уровне общей идеи не просто предполагается наличие нескольких сторон, но более того, интересы каждой из сторон могут быть подвижны (цикличные предпочтения).

II. Проблема агрегирования предпочтений группы

Итак, как уже было отмечено выше, проблема интереса в корпоративном праве методологически может быть сведена к двум подходам, условно их можно обозначить как (1) концепция общего вмененного интереса и (2) концепция суммированного интереса участников или превалирующего интереса участников.

При подходе, когда под интересом юридического лица понимается некий вмененный извне абстрактный интерес, ради которого якобы создается и функционирует юридическое лицо, интерес организации — это не сумма предпочтений всех или части участников, а некая абстракция, ради которой эти участники, вообще говоря, вступали в правовые отношения с юридическим лицом либо его учредители когда-то создали конкретное юридическое лицо. В таком случае даже если интересы отдельных (или всех) участников юридического лица расходятся с вмененным интересом, их мнение, видимо, не особо важно: до той поры пока объективное право полагает, что интерес должен быть таким, а не иным, следует вмененному интересу. Интерес юридического лица при подобном подходе не обязательно должен быть описан в позитивном праве, он может быть и проявлен судебной практикой, и описан так или иначе в доктрине. Так, в качестве типичного примера подобного подхода можно указать на попытки описать интерес публичного АО как стремление АО к максимизации прибыли его участников, причем в пользу не только отдельных, а всех акционеров подобного общества22.

Все в этом подходе хорошо и логично, за одним лишь исключением — его абстрактностью и малой применимостью на практике как правовой конструкции, позволяющей решать проблемы как политико-правового, так и сугубо прикладного свойства. Можно привести множество примеров, когда такой абстрактный, вме-

Предположим, что общий интерес юридического лица, коммерческой корпорации, состоит в максимизации прибыли участников, что возможно за счет постоянного роста дивидендов и (или) увеличения стоимости принадлежащих им акций (долей). Подобная позиция кажется очень заманчивой. Однако добавьте сюда гетерогенность интересов участников и временную составляющую — изящная привлекательность красивого тезиса о максимизации прибыли рушится. К примеру, публичная корпорация из года в год платит некоторый дивиденд, ее акции равномерно растут, однakoво или даже выше рынка. Затем эта корпорация — в лице менеджеров или контролирующих акционеров — решается сделать рискованную инвестицию (вложиться в новое производство, приобрести другую компанию, привлечь огромный кредит и т. п.), в результате которой ее акции начинают падать или оказывается, что дивиденды вообще не будут выплачены в этом году (будут выплачены в меньшем объеме). Если прибыль акционеров не максимизируется, то вроде бы деятельность корпорации идет вразрез с вмененным ей интересом. А если стоимость акций (и уровень дивидендов) от такой

23 Подобный идеализм можно проиллюстрировать на примере одного из недавних исследований, специциально посвященных интересу АО. Так, Е.И. Никологорская, основываясь на идее общего интереса АО как интереса, не сводимого к интересу какой-либо группы участников корпоративных отношений, предлагает исходить из того, что общий интерес юридического лица задает (или, по крайней мере, в идеале должен задавать) баланс интересов всех участников корпоративных отношений, приводя разнонаправленные интересы к консенсусу (см.: Никологорская Е.И. Указ. соч. С. 152–154). Однако признавая (С. 72), что фактические интересы участников корпоративных отношений могут не совпадать с общим интересом, который в таком случае является желательным, идеальным образом, но вовсе не данностью, автор так и не дает ответа на принципиальный вопрос: как примирить идеальный образ под названием «общий интерес АО» с тем, что реально происходит в любой корпорации, где есть несколько участников с разнонаправленными и изменяющимися во времени интересами? Последующие рассуждения Е.И. Никологорской, когда она переходит к обсуждению частных механизмов корпоративного права, призванных обеспечить «общий интерес АО», позволяют заключить, что автор и вовсе отходит от понимания интереса как предпочтений, или преференций, отдельных участников корпоративных отношений, а равно самой корпорации, переключая свое внимание на критерий эффективности Калдора — Хикса, который автор применяет к каждому из анализируемых институтов корпоративного права (см. там же. С. 156–165). В таком случае, видимо, правильнее было бы вести речь об эффективности того или иного института корпоративного права (с позиций ли эффективности по Парето или Калдора — Хикса), но к собственно интересам АО или его участников подобные рассуждения, очевидно, будут иметь крайне опосредованное отношение: интересы участников корпоративных отношений, как и интересы юридического лица, остаются примерно такими же, как и прежде, наскоро схожие эффективные или иные институты корпоративного права, но, судя по всему, это слабо связано с интересами юридического лица вообще или всех (большей части) его участников, а скорее, представляет собой иную угрозу рассмотрения извечной проблемы — что «правильнее» с точки зрения регулирования, в данном случае корпоративно-правового. Подробнее о двух критериях эффективности см.: Nicholas Kaldor, Welfare Propositions of Economics and Interpersonal Comparisons of Utility, 49 Econ. J. 549 (1939); John R. Hicks, The Foundations of Welfare Economics, 49 Econ. J. 696 (1939); Luigi Amoroso, Vildredo Pareto, 6 Econometrica, 1, 3–8 (1938); James M. Buchanan, The Relevance of Pareto Optimality, 6 J. Conflict Res. 341 (1962); Jules L. Coleman, Efficiency, Utility, and Wealth Maximization, 8 Hofstra L. Rev. 509 (1980).

инвестиции вырастет в разы, но не через год, а через пять или десять лет, то все же общий интерес соблюдается? Если интерес акционеров состоит в том, чтобы поскорее продать акции с выгодой (спекулянты на акциях), то их интересы такой стратегией нарушены. Если акционеры держат акции надолго (пенсионные фонды, граждане для накоплений и т.п.), то подобная стратегия в их интересах. А если это была не выгодная (хотя бы и высоко рискованная) инвестиция, а банальный вывод активов? Или просто недальновидность менеджмента: что если они просто совершали глупость, ошиблись, или были чрезвычайно самоуверенны? Никакого роста стоимости ни акций, ни дивидендов акционерам в таком случае ожидать не приходится. Тогда их интересы нарушены. На этом банальном примере, который можно усложнять до бесконечности, проще всего увидеть, что абстрактный интерес корпорации вообще — не более чем красивая идея, лишенная какого-либо содержательного наполнения. Как только в рассмотрение добавляются разнонаправленные интересы акционеров и разные временные горизонты, эта идея оказывается совершенно неработающей. Иначе в чем смысл такой концепции, когда интересы акционеров расходятся: интересы одних нарушаются, других — игнорируются. А как быть с общим интересом корпорации? В общем, ясно, если есть общий интерес, который никак не обеспечивается правовой защите, или интересы значительной части акционеров с ним не коррелируют, то грош ему цена. Во многом именно поэтому концепция вмененного интереса приводит к ее антитезе, концепции интересов юридического лица как так или иначе суммированного интереса всех или некоторой части его участников.

Однако, прежде чем перейти к критическому анализу концепции суммированного интереса, следует упомянуть проблему защиты средствами корпоративного права интересов иных лиц, непосредственно не являющихся участниками корпоративных отношений. Если пытаться раздвигать границы корпоративного права и включать в число «бенефициаров» корпоративного права иные категории лиц, скажем, кредиторов юридического лица или кредиторов, например, единственного участника корпорации, когда такой участник скрывает имущество от своих кредиторов, передавая его корпорации, работников организации, наконец, общество или государство, то интерес юридического лица должен быть включать в себя, помимо интересов участников корпорации, также интересы всех тех, кого правопорядок защищает средствами корпоративного права. Вместе с тем подобный широкий подход к назначению корпоративного права вряд ли можно признать актуальным, коль скоро повсеместно корпоративные правопорядки все более отходят от стремления защищать кредиторов и иных лиц, помимо собственно участников корпоративных отношений. Соответственно, интересы всех прочих групп субъектов

25 Из оставшихся в настоящее время в российском корпоративном праве примеров того, когда средствами корпоративного права защищаются интересы иных лиц, не являющихся буквально участниками корпоративных отношений, можно назвать следующие институты: 1) не имеющий какого-либо формального законодательного закрепления механизм снятия корпоративных покровов, развиваемый судебной практикой за рамками банкротного процесса; 2) солидарная ответственность головной компании по сделкам дочерней, если головная компания давала указание на совершение сделок (абз. 2 п. 2 ст. 67 ГК РФ); 3) права кредиторов при реорганизации и ликвидации (ст. 60, 63 ГК РФ); 4) права кредиторов при уменьшении уставного капитала (п. 5 ст. 90, п. 1 ст. 101 ГК РФ). Количество институтов, защищающих кредиторов юридического лица средствами корпоративного права, сокращается год от года в самых разных правопорядках, но интересно другое: если сравнить несколько перечисленных выше институтов, с массовым нормами всего корпоративного права, то станет очевидным, насколько несущественны интересы кредиторов в сравнении с интересами главных «бенефициаров» корпоративного права — участников корпораций.
в таком случае могут быть вынесены за скобки26, поскольку интересы кредиторов в таком случае, даже если они не были эффективно защищены ex ante средствами договорного, трудового права или законодательства о социальном страховании, получают приоритет при регламентации ex post в специальном институте, банкротстве27, которое, по сути, является перелицованным корпоративным правом, где интересы участников корпорации замещаются интересами кредиторов28.

Итак, коль скоро в настоящей работе домен корпоративного права не включает в себя интересы иных лиц, буквально не являющихся участниками корпоративных отношений, то следует вернуться к интересам участников корпораций и рассмотреть иные теории агрегирования их интересов и то, как их интересы могут уравниваться с интересами самого юридического лица. Сторонники подхода, предполагающего агрегирование преференций участников юридического лица, предлагают выявить превалирующий интерес, который отражал бы интересы всех или некоторой, скорее всего значительной, части участников корпорации. Как только будет найдена формула, которая позволит выявлять такой превалирующий интерес на любой момент времени, все проблемы с выявлением интереса юридического лица будут сняты: интерес корпорации не абстрактен, а вполне конкретен, причем не существует — даже для одной конкретной корпорации — раз и навсегда установленного интереса. Интерес отдельного юридического лица здесь и сейчас равен превалирующему интересу его участников (всех или некоторой части).

26 Поскольку проблема того, насколько широко должно простираться корпоративное право, точнее, какие группы субъектов должны защищаться его средствами — только ли акционеры (участники) либо также кредиторы, работники и прочие так называемые стейкхолдеры, довольно обширна и имеет долгую историю вопроса, здесь нет смысла останавливаться на ней более подробно. Для ознакомления можно рекомендовать одну из центральных работ по корпоративному управлению, обосновывающую концепцию стейкхолдеров (см.: Margaret M. Blair and Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999)). Автор настоящей статьи придерживается довольно узкого подхода к данной проблеме, предполагающего, что корпоративное право — это право для акционеров (участников), а равно иных участников корпоративных отношений, а для защиты кредиторов юридического лица существуют обязательственное право (способности обеспечения исполнения обязательств для так называемых добровольных кредиторов), механизмы банкротства и социального страхования (для так называемых недобровольных кредиторов). Для борьбы с монополизмом и откровенным жульничеством частное право и вовсе неприемлемо, для этого есть антимонопольное и уголовное законодательство. Более подробно данная проблематика рассмотрена на примере минимального уставного капитала хозяйственных обществ, где вопрос назначения корпоративного права и его защитной функции проявляется самым острым образом (см.: Степанов Д.И. Для чего необходим минимальный уставный капитал и как определять его уровень? // Вестник ВАС РФ. 2011. № 4. С. 43–53).

27 Как отмечается в специальной литературе, конкуренция между корпоративными правопорядками по вопросу о том, право какой страны должно регулировать деятельность корпораций, трансформировалась в конкуренцию систем банкротства: неважно, какое корпоративное право применимо к отдельной корпорации, более существенно в мировой конкуренции правопорядков, где и по какому праву будет идти банкротный процесс. Сравниательно-правовой обзор по этой теме см.: Thomas Bachner, Creditor Protection in Private Companies: Anglo-German Perspectives for a European Legal Discourse (Cambridge University Press, 2009).

(то есть), определенному на текущий момент времени. Следовательно, чтобы понять, что хорошо для юридического лица, а что плохо, нужно просто найти некоторую сумму или среднее арифметическое значение (либо медианное — для тех, кто предпочитает более иерархированное математическое знание), которое описывало бы сначала интересы участников, а через них — интересы юридического лица в целом. Даже если завтра у корпорации появятся новые участники или интересы наличных участников изменятся, это не разрушит логичности подобной модели: значит, завтра и интерес корпорации будет другим.

На первый взгляд подобный методологический подход снимает проблему, о которой говорилось выше применительно к вмененному интересу юридического лица. Более того, он представляется более продвинутым с точки зрения его иерархированности и общей оригинальности. Однако гибкость и подвижность предпочтений участников корпорации оказываются ахиллесовой пятой подобного подхода: то, ради чего он может предлагаться (отразить меняющиеся предпочтения участников, чтобы в любой момент иметь точное понимание, что они хотят, в чем их интересы, которые можно было бы отождествить с интересом юридического лица в целом), как раз и не позволяет определить сумму интересов участников.

Подход, подразумевающий отождествление интереса юридического лица с суммой интересов его участников, может работать в случае, когда в корпорации немного участников (один-два), и при этом их предпочтения (интересы), связанные с участием в таком юридическом лице, стабильны, т.е. более или менее неизменны с течением времени. Как только мы отходим от подобных ограничений, суммирование интересов участников и последующее их приписывание самому юридическому лицу оказывается затруднительным. Чтобы не быть абстрактным, можно рассмотреть, как отмеченная проблематичность подхода проявляется с увеличением числа участников.

Один участник (компания одного лица в коммерческом обороте29 или учреждение как организация некоммерческая30). Если у юридического лица, в принципе предполагающего наличие у него учредителей (участников), число участников не превышает одного, то для такой организации интерес юридического лица по общему правилу может быть уравнен с интересом его единственного участника. В таком случае просто нет никого иного, кто мог бы иметь интерес, отличный от интереса единственного участника, конечно, при условии, что корпоративное право понимается как раздел частного права, который печется об интересах тех, кто создает

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29 Под компанией одного лица в данном случае понимается коммерческая корпорация, которая, однако, создается и существует какое-то время как юридическое лицо с одним участником. Несмотря на то, что унитарные (МУП или ГУП) и казенные предприятия сложно назвать компанией одного лица, видимо, тот же самый подход, допускающий отождествление интересов юридического лица с интересами его единственного учредителя, может быть распространен и на них.

30 К учреждениям как некоммерческим образованиям, создаваемым одним лицом, а потому имеющим самую тесную связь между интересами учредителя как юридическим лицом (организации некоммерческой) и его единственным учредителем, можно в таком случае добавить иные некоммерческие организации, которые по своей модели вообще не предполагают членских отношений, но в силу создания одним лицом получают схожую природу. К примеру, аналогичную логику можно применять к автономным некоммерческим организациям, учрежденным одним лицом (абз. 2 п. 1 ст. 123 ГК РФ).
и использует юридическое лицо31. Иными словами, здесь произвол единственного участника является определяющим для интереса, который будут вменен правом юридическому лицу как его собственный32. Непостоянство интересов участника во времени здесь также не представляет какой-либо проблемы: даже если преференции единственного участника меняются очень часто, всегда можно без труда дать критерий определения интересов юридического лица: это то, что интересно в конкретный момент времени единственному участнику.

Два участника (корпорация — коммерческая или некоммерческая). Добавление хотя бы одного участника существенным образом изменяет смысловую конструкцию. Становится возможным возникновение если не острого конфликта интересов, то хотя бы их противопоставление. Более того, динамика изменения преференций, а значит, и некого общего интереса, который можно было бы приписать юридическому лицу, уже не совпадает: у каждого из двух участников интересы могут меняться по-разному. Даже если интересы одного из них стабильны, это не значит, что второй участник не будет менять своих предпочтений в будущем. Все еще более усложняется за счет проявления так называемого стратегического поведения, когда лицо, даже при неизменных фундаментальных интересах, посылает сигнал вовне, что его предпочтения изменились, либо они больше не сводятся к тому, что о них думают окружающие33. Стратегическое поведение на самом деле сугубо рационально, оно направлено на то, чтобы субъект, задействующий такое поведение, получил в итоге именно то, что отвечает его реальному интересу34. Однако

31 Здесь возможна чрезвычайно важная смысловая развилка: насколько обосновано применение однородной логики в данном вопросе к коммерческим и некоммерческим организациям. Для компаний одного лица, являющихся коммерческими юридическими лицами, допустим в принципе максимально инструменталистский подход к юридическому лицу (юридическое лицо как инструмент участия коммерсанта в торговом обороте), а значит, уравнивание интереса единственного участника с интересом самой организации. Можно ли ту же логику распространить на унитарную некоммерческую организацию? В обоснование тезиса о принципиально разном подходе к коммерческим и некоммерческим организациям, состоящим из одного лица, могут указываться, во-первых, доводы о том, что учреждения, как и все прочие унитарные некоммерческие организации, должны по общему правилу создаваться для неких общеполезных целей, а потому, возможно, произвол единственного учредителя унитарной некоммерческой организации должен быть ограничен — в интересах общества и всех тех лиц, которые получают блага от деятельности подобной некоммерческой организации; во-вторых, произвол единственного участника коммерческой корпорации так или иначе уравновешивается нормами о так называемом снятии корпоративных покровов, позволяющими пустяк и post factum, но привлекать к ответственности единственного учредителя корпорации торгового права за его произвол, а потому эти нормы ставят коммерческие компании одного лица в иное положение, чем те же некоммерческие унитарные организации. В настоящей статье просто обозначается этот вопрос, имея в виду, что в зависимости от того или иного решения интерес некоммерческой организации с одним учредителем может отождествляться или, напротив, отграничиваться от интереса такого одного лица.

32 Другой вопрос, что у подобного вмешательства есть оборотная сторона: именно для компании одного лица, предельно подконтрольной единственному участнику, в наибольшей степени применима доктрина снятия корпоративных покровов, когда юридическое лицо перестает выполнять роль ограничителя имущественной ответственности. Это, в свою очередь, подтверждает правильность тезиса о том, что интерес компании одного лица равен интересу ее единственного участника.


оборотной стороной подобного поведения и маскирования своих истинных пре-
ференций является конфликт — от безобидного несогласия по мелочам до жесто-
чайшего противостояния.

Интерес корпорации, состоящей из двух лиц, может быть без каких-либо усилий выведен из интересов ее участников до той поры, пока они не находятся в жестком противопоставлении, пока эти два участника являются договороспособными35. Даже если их интересы буквально не совпадают, но они могут достигать договоренности как по текущим вопросам, связанным с деятельностью корпорации, так и по стратегическому видению ее целей, интерес юридического лица может быть отождествлен с тем, как его видят эти два участника. Иными словами, интерес юридического лица здесь и сейчас равен соглашению участников, в котором вы-
ражен их общий интерес. Даже если интересы участников подвержены измене-
нию, но они не переходят некоторой грани, после которой конфликт интересов становится непримиримым, а участники — не способными к достижению догово-
ренностей, общий интерес корпорации может быть отождествлен с тем, как его понимают два участника сообща. Однако при размежевании участников, возраста-
нии конфликтности данный подход перестает работать. Как быть в таком случае? Одна из возможных опций для установления интереса юридического лица, вы-
водимого из превалирующего интереса участников, — это механизм корпоратив-
ного контроля: определяющим является мнение того из них, у кого больше доля в акционерном (уставном) капитале. Однако что, если этот участник использует корпоративный контроль исключительно в своекорыстных целях, нарушая права и законные интересы миноритария? Или, напротив, миноритарий, не в силах ока-
зать влияние на деятельность корпорации в связи с незначительностью принад-
лежащих ему прав корпоративного контроля, начинает сознательно делать что-то, что на первый взгляд неразумно для его лично и вредно для корпорации (страте-
гическое поведение)? Очевидно, что тут мы возвращаемся к проблеме вмененного абстрактного интереса: поскольку объем корпоративного контроля не позволяет однозначно сказать, чей интерес — из двух недоговороспособных участников — должен иметь решающее значение для определения интереса юридического лица в целом, то возникает соблазн вмешаться и вмешаться, чтобы, назвав что-то, что на первый взгляд неразумно для его лично и вредно для корпорации (страте-
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гическое поведение)? Очевидно, что тут мы возвращаемся к проблеме вмененного абстрактного интереса: поскольку объем корпоративного контроля не позволяет однозначно сказать, чей интерес — из двух недоговороспособных участников — должен иметь решающее значение для определения интереса юридического лица в целом, то возникает соблазн вмешаться и вмешаться, чтобы, назвав что-то, что на первый взгляд неразумно для его лично и вредно для корпорации (страте-
гическое поведение)}
Свободная трибуна

коего исключения, и корпорации, состоящие из двух лиц, которые более часто встречаются в обороте и показывают динамику развития и противопоставления интересов, скорее типичную для обычного гражданско-правового договора, дву- сторонней сделки, построенной по модели «ты мне — я тебе». Однако наиболее типичной моделью корпорации является организация, состоящая из трех и более участников. В таком случае корпорация хотя и схожа с договорным образованием, но все же ее идеально-типическая модель — это конструкция сделки многосторонней, основанной на идее распределенной модели, где интересы участников могут меняться сколь угодно часто и оттого участники склонны образовывать самые разнообразные коалиции36.

Если переход от компании одного лица к корпорации с двумя участниками существенно усложнил механизм установления общего интереса участников, а вслед за ним и интереса юридического лица, то переход к корпорации, состоящей из трех и более лиц, это не просто добавление еще одного субъекта, интерес которого нужно учитывать при выявлении «суммы» интересов или превалирующего интереса. Интуитивно понятное юристу разграничение между двумя моделями (модель двусторонней сделки с конфликтом интересов «ты мне — я тебе» и модель сделки многосторонней, где нет буквально именно такого противопоставления в виде общего правила) оказывается не только различием в правовой конструкции — за ним стоит более фундаментальная проблема, а именно сложность агрегирования интересов группы с числом участников более двух. Проблема эта обычно иллюстрируется так называемым парадоксом голосования, или парадоксом Кондорсе37.

Этот парадокс можно рассмотреть на примере избрания единоличного исполнительного органа корпорации, когда каждый из трех участников имеет свой интерес, т.е. предпочтения каждого из них по кандидатурам на пост директора серьезно различаются38. Если механизм корпоративного контроля не решает проблему предпочтений, т.е. ни один из участников не обладает необходимым объемом прав корпоративного контроля, достаточным для избрания своего кандидата, участникам остается лишь договариваться между собой, создавать коалиции. Здесь подобная корпорация мало чем отличается от юридического лица, состоящего из двух участников. Однако при неспособности достичь договоренности или невозможности

36 Рассматриваемая ниже специфика агрегирования интересов участников корпорации с числом три и более также применима, как ни странно, к некоммерческой унитарной организации, вообще не предполагающей членства, а именно к фондам (п. 1 ст. 123 ГК РФ). Поскольку учредители фонда не участвуют напрямую в его управлении, а высшим органом управления фондом является его высший коллегиальный орган управления, определяемый уставом фонда (п. 2 ст. 123, ст. 123 ГК РФ), то в ситуации, когда такой высший орган управления будет состоять минимум из трех лиц, фонд в части функционирования такого органа управления будет показывать ту же динамику, что и обычная коммерческая корпорация.


38 Если отрешиться на секунду от предлагаемого примера с выборами директора, который приводится как иллюстрация парадокса Кондорсе, то парадокс голосования как таковой не обязательно предполагает выборы кого-либо, голосование в таком случае понимается самым широким образом — как механизм выявления общего интереса и (или) согласования воли нескольких лиц, если они способны к достижению договоренностей между собой.
ности создания коалиции хотя бы двумя участниками корпорации, состоящей из трех и более участников, как раз обнаруживается парадокс Кондорсе: пререкции каждого из трех участников, выставленные по ранжиру (от наиболее предпочитительного кандидата к наименее предпочитительному), вообще не позволяют понять, в чем состоит превалирующий интерес участников, какой из кандидатов наиболее полно отражает их предпочрения, другими словами, является изобразителем превалирующего интереса. Иначе говоря, при остром конфликте интересов в такой корпорации вообще чрезвычайно сложно или почти невозможно установить превалирующий интерес участников, который можно было бы затем вменить юридическому лицу.

Интересы участников в такой ситуации можно представить в виде следующей таблицы:

<table>
<thead>
<tr>
<th>Кандидаты</th>
<th>Участники юридического лица</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>участник 1</td>
</tr>
<tr>
<td>Наиболее предпочитительный</td>
<td>A</td>
</tr>
<tr>
<td>Промежуточный</td>
<td>B</td>
</tr>
<tr>
<td>Наименее предпочитительный</td>
<td>C</td>
</tr>
</tbody>
</table>

Когда никто из участников не доверяет друг другу, а каждый преследует свой интерес, то правильным для такого голосования будет ряд допущений, включая невозможность достижения и последующего исполнения договоренностей по избранию отдельного кандидата (инчае бы участники заранее договарились и не было бы никаких проблем), невозможность согласования воли или открытой коммуникации при голосовании, чистота процедуры, исключающая манипуляции (участие в голосовании всех, тайное голосование, одномоментное вскрытие итогов голосования)39.

Если взглянуть более внимательно на эту таблицу, то с учетом заданных правил игры обнаружится удивительная вещь: никто из трех кандидатов не будет избран. Более того, в ситуации, когда для отдельного участника кандидаты ранжируются по степени предпочтения (так, для участника 1 это можно выразить как вариант A более предпочителен, чем B, который, в свою очередь, более предпочителен, чем C, или A > B > C; для участника 2 — B > C > A, и т.д.), каждый из трех участников по сути играет против другого. Когда число участников голосования больше

39 Для упрощения также можно сделать еще ряд допущений, которые не меняют суть, но отсекают за ненадобностью лишние вопросы (на которые легко ответить, просто за неимением места приходится жертвовать нюансами): 1) участники обладают одинаковым объемом корпоративного контроля, т.е. равными голосами (% уставного капитала или, что в общем то же самое, один участник имеет только один голос, при этом никому не принадлежит право решающего голоса); 2) голосование возможно лишь как голосование за конкретного кандидата, варианты «против», «воздержался», а равно неучастие в голосовании не рассматриваются; 3) избранным считается кандидат, набравший простое большинство голосов, в данном случае 2 из 3; 4) участники голосуют одновременно, точнее, до истечения отпущеного на голосование времени, после чего итоги голосования подводятся одновременно, чтобы никто не мог проголосовать позже других; 5) участники могут предполагать, в чем состоит предпочрение друг друга по кандидатам, но не могут, как было указано выше, голосовать согласованно, иначе такое голосование мало чем отличается от исполнения ранее достигнутой договоренности, где общий интерес проявляется в согласованном волеизъявлении.
двух, их предпочтения, линейные для каждого из них, или, как принято в таком случае их называть, транзитивные предпочтения, превращаются в цикличные: вместо четкого ранжира \( A > B > C \) \( (C > A) \), \( C > A > B \) образуется круг \( A > B > C > A \). Примечем в этот круг попадает любой из участников\(^{40}\), вне зависимости от того, какими были его предпочтения (истинные предпочтения) до начала голосования.

Не слишком помогает в таком случае и так называемое стратегическое поведение: если один из участников, желая все же избрать пусть не своего кандидата, то хотя бы второго по предпочтительности (например, участник 1 голосует за кандидата \( B \), хотя его истинные предпочтения связаны с кандидатом \( A \)), скорее всего, и это не поможет разорвать круг — неизвестно, не подумают ли об этом же (проголосовать за второго по предпочтительности) остальные. Таким образом, стратегическое поведение может привести к избранию кандидата лишь по воле случая: если один из участников специально проголосовал так, что его голосование не будет отвечать его интересам, но при этом другие участники будут вести себя именно так, как он предполагал (например, участник 1 голосует за кандидата \( B \), хотя предпочитает видеть директором \( A \), при этом предполагает видеть кандидата \( A \), при этом предполагает, что участник 2 голосует за кандидата \( B \), а участник 3 — за \( C \), соответственно, кандидат \( B \) получает большинство).

Парадокс Кондорсе при указанных выше условиях с увеличением числа участников не устраняется\(^{41}\), напротив, шансы на избрание одного лица директором уменьшаются, если у каждого из участников есть своя шкала интересов, при этом они не могут кооперироваться и образовывать коалиции. Более того, как уже было указано выше, подобный парадокс характерен не только для голосования при избрании директоров или голосования на общем собрании участников при решении иных вопросов, он отражает проблему более общего свойства — сложности выявления, или агрегирования, интересов всех или большинства группы, когда число субъектов и альтернатив, из которых нужно выбирать, становится больше двух.

\(^{40}\) См.: Miller, supra note 37, at 776-9.

Описанный парадокс голосования долго занимал умы ученых в области экономики и математики, пока не получил более основательного изучения в трудах Кеннета Эрроу, благодаря стараниям которого была обоснована теорема невозможности Эрроу. Она имеет множество смысловых ответвлений и является одним из наиболее фундаментальных открытий в области экономической мысли ХХ в. Далее будет рассмотрен ряд позиций, которые имеют ключевое значение для целей настоящей работы.

Отправная точка в теореме Эрроу — это предпочтения субъектов, которые можно выстроить по ранжиру. Ранжирование (условно говоря, расположение по шкале нравится (предпочитаю что-то) больше — нравится (предпочитаю) меньше) составляет основу основ для того, чтобы описать полезность, которую мы придаем чему-либо. Предпочтения и ранжирование предпочтений можно обнаружить применительно практически к любому аспекту нашей жизни: от еды и внешнего вида до политических взглядов и морально-нравственных суждений. Ранжирование предпочтений в таком случае позволяет, с одной стороны, разграничить разные предпочтения (иначе сложно понять, что именно нравится конкретному индивиду), а с другой — дает возможность выделять приоритеты, что наиболее важно. Тем самым — развивая рассуждения Эрроу для целей настоящей статьи — ранжированные предпочитения предопределяют интерес субъекта: только тогда, когда у лица есть предпочтение одного перед другим (опция A предпочтительнее опции B), далее это обозначается как A > B, причем предпочтение артикулированное, имеющее приоритет над иными предпочтениями, оно находит выражение в активно отстаиваемом интересе, притязающем среди прочего и на правовую защиту.

Предпочтения (1) субъективны (кто-то предпочитает клубнику яблокам, а кто-то яблоки клубнике); (2) вообще не поддаются или чрезвычайно сложно поддаются переводу на язык цифр (как выразить, насколько сильно в процентах или во сколько раз сильнее кто-то предпочитает клубнику яблокам), а потому их можно описывать как нечто более предпочтительное в сравнении с чем-то менее предпочтительным (A > B > C), наконец, что принципиально именно для рассуждений Эрроу, (3) предпочтения не просто субъективны, сложно буквально сравнивать предпочтения одного лица с предпочтениями другого с точки зрения того, какой вес придается тому или иному предпочтению (да же если два лица предпочитают клубнику яблокам, это вовсе не значит, что оба они одинаково ценят клубнику и яблоки в их внутренней системе предпочтений: одно лицо, возможно, жить не может без клубники, а второму она в общем безразлична, хотя и более приятна, чем яблоки). Таким образом, предпочтения — если речь заходит о нескольких субъектах, обладающих схожими предпочлиенциями, — могут быть описаны через цепочки предпочтений, в которых наиболее предпочтительные опции будут иметь

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**В 1972 г. Эрроу была присуждена Нобелевская премия в области экономики (ее он разделил с Д. Хиксом), ключевой заслугой при присуждении премии был указан вклад в экономику эвфера и обоснование теоремы невозможности (см.: *http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1972/press.html* [20.11.2014]).**

наибольший вес для каждого субъекта, а наименее предпочитительные — наименьший. Но такое описание вовсе не означает, что каждый из субъектов готов заплатить одинаковую цену за наиболее предпочитительную опцию. Так, в рассмотренном выше примере с парадоксом Кондорсе каждый из участников корпорации имел свои предпочтения в отношении кандидата, подлежащего избранию, причем предпочтения эти были выставлены по ранжиру от наиболее желательного к менее желательному, каждый из них хотел бы видеть своего кандидата избранным. Однако насколько одинаково сильны были желания, интересы каждого из этих участников, насколько далеко каждый из них мог пойти, чтобы именно его кандидат был избран, — все эти вопросы объективно не могут быть разрешены с некоторой математической точностью. Поэтому все, что остается в таком случае, — это описательный подход, предполагающий ранжирование набора доступных опций для каждого субъекта, участвующего в голосовании.

По Эрроу, капиталистические демократии предусматривают для людей два варианта социального выбора: политические выборы для политических решений и рыночный механизм для всех экономических решений. Там же, где демократия недостаточно развита, социальный выбор делается диктатором или путем достижения согласия внутри некоторой социальной группы. Соответственно, голосование может представляться не только как поход избирателей к урнам в рамках установленной процедуры, когда проводятся выборы в органы власти, а как универсальный процесс, который наблюдается на разных уровнях — от всего государства до группы, состоящей хотя бы из двух человек, когда делается попытка выявить, какая из нескольких опций предпочтительна для группы, если у каждого члена группы есть собственный набор опций для каждой группы предпочтений. Иначе говоря, и голосование на выборах в парламент, и «голосование рублем», когда мы что-то предпочитаем покупать или нет, и избрание директора в корпорации — все это частные примеры того, что Эрроу рассматривает как разновидности более общей категории, так называемого коллективного социального выбора. Самые же механизмы, которые позволяют агрегировать предпочтения членов той или иной группы, т. е. выводить некую сумму предпочтений или превалирующее среди членов группы предпочтение, — это набор правил или процедура, благодаря которым такие предпочтения приводятся к некому итоговому знаменателю. Набор таких правил экономисты обычно именуют функцией общественного благосостояния (social welfare function, далее для краткости — функция агрегирования). Она показывает, как предпочтения индивидов, а значит, полезность, которую каждый из членов группы видит в наиболее предпочитительной для него опции, складываются в наиболее предпочтительную, а значит, наиболее полезную для группы опцию. Агрегирование предпочтений членов группы в таком случае является центральным институтом любого социального знания — права, экономики, политики, социологии, социальной психологии.

Вместе с тем создать формулу для агрегирования потребностей группы, которая бы позволяла отразить предпочтения всех членов группы, невозможно в принципе. Как отмечает Эрроу, можно допустить функцию агрегирования, когда число опций на выбор составляет не более двух, чтобы такая функция одновременно отвечала

46 Id., at 5.
47 Id., at 23.
ряду критериев, главный из которых для настоящей статьи — это отсутствие так называемого диктатора, т.е. лица, воля которого являлась бы определяющей для итогов голосования. При этом для того, чтобы она работала, (1) голосование должно базироваться на принципе простого большинства; (2) количество участников голосования нечетное и финально (не бесконечно); (3) каждый голосующий должен рассматриваться одинаково, т.е. ни у кого нет никаких преимуществ при голосовании (в пределе — каждый голосующий анонимен); (4) равенство голосов разрешается в пользу одной из двух опций. Однако как только количество опций становится больше двух (три и более), причем каждая из опций может быть проранжирована каждым участником группы в любом порядке — сообразно его предпочтениям, то для группы, состоящей минимум из трех членов, становится невозможным создать функцию, которая позволяла бы адекватно агрегировать ее предпочтения.

Соответственно, ключевой для настоящей работы момент, вытекающий из теоремы Эрроу, сформулирован ученым следующим образом: если есть три альтернативы и субъекты волны ранжировать их как им угодно согласно их собственным предпочтениям, то всякая функция агрегирования должна быть либо навязанной, либо диктаторской. Инными словами, если опустить ряд деталей, связанных с обоснованием этой теоремы, единственным методом для того, чтобы перейти от предпочтений индивидов к агрегированному предпочтению группы, может быть либо навязывание определенного предпочтения индивидам, либо включение диктата одного лица, воля и предпочтения которого будут отождествлены с предпочтениями группы. В более поздней (1963 г.) версии теоремы невозможности Эрроу из двух указанных элементов остался только критерий диктатора: для всякой социальной группы, где в принципе допустимо появление разногласий по предпочтениям, всегда возможен диктатор. В данном случае принципиальная невозможность создать функцию агрегирования, которая бы не была диктаторской, является одним из самых важных моментов теоремы для всего корпоративного


Arrow, supra note 44, at 59.

Id.

Id., at 103.

Из-за ограничений в объеме теорема Эрроу в настоящей работе рассматривается в самом общем, можно сказать, поверхностном виде. Во-первых, не описываются все допущения, при которых она обосновывается. Во-вторых, не обсуждаются сопредельные с ней теоремы, предшествовавшие ей или созданные впоследствии. В-третьих, за рамками рассмотрения намеренно оставлены вопросы соотношения предпочтений с полезностью \( utility \), сравнение предпочтений и полезности между субъектами \( interpersonal comparison of utility \). В-четвертых, не исследуется Парето-оптимальность в соотношении с теоремой Эрроу. В-пятых, здесь артикулируется лишь одно, пусть и самое ключевое, следствие теоремы — невозможность функции агрегирования для трех и более опций, если они могут быть расставлены по ранжиру предпочтительности. Литература по этому вопросу поистине безмерна: помимо цитированных выше работ самого Эрроу, а также великолепных книг Шепсле, Остин-Смита и Бэнкса (том I), в которых эта проблематика рассматривается вполне присевным образом, заинтересованному читателю можно порекомендовать следующие источники: Austen-Smith & Banks, supra note 34; William Vickrey, Utility, Strategy, and Social
права в самых разных его проявлениях — от наличного законодательства и практики его применения до теории корпоративного права и правовой политики. Всюду, на любом участке функционирования и развития корпоративного права, коль скоро всегда возможно наличие двух и более лиц, участвующих в корпоративных отношениях, а эти лица в принципе могут иметь три и более опции, подлежащие рассмотрению, их предпочтения не могут быть собраны воедино без прямого диктата одного лица.


Обычно, когда речь идет о диктаторе, представляется образ не терпящего каких-либо возражений авторитарного политического лидера. Однако диктатор в терминологии Эрроу понимается довольно широко: как любое лицо, обладающее возможностью замещать предпочтения членов социума или определенной группы предпочтениями всего лишь одного лица, причем такой диктатор может как входить в группу, так и находиться вне ее.

К примеру, в качестве диктатора для целей функции агрегирования можно рассматривать судью, которому предоставлено дискретное право сказать финальное слово, что предпочтительнее авторитарного политического лидера. Однако диктатор в терминологии Эрроу понимается довольно широко: как любое лицо, обладающее возможностью замещать предпочтения членов социума или определенной группы предпочтениями всего лишь одного лица, причем такой диктатор может как входить в группу, так и находиться вне ее.

Таким образом, диктат в корпоративном праве может иметь самые разные проявления, а диктатором в зависимости от описанной функции агрегирования (такая функция задается правилами поведения, устанавливаемыми корпоративным правом) могут оказываться как всевозможные участники корпоративных отношений, так и внешние по отношению к ним лица, например судьи или кредиторы, участвующие в корпоративных договорах. Диктаторские полномочия в данном случае дозволяются функцией агрегирования, а диктатор маркируется законом (иным источником права). При этом важно отметить, что как только конкретное лицо получит полномочия диктатора для целей агрегирования предпочтений группы лиц, участвующих в корпоративных отношениях (даже если такие полномочия касаются чрезвычайно узкого вопроса и не имеют никакого универсального значения), далее его предпочтения будут рассматриваться как превалирующее предпочтение всей или значительной части соответствующей группы, в конечном счете — как ее превалирующий интерес. Гетерогенные интересы множества субъектов, в том числе меняющиеся во времени, отступают на задний план, их место занимает интерес

одного лица. При множестве участников группы их предпочтения не только не могут быть собраны воедино, приведены к некоему общему знаменателю, а, напротив, как показал Эрроу, такие предпочтения повсеместно сводятся к предпочтениям диктатора. В этом смысле корпоративные отношения ничем не отличаются от иных социальных срезов, вопрос же, который ставит корпоративное право, — кого назначить диктатором для целей того или иного специального института.

Итак, столь длительное отступление в сторону одного из фундаментальных открытий в экономической теории, теоремы невозможности Эрроу, привело к довольно парадоксальному выводу: то, что рассматривается — в любом социальном контексте, а не только в праве — как предпочтение группы (если в этой группе два и более лица и минимум три опции, ранжированные каждым из участников группы по предпочтениям), на деле не является «суммой» предпочтений или средним арифметическим всех предпочтений, а представляет собой паллиативное решение — предпочтение одного или в лучшем случае немногих, вмененное группе как предпочтение всех или почти всех. Что нового в таком случае теорема Эрроу, примененная к интересам участников юридического лица, дает для анализа рассматриваемой проблематики интересов юридического лица и (или) его участников, в чем эвристическая сила наложения этой теоремы на проблематику корпоративного права?

Ответ на указанный вопрос на первый взгляд может показаться банальным, простым до примитивности, но в этой простоте — вся сила идей, связанных с механизмом агрегирования предпочтений членов группы. Если всякий механизм агрегирования предпочтений упирается в проблему диктатора, то любое построение в рамках корпоративного права, направленное на защиту интереса того или иного участника корпоративных отношений (уже — участника юридического лица), — это не более чем маркирование диктатора, т.е. наделение через правотворческий процесс отдельного лица полномочиями диктатора. Соответственно, все прочие участники юридического лица — по крайней мере, для целей конкретного правового института — пре- вращаются в таком случае в субъектов, подчиняющихся в некотором смысле диктату названного лица. Обособление интересов диктатора для целей регламентации того или иного института корпоративного права как интересов, подлежащих приоритетной защите, приводит к тому, что интересы и предпочтения иных лиц приносятся в жертву интересам (предпочтениям) обозначенного диктатора, именно его интерес является определяющим как для участников, так и для самого юридического лица в данный момент по вопросу, обозначенному в источнике права. Следовательно, все рассуждения про интересы юридического лица вообще или интересы его участников, включая дискуссии о том, насколько тождественны интересы юридического лица и всех или отдельных его участников, оказываются не имеющими какого-либо научного значения: корпоративное право в его позитивно-правовом выражении представляется картой, на которой спорадически расставлены маркеры приоритетов одних лиц перед другими, причем рельеф местности, обозначенной на такой карте, далек от какой-либо логической выдержанности или живописности.

Коль скоро добиться справедливого агрегирования предпочтений, а значит, и интересов всех членов группы, т.е. множества субъектов, невозможно без включения диктаторского элемента, то не стоит дальше убеждать себя, что в той или иной правовой конструкции защищается интерес всех или значительной части участников корпоративных отношений. Самое правильное с эвристической точки зре-
ния в таком случае — не продолжать поиск неведомого «интереса юридического лица вообще» или «интересов всех акционеров», а попытаться понять, чей интерес в каждом конкретном случае получил приоритетную защиту в позитивном праве, иными словами, кто был избран в качестве диктатора для целей регулирования того или иного института корпоративного права. Именно к этому анализу можно, наконец, уже перейти.

III. Применение логики предпочтений диктатора в отдельных институтах

Если верным является обозначенный выше тезис, что корпоративное право вовсе не защищает интересы всех или большинства участников корпоративных отношений, а является, в общем, довольно банальным прикрытием того, что в ходе правотворческого процесса выделяется тот или иной диктатор, предпочтения которого будут отождествлены с предпочтениями некой группы, то далее можно описать, кто именно был выделен в качестве диктатора применительно к любому специфическому институту корпоративного права. При этом, как будет показано ниже, диктаторские полномочия могут оказаться у одного из участников корпоративных отношений, но вполне возможно допустить ситуацию, когда диктатор оказываеться из числа лиц извне, например, если интересы ни одного из участников таких отношений не принимаются во внимание как определяющие, а вместо выявления чьих-либо предпочтений и их последующей защиты решение спора передается судье, наделяемому самой широкой дискрецией. В последнем случае — если в принципе допускать такую конструкцию, когда интересы ни одного из участников корпоративных отношений вообще не обязательны для того, чтобы их учитывать при разрешении корпоративного спора, — внешнее лицо, наделенное полномочиями арбитра, т.е. судья, рассматривающий конкретный спор, также может быть квалифицирован в роли диктатора для целей корпоративного права. Кроме того, определенный дизайн правовых норм, дающий полномочия диктатора некоторому лицу, может попутно решать и иную задачу — минимизацию так называемого стратегического поведения отдельных участников корпоративных отношений, когда они посылают вовне ложные сигналы о своих предпочтениях, провоцируя корпоративные конфликты, которые в таком случае являются средствами достижения истинных интересов (предпочтений), тщательно скрываемых от иных лиц. Соответственно, позитивное право может наделять диктаторскими полномочиями отдельное лицо не только, чтобы защитить его права, но нередко и для того, чтобы сделать невозможным или экономически очень обременительным стратегическое поведение отдельных участников корпоративных отношений, достигая тем самым равновесия между разнонаправленными интересами участников корпорации.

Последующее изложение можно разделить на две части: описание действующего права с позиций выявления диктатора, интересы которого получили приоритетную защиту, а после каталогизирования действующих институтов — описание общего подхода, который давал бы ответ на вопрос, каким образом могли бы конструироваться те или иные институты в будущем, когда будут осуществляться новые политико-правовые выборы, кого именно следует защищать.

См.: Austen-Smith & Banks, supra note 34, at 113.
A. Общий тест для выявления приоритетного интереса в отдельных институтах действующего корпоративного права

Итак, проблема под названием «интересы юридического лица» имеет две «переменные»: (1) интересов у самого юридического лица нет как таковых, а потому его интересы каждый раз должны отождествляться с интересами его участников, при этом (2) интересы участников практически не поддаются корректному агрегированию, если число участников три и более. Следовательно, единственный реалистичный вариант ее решения — это выявление интересов какого-либо одного лица, которые в итоге правотворческого процесса получают безусловный приоритет над интересами всех иных лиц. При этом не стоит думать, что все корпоративное право выстраивается исходя из раз и навсегда избранного приоритета интересов одного лица или одной группы участников корпоративных отношений над интересами других. Напротив, маркировка того самого диктатора может различаться от одного института корпоративного права к другому: где-то приоритет может быть отдан мажоритарному участнику, где-то миноритарному. Наконец, никого из участников вообще могут не спрашивать, если их предпочтения не принимаются во внимание как определяющие. Так, в одной из более ранних работ автор настоящей статьи предпринял попытку описания в качестве универсальной категории, объясняющей большинство проблем корпоративного права через ссылку к превалирующему участнику в основном капитале, того, что обычно имеется корпоративным контролем⁵⁷. Однако попытка эта не привела к какому-либо позитивному решению, точнее, к ответу на вопрос, почему в одних случаях больший объем прав корпоративного контроля дает по закону защиту интересам превалирующего участника, а в других, напротив, наличие такого корпоративного контроля лишь работает против мажоритарного участника, поскольку право встает на защиту миноритариев. Иными словами, корпоративный контроль — категория, позволяющая объяснить, как принимаются решения внутри корпоративного образования, почему решения, принятые даже некоторой частью от общего состава участников корпорации, имеют юридическое значение. Однако корпоративный контроль сам по себе не дает ответа на вопрос, почему в одних случаях защищаются интересы одних участников, а в других они же приносятся в жертву интересам других участников. В этом смысле настоящая статья является комплементарной по отношению к упомянутой работе о корпоративном контроле: если там был описан корпоративный контроль и механизмы его проявления, то здесь дается ответ на вопрос, в каких случаях интересы превалирующего участника могут быть поддержаны правом и получить юридическую защиту, а в каких, напротив, ограничены и право встанет на сторону защиты противоположных интересов иных лиц.

Таким образом, коль скоро все корпоративное право лишено раз и навсегда зафиксированного интереса одного лица или группы лиц, подлежащего приоритетной защите, необходимо предложить специальный инструмент, некий тест, который выполнял бы диагностическую функцию, т.е. позволял бы — при его наложении на тот или иной институт корпоративного права — четко установить, что именно интересы подлежат приоритетной защите, кто в позитивном праве был промаркирован как диктатор, предпочтяющего которого приоритетны для всех остальных лиц.

Важно отметить, что такой тест применим преимущественно для анализа позитивного права, т.е. корпоративного законодательства, поскольку подобная маркировка одного лица или узкой группы лиц как диктатора для целей выделения превалирующих интересов обычно является следствием сознательного выбора правотворцев. В этом смысле данная ситуация представляет собой наиболее яркий пример так называемого рационального выбора в юриспруденции. В редких случаях подобный выбор (маркировка диктатора) возможен и через судебный прецедент, однако помимо доктринальных соображений (насколько далеко, вообще говоря, суды могут заходить в деле создания новых правовых построений) такая возможность для судов объективно ограничена двумя моментами. Во-первых, нормы об ограничении прав, а тем более о введении ответственности, не подлежат распространительному толкованию, а потому суду крайне сложно создать какую-либо новую конструкцию, не опираясь на существующие нормы права, которые в таком случае чрезвычайно затруднительно использовать как основание для по сути новой нормы об ответственности или ограничении чьих-либо прав. Во-вторых, даже если суды находят нормативное основание для введения фактически новой нормы права, зачастую им крайне сложно описать через судебный прецедент полноценную правовую конструкцию, направленную на защиту прав отдельной группы участников корпоративных отношений: суды во многих случаях просто не могут этого сделать, поскольку введение новых институтов зачастую предполагает существенную перестройку законодательства.

Так, российские арбитражные суды в свое время создали правовые конструкции ответственности эмитента за списание акций ОАО или так называемого восстановления корпоративного контроля, которые не предполагали какой-либо существенной перестройки иных институтов корпоративного права, т.е. они вполне могли работать и без изменения иных разделов корпоративного законодательства. Но те же арбитражные суды не смогли создать работающей конструкции иска о принудении направить обязательное предложение в случае нарушения контролирующим лицом обязанности, установленной п. 1 ст. 84 Федерального закона от 26.12.1995 № 208-ФЗ «Об акционерных обществах» (далее — Закон об АО), а равно реально работающей ответственности контролирующего лица (маJORитарного участника и/или лица, замещающего исполнительный орган корпорации) по возмещению убытков, поскольку обе эти конструкции предполагают существенную ревизию законодательства об аффилированных лицах, что сами суды — без помощи со стороны законодательной власти — сделать были не в состоянии. Поэтому, хотя предлагаемый ниже тест может быть в принципе применен к анализу судебного правотворчества, на деле его применение все же сводится главным образом к институтам позитивного права, т.е. действующего корпоративного законодательства.

Для того чтобы понять, ради защиты чьих интересов был введен тот или иной специальный институт корпоративного права или, что то же самое, чьи интересы, предпочтения маркируются как определяющие назначение конкретного институ-та и его последующее применение на практике, следует ответить на три вопроса.


2. Каким образом обозначен приоритет одного интереса над другими? В данном случае важно выявить, как описан или артикулирован интерес, получивший приоритет, при этом он может быть выявлен через противопоставление двух моментов: как обозначен (А) субъект, интерес которого защищается, и (Б) субъект, интерес которого ограничивается или ущемляется фактом допущения средства защиты. Если для целей специального института вводится посредствующее звено в виде интереса юридического лица как интереса, подлежащего защите данным институтом корпоративного права, то нужно также понять, интересы каких именно лиц стоят за абстрактным интересом юридического лица, после чего противопоставить их интересам того, кто поражается или ограничивается в правах.

3. Как должен применяться этот институт с учетом заданного приоритета интересов? Если обозначенное в качестве диктатора лицо или группа участников отношений имеют определяющие значение в деле агрегирования предпочтений группы, именно их интересы приоритетны, то применение такого института по общему правилу должно быть исключено в противоречии с приоритизированным интересом. Так, при необоснованности иска лица, интересы которого подлежат приоритетной защите, в иске может быть указано, но при этом нормы специального института по общему правилу не должны позитивно работать против того, на защиту чьих интересов был изначально направлен соответствующий институт. Привлекательная сторона, т.е. лицо, интересы которого потенциально могут быть ущемлены, ограничены или иным образом умаляются посредством данного института, не может ссылаться в обоснование своей позиции на противоречие заявленного против его иска или иного средства защиты, а равно допустимости применения механизмов, предусмотренных специальным институтом корпоративного права, на то, что заявленные против него требования противоречат интересу юридического лица вообще. В этом случае интерес юридического лица — для целей конкретного института — отождествляется с интересом иного участника отношений, который защищает свои интересы средствами, проистекающими из анализируемого института. Фактом введения института правопорядок сигнализирует, что он дает специальную защиту определенной группе, точнее, вводит диктаторство против цикличности интересов, приоритетно защищая одних в ущерб другим, самим фактом введения института смещается баланс от одной группы участников корпоративных отношений к другой.

Предложенный тест пока что выглядит довольно абстрактно. Соответственно, следует посмотреть, как он работает применительно к отдельным институтам корпоративного права, где возникает проблема противопоставления интересов различных групп участников корпоративных отношений.
**Б. Применение теста на примере специальных институтов**

Рассмотрим ряд наиболее важных с практической точки зрения институтов, описанных в действующем законодательстве, чтобы проиллюстрировать, как работает предложенный выше тест и что дает в таком случае выявление превалирующего интереса (предпочтений, которые получают приоритет как предпочтения диктатора).

**ответственность контролирующего лица перед юридическим лицом за нарушение фидуциарных обязанностей.** Нормативное основание: п. 3 ст. 53 ГК РФ.

1. Главный бенефициар: любой участник юридического лица (на деле это любой участник, не относящийся и не связанный с другим участником или иным лицом, имеющим фактическую возможность определять действия юридического лица, в том числе через указания лицам, обозначенным в законе как входящие в органы управления организации).

2. Как обозначен приоритет интересов: контролирующее лицо отвечает по иску другого участника или самого юридического лица. Исключением является правило производный, однако если предъявлен самим юридическим лицом — прямой. В обоих случаях используется посредствующее звено, юридическое лицо, поскольку возмещаются убытки, причиненные юридическому лицу. Интересы мажоритария, а равно любого иного инсайдера, контролирующего юридическое лицо иным образом, не через механизм корпоративного контроля, предполагающего большую долю в акционерном капитале, формально противопоставляются интересам юридического лица. Следовательно, приоритет (1) у интересов мажоритариев, если контролирующее лицо — мажоритарий, (2) у интересов участников, если контролирующее лицо не является участником корпорации и не связано ни с одним из участников59. В противном случае один из участников признается превалирующим и его интересы умаляются в пользу других участников, которые оказывают в роли мажоритариев, чьи интересы приоритетны по отношению к интересам участника, получившего контроль.

3. Как должен применяться институт: обсуждение вопроса, нарушены или нет фидуциарные обязанности заботы и преданности (п. 3 ст. 53 ГК РФ), производится с позиций участника корпорации, одновременно отвечающего трем критериям: 1) независимость, или несвязанность с тем субъектом, интерес которого умаляется привлечением к ответственности; 2) абстрактность, предполагающая некий собирательный образ неконтролирующего лица, вовсе не увязанный с определенной долей участия; 3) связанность с данным, в полном виде конкретным юридическим лицом (далее для краткости все вместе три критерия обозначаются как фигура незainteresованного абстрактного миноритария конкретного юридического лица). В случае обоснованности заявленных требований контролирующее лицо возмещает убытки в пользу юридического лица. Сам по себе институт не может применяться как основание для прекращения участия в корпорации (однако может быть эле-

59 Аналогичное противопоставление интересов наблюдается во всех иных ситуациях нарушения фидуциарных обязанностей, когда они допускаются лицами, входящими в исполнительные органы и/или советы директоров / наблюдательные советы (п. 3 ст. 53, п. 1–2 ст. 53 ГК РФ, ст. 71 Закона об АО, ст. 44 Закона об ООО).
ментом иных исков, включающих требования, направленные на принудительное прекращение участия в корпорации). Доля корпоративного контроля не являетъся определяющей: может применяться как против мажоритарного, так и против миноритарного участника, а равно лица, вообще не участвующего в акционерном (основном) капитале. В последнем случае лицо должно обладать экономической властью над юридическим лицом, позволяющей определять принятие хозяйственных решений организацией.

Ответственность головной компании (основного хозяйственного товарищества или общества) перед дочерним хозяйственным обществом. Нормативное основание: п. 3 ст. 673 ГК РФ, абз. 4 п. 3 ст. 6 Закона об АО, абз. 4 п. 3 ст. 6 Закона об ООО.

1. Главный бенефициар: любой миноритарный участник дочерней компании (участник дочернего общества, не относящийся и не связанный с мажоритарным участником — основным хозяйственным товариществом или обществом).


3. Как должен применяться институт: обсуждение вопроса, нарушены или нет права и законные интересы юридического лица, как и в предыдущем институте, производится с позиций незаинтересованного абстрактного миноритария такой организации. В случае обоснованности заявленных требований мажоритарий возмещает убытки в пользу юридического лица. Сам по себе институт не может использоваться как основание для прекращения участия в корпорации. Применение против миноритарных участников (участника, не отвечающего критериям «основное хозяйственное товарищество или общество») исключено.

Сделки, в совершении которых имеется заинтересованность. Нормативное основание: ст. 81 Закона об АО, ст. 45 Закона об ООО.

1. Главный бенефициар: любой миноритарный участник (участник, не относящийся и не связанный со сравнительно крупным участником или иным лицом, заинтересованным в совершении сделки с имуществом корпорации).

2. Как обозначен приоритет интересов: незаинтересованным миноритариям (их представителям в совете директоров, если сделка одобряется советом) фактически предоставлено право вето — блокировать сделку (конечно, при условии соблюдения всех корпоративных процедур со стороны заинтересованных лиц, т.е. когда они в принципе делают возможным сам факт обсуждения и одобрения сделки). Участник, а равно любое иное лицо, заинтересованное в совершении сделки,

60 Это, очевидно, не исключает заключения мирового соглашения между мажоритарным участником и миноритариями, минуя само юридическое лицо, в процессуальных интересах которого предъявлен иск. Однако в таком случае в мировом соглашении должны участвовать все миноритарии.
должен раскрыть заинтересованность, отойти в сторону и дать возможность иным лицам решить, стоит ли совершать сделку (право вето ex ante). Интерес заинтересованных лиц всецело подчиняется в таком случае интересу незаинтересованных участников (членов совета директоров). Кроме того, у миноритариев, по крайней мере потенциально, есть право оспаривать сделку ex post, если она совершена с нарушением установленных требований, а также требовать возмещения убытков в пользу корпорации (производный иск — см. абз. 6 п. 1 ст. 65 ГК РФ, указывающий на право оспаривать сделку, действуя от имени корпорации).

3. Как должен применяться институт: при судебных процедурах оспаривания сделки интерес оценивается как с позиций конкретного участника — истца по иску (абз. 4 п. 1 ст. 84 Закона об АО, абз. 4 п. 5 ст. 45 Закона об ООО), так и с использованием посредствующего звена, самой корпорации (абз. 5 п. 1, п. 2 ст. 84 Закона об АО, абз. 5 п. 5, абз. 2 п. 6 ст. 45 Закона об ООО). Причем и для исков об оспаривании сделки, и для исков об убытках в таком случае интерес должен оцениваться с позиций абстрактного незаинтересованного миноритарного участника данного юридического лица. Поскольку институт изначально ориентирован на то, чтобы дать незаинтересованным участникам право самим решить, совершать сделку или нет, а последующие судебные процедуры направлены лишь на обеспечение реальной исполнимости этого решения, незаинтересованные участники в принципе не могут привлекаться к ответственности (в виде возмещения убытков или прекращения участия в корпорации) за блокирование, в том числе неоднократное неодобрение сделки. Исключение могут составлять лишь случаи, когда обязательность совершения конкретной сделки будет вытекать из императивных предписаний закона и участники, действуя недобросовестно, блокируют ее, преследуя свои коммерческие интересы.

**Крупные сделки**61. Нормативное основание: ст. 78 Закона об АО, ст. 46 Закона об ООО.

1. Главный бенефициар: участник или группа участников, действующих в коалиции, которые обладают блокирующим пакетом62 (миноритарный участник, не относящийся и не связанный с мажоритарным участником).

2. Как обозначен приоритет интересов: мажоритарий делает раскрытие, отходит в сторону, предоставляя миноритарным участникам (или членам совета директоров).
Свободная трибуна

3. Как должен применяться институт: логика во многом повторяет то, что описано выше для заинтересованных сделок в части стандарта определения того, чей интерес учитывается при оспаривании сделки, с той лишь поправкой, что в данном случае у миноритариев есть право оспаривать сделку, но не взыскивать убытки (абз. 4, 5 п. 6 ст. 79 Закона об АО, абз. 4, 5 п. 5 ст. 46 Закона об ООО). Однако убытки в таком случае могут быть взысканы по другим основаниям, например в силу того же п. 3 ст. 67 ГК РФ. Аналогичная описанной выше логика примена к миноритарным участникам, блокирующим сделку: поскольку сам институт введен для обеспечения их интереса по блокированию сделки, по общему правилу миноритарии не могут привлекаться к ответственности за реализацию своего права вето, конечно, если необходимость совершения не проистекает из императивного предписания специального закона.

**Преимущественные права при увеличении уставного капитала корпорации.** Нормативное основание: п. 1 ст. 40 Закона об АО, абз. 2 п. 1 ст. 19 Закона об ООО63.

1. Главный бенефициар: любой миноритарный участник (участник, в силу незначительной доли корпоративного контроля не способный заблокировать принятие решения об увеличении уставного капитала корпорации, а в случае с АО — еще до увеличения уставного капитала также и решения о количестве объявленных акций).

2. Как обозначен приоритет интересов: вне зависимости от содержания принятого некоторым большинством участников решения об увеличении уставного капитала миноритарий, который объективно, в силу незначительности доли корпоративного контроля, не мог заблокировать принятие указанного решения, вправе выку-

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63 Несмотря на то, что Закон об ООО (в отличие от ГК РФ — см. подп. 7 п. 3 ст. 66) не называет данный институт преимущестсвенным правом участника ООО на приобретение дополнительной доли при увеличении уставного капитала ООО, а говорит о праве участника ООО внести дополнительный вклад в уставный капитал при его увеличении пропорционально размеру доли этого участника в уставном капитале, по сути эта конструкция является аналогом преимущестсвенного права приобретения акций в АО при открытых подписках. Так, согласно абз. 1 п. 1 ст. 40 Закона об АО акционеру, который не в состоянии заблокировать решение об увеличении уставного капитала, дается возможность докупить (со скидкой до 10%) акции АО, чтобы сохранить свою долю в уставном капитале. Вместо преимущестсвенного права при закрытых подписках в АО, которое дается лишь несогласным акционерам (абз. 2 п. 1 ст. 40 Закона об АО), в ООО оно так же предусматривается иной механизм — право вето любого участника на увеличение уставного капитала непропорционально существующим долям, в том числе за счет принятия нового лица в число участников (абз. 1 п. 2 ст. 19 Закона об ООО). Соответственно, применительно к ООО о преимущественных правах можно вести речь лишь при пропорциональном существующим долям участников увеличения уставного капитала. О логике защиты миноритарных участников ООО при увеличении уставного капитала см.: постановление КС РФ от 21.02.2014 № 3-П «По делу о проверке конституционности пункта 1 статьи 19 Федерального закона «Об обществах с ограниченной ответственностью» в связи с жалобой общества с ограниченной ответственностью «Фирма Рейтинг». 

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пить преимущественно перед всеми иными лицами часть акций нового выпуска (часть доли от предполагаемого увеличения уставного капитала ООО). Тем самым интерес мажоритария, обеспечивающего принятие решение об увеличении уставного капитала, умаляется: если преимущественное право реализуется, то мажоритарий не достигает целей размывания долей миноритарных участников. Миноритарно не дается право вето в части принятия решения участниками, но предоставляется механизм защиты, хотя бы и предполагающий затраты со стороны такого несогласного участника, который позволяет сохранить долю в уставном капитале. Таким образом, диспропорция в корпоративном контроле устраняется через опцион, который в силу закона предоставляется миноритарию, — именно его интерес оказывается в приоритете от подобного механизма.

3. Как должен применяться институт: поскольку механизм преимущественного права направлен на обеспечение возможности сохранить долю в уставном капитале (выраженную в процентах или в виде дроби), любые нарушения процедуры со стороны мажоритария или подконтрольных ему органов юридического лица, трех лиц (регистраторов, трансфер-агентов и т.д.) при возникновении споров должны быть толкованы против мажоритария и лиц, действующих с ним сообща. Все механизмы защиты прав миноритария в таком случае носят строго срочный характер: если у миноритария была реальная возможность реализовать преимущественное право, но он ею не воспользовался по тем или иным причинам, в судебной защите должно быть отказано. Мотивы увеличения уставного капитала не имеют принципиального значения (а значит, неважно, делается ли это увеличение в интересах юридического лица в целом или нет), если соблюдено обеспечение преимущественного права. Причины, по которым миноритарий не смог реализовать преимущественное право (например, временное отсутствие денежных средств), также иррелевантны.

Восстановление корпоративного контроля. Нормативное основание: п. 3 ст. 65 ГК РФ.

1. Главный бенефициар: любой участник коммерческой корпорации (на деле это, как правило, миноритарные акционеры, обладавшие до нарушения прав блокирующим пакетом, либо мажоритарии, утратившие контрольный пакет в результате произошедшего помимо их воли лишения акций или доли в уставном капитале).

2. Как обозначен приоритет интересов: участник корпорации, утративший свою долю участия, может требовать возврата ее в натуре, даже несмотря на то, что акции (доли в уставном капитале), ранее принадлежавшие такому лицу, возможно,

Восстановление корпоративного контроля — редкий пример того, когда полноценный механизм защиты нарушенных прав одной группы участников корпоративных отношений был создан сугубо в рамках судебной практики, при этом приоритет интересов одной группы над интересами другой был определен судами без каких-либо дополнительных изменений в области позитивного права. В данном случае позитивное право лишь закрепило то, что ранее было уже отработано судебной практикой, поэтому правотворцами здесь реально выступили не законодатели, а суды. Подробнее о появлении данного института в судебно-арбитражной практике см.: Сарбаш С.В. Восстановление корпоративного контроля // Вестник гражданского права. 2008, Т. 8, № 4. С. 74—79; Маковская А.А. Восстановление корпоративного контроля в системе способов защиты корпоративных прав // Вестник ВАС РФ. 2009, № 1. С. 119—121; Алеев И. О развитии концепции корпоративного контроля // Корпоративные споры. 2009. № 3. С. 46—52; Степанов Д.И. Феномен корпоративного контроля. С. 195—199.
в настоящее время находятся у добросовестного приобретателя, уставный капитал был изменен, в том числе неоднократно (проведены размывание доли, конвертация акций, размещены акции других категорий и типов), наконец, самой корпорации уже не существует в прежнем виде — проведена ее реорганизация, причем даже не одна. Во всех этих случаях участник корпорации, лишившийся своей доли корпоративного контроля помимо собственной воли, вправе требовать возврата доли от общей величины уставного капитала или общего числа голосов, а не просто буквально тех акций или доли, которые принадлежали ему прежде. Таким образом, данное средство защиты намного шире, чем обычная виндикация (или применение модели виндикации к истребованию акций и долей, как это можно наблюдать в судебно-арбитражной практике). Соответственно, если суд, рассматривающий такое дело, не находит указанных в законе оснований не возвращать долю истцу, то фактом возврата именно доли — особенно после череды ее отчуждений от одного лица к другому либо трансформации самой корпорации и ее уставного капитала — интересы участника корпорации, ранее необоснованно лишенного акций или доли в уставном капитале, оказываются превалирующими над интересами самого широкого круга лиц. В таком случае интересы пострадавшего участника могут иметь приоритет не только над интересами тех, кто способствовал тому, что доля выбыла из обладания участника помимо его воли (что, в общем, понятно, когда речь идет о защите нарушенных прав), но также и над интересами довольно широкого круга потенциальных приобретателей акций или долей, всех прочих участников корпорации (как в случае с возвратом доли после увеличения уставного капитала) и даже третьих лиц, контрагентов корпорации, вообще не являющихся участниками корпоративных отношений (в случае реорганизации, особенно при восстановлении корпоративного контроля, когда реорганизация признается несостоявшейся, — см. подп. 4 п. 2 ст. 602 ГК РФ).

3. Как должен применяться институт: несмотря на то, что механизм ориентирован на реальную, а не формальную судебную защиту нарушенных прав, т.е. на достижение положения, которое существовало до нарушения, институт в том виде, как он описан в позитивном праве (и судебной практике), допускает множество отступлений от провозглашаемой цели приоритетной защиты прав и законных интересов пострадавшего участника. При рассмотрении заявленных требований суд, как следует из требований закона, должен провести взвешивание на гипотетических весах потенциальных благ от удовлетворения иска, с одной стороны, с негативными последствиями для иных лиц — с другой. Если блага для истца от удовлетворения иска перевешивают негатив для иных лиц, иску удовлетворяется, в противном случае истец, не получая долю в основном капитале в размере, существовавшем до нарушения, может добиваться лишь денежной компенсации. Тем самым в данном институте судья оказывается диктатором (в смысле агрегирования предпочтений различных участников корпоративных отношений и даже участников коммерческого оборота), имеющим наиболее широкие дискретные полномочия по навязыванию своей воли. Конечно, дискретция судей при рассмотрении подобного рода споров будет ограничена некими рамками (критерии справедливости, взвешивания негативных последствий, заложенные в норме закона, плюс дифференциация в зависимости от доли утраченного корпоративного контроля и того, насколько вопиющими были нарушения при утрате доли), однако из всех рассматриваемых в данном разделе институтов этот, пожалуй, является наиболее показательным примером того, когда судья, вовсе не являющийся участником корпоративных отношений, т.е. внешнее по отношению к участникам лицо, получает самые широкие
диктаторские полномочия по агрегированию предпочтений группы и выявлению интереса, заслуживающего приоритета над интересами иных субъектов.

**Ответственность эмитента за необоснованное списание акций.** Нормативное основание: п. 4 ст. 44 Закона об АО

1. Главный бенефициар: любой миноритарный акционер, не обладавший до нарушения прав даже блокирующим пакетом (на практике миноритарии, лишившиеся блокирующего пакета, обычно предпочитают не использовать компенсационные механизмы, а отыскивать свои акции в натуре от конечных приобретателей — посредством виндикации или при помощи правил о восстановлении корпоративного контроля, в том числе если после списания акций уставный капитал был изменен или проведена реорганизация).

2. Как обозначен приоритет интересов: акционер, лишившийся акций помимо своей воли, вместо того, чтобы искать акции в натуре, может пойти более легким путем — потребовать денежную компенсацию, равную стоимости необоснованно списанных акций (что особенно просто в случае акций публичных АО, широко обращающихся на рынке). Более того, пострадавший акционер, поскольку закон предусматривает солидарную ответственность АО и регистратора в данном случае, на деле имеет три опции: требовать компенсации от обоих, только от АО или только от регистратора, т.е. получить компенсацию как можно быстрее от того, кто может реально возместить ущерб. Однако поскольку в конечном случае ущерб полностью или в значительной части возмещает эмитент акций, то от выплаты одному акционеру компенсации, равной стоимости утраченных акций, опосредованно страдают все прочие акционеры такого АО: стоимость их акций соразмерно уменьшается. Соответственно, за ошибки или умысл тех, кто способствовал необоснованному списанию акций, косвенно приходится расплачиваться всем иным акционерам — их интересы оказываются соподчиненными интересам акционера (как правило, уже бывшего), права которого были нарушены. Если пытаться в теоретическом плане отстаивать интересы акционерного общества в целом, то данный институт также будет ярким примером того, как они приносятся в жертву интересам отдельного акционера.

3. Как должен применяться институт: поскольку это компенсационный по своей природе механизм, то ключевым вопросом является определение цены акций,

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65 Ответственность эмитента за списание акций — еще один довольно нетипичный с позиций политики права пример того, как полноценный институт защиты прав и законных интересов отдельной группы участников корпоративных отношений был впервые создан судами и лишь впоследствии закрепился в позитивном праве. Тем самым суды, а не законодатели провели приоритезацию интересов участников корпоративных отношений. Изначально данный механизм был создан в судебно-арбитражной практике для защиты миноритарных акционеров ОАО с целью предоставить им удобное компенсационное средство защиты, вместо того чтобы они заявляли иски, направленные на отыскание акций в натуре. Впоследствии он получил универсальное значение для всех АО и при отражении его в законодательство был несколько доработан за счет добавления к ответственности самого эмитента солидарной ответственности регистратора. Подробнее о появлении и развитии этого института в судебно-арбитражной практике, а также спорах о том, чьи интересы должны защищаться в таком случае см.: Степанов Д.И. Ответственность эмитента и регистратора за необоснованное списание акций // Вестник ВАС РФ. 2007. № 3. С. 11–31; Ломакин Д.В. Правовые проблемы определения субъектов ответственности за необоснованное списание акций // Вестник ВАС РФ. 2007. № 9. С. 44–59; Степанов Д.И. От субъекта ответственности к природе корпоративных отношений // Вестник ВАС РФ. 2009. № 1. С. 21–23; Он же. Акционерное общество — дело добровольное. Пока в нем не участвует. К продолжению дискуссии с Д.В. Ломакиным // Корпоративный юрист. 2009. № 2. С. 5–12.
Свободная трибуна

особенно для непубличных АО, хотя эта же проблема актуальна для публичных АО, которые не имеют ликвидного рынка своих акций. Одним из возможных вариантов ее решения для неликвидных акций могло бы быть определение цены, предполагающее проведение оценки под надзором суда по модели аукциона на понижение или серии встречных предложений, так называемой техасской стрельбы, где первое предложение о выкупе делает пострадавший акционер. В обоих случаях участниками такого механизма являются ответчик (АО и/или регистратор) и пострадавший акционер, а целью будет определение справедливой цены выкупа. Кроме того, как во всех иных институтах, связанных с прекращением участия в корпорации и выплатой справедливой компенсации, любые нарушения со стороны АО и лиц, действовавших сообща, а равно манипуляции с ценой должны толковаться против ответчика и максимально облегчать защиту прав и законных интересов пострадавшего акционера.

Выкуп акций / приобретение доли участника ООО по его требованию, когда участник корпорации не согласен с решениями других участников. Нормативное основание: п. 1 ст. 75 Закона об АО, п. 2 ст. 23 Закона об ООО (п. 3, 6 ст. 93 ГК РФ).

1. Главный бенефициар: любой миноритарий (участник, в силу незначительной доли корпоративного контроля не способный заблокировать принятие поименованных в законе решений, которые могут ухудшить его положение). В случае с ООО — в дополнение к несогласным также любой участник, включая мажоритария, а равно наследники и правопреемники участника, если уставом ООО существенно ограничен оборот долей (предусмотрен запрет на переход доли третьим лицам или необходимо согласие иных участников, при этом уставом не предусмотрено право выхода участника).

2. Как обозначен приоритет интересов: логика описания интереса во много повторяет то, что указано выше в отношении преимущественных прав. Миноритарий, который в силу незначительности своей доли корпоративного контроля не мог заблокировать принятие решения, вправе предъявить свои акции к выкупу (потребовать приобрести свою долю в уставном капитале). Интересы мажоритария, обеспечившего принятие решения на общем собрании, умаляются: хотя решение остается в силе и порождает те правовые последствия, на которые оно изначально было направлено, доля несогласных выкупается за счет средств корпорации, а значит, соразмерно уменьшается стоимость имущества, приходящегося на долю мажоритария. Миноритарию не дается право вето в части принятия решения участниками, но предоставляется механизм, который может сделать исполнение ранее принятого решения не-привлекательным для мажоритария. Аналогично в отношении приобретения доли в уставном капитале ООО при наличии существенных ограничений на ее обращение: интересы остающихся участников, не заинтересованных в смене состава участников корпорации и не желающих приобретать долю, приносятся в жертву интересам выходящего участника, поскольку доля выкупается за счет средств ООО, а значит, соразмерно уменьшается реальная стоимость долей остающихся участников.

3. Как должен применяться институт: основная идея механизма защиты — это выплата справедливой компенсации несогласному участнику или лицу, не способному изменить существующее положение вещей (ограничение на обращение долей). Соответственно, любые нарушения процедуры выкупа акций (приобретения доли), а равно манипулирования ценой со стороны мажоритария или подконтрольных ему органов юридического лица, третьих лиц (регистраторов, трансфер-агентов и т.д.) при возникновении споров должны по общему правилу толковаться против мажоритария и лиц, действующих с ним сообща. Экономические мотивы принятия решения, послужившего основанием для выкупа акций или доли, не имеют принципиального значения. Механизмы защиты прав миноритария в случае выкупа акций (приобретения доли) носят строго срочный характер. В случае манипулирования ценой выкупа лицу, уже не имеющему статуса участника корпорации, должны предоставляться широкие возможности компенсации убытков ex post, причем как против мажоритария и всех лиц, действовавших с ним сообща, так и против корпорации, которая, собственно, и производила выкуп акций (приобретение доли).

Определительная оферта на акции публичного АО и выкуп акций лицом, которое приобрело более 95% акций публичного АО, по требованию акционеров такого АО. Нормативное основание: п. 1 ст. 843, ст. 847 Закона об АО.

1. Главный бенефициар: любой из миноритарных акционеров публичного АО (до приведения Закона об АО в соответствие с ГК РФ — того, что ранее именовалось ОАО)67.

2. Как обозначен приоритет интересов: лицу, которое приобрело крупный пакет акций публичного АО, даже если оно хотело бы ограничиться текущим уровнем корпоративного контроля, навязывается обязанность приобрести акции миноритарных акционеров, если, конечно, последние желают их продать. Тем самым интересы миноритарных акционеров получают приоритет над интересом мажоритария, причем мотивы приобретения мажоритария корпоративного контроля (превышения одного из пороговых значений, обозначенных в законе) в общем не имеют какого-либо значения, фактически он обязан обеспечить безусловное соблюдение приоритета интересов миноритарных акционеров над собственным интересом.

3. Как должен применяться институт: мажоритарий обязан раскрыть информацию о факте превышения порового значения, после чего соблюсти процедуру направления обязательной оферты или выкупа акций по требованию акционеров после превышения порога в 95%. Соответственно, поведение мажоритария должно рассматриваться через призму того, насколько он реально способствовал или, напротив, препятствовал миноритариям в реализации их приоритизированного интереса. Аналогично предыдущему институту, связанному с выкупом, применение этого института должно максимально предотвращать злоупотребления в части процедур направления оферты и выкупа, манипулирования ценой со стороны мажоритария или подконтрольных ему органов юридического лица, третьих лиц (регистраторов, трансфер-агентов и т.д.). Точно так же здесь механизмы защиты прав миноритариев носят строго срочный характер в части их активации со стороны миноритарий.

67 О применении данного института, а также института обязательной оферты до приведения Закона об АО в соответствие с новыми положениями ГК РФ см. п. 3 письма Банка России от 01.12.2014 № 06-52/9527 «О применении законодательства Российской Федерации в связи с вступлением в силу новой редакции Гражданского кодекса Российской Федерации» // СПС «КонсультантПлюс».
риев. При этом при манипуляциях с ценой выкупа лицу, уже не имеющему статуса акционера публичного АО, должны предоставляться широкие возможности компенсации убытков — как против мажоритария, так и всех лиц, способствовавших занижению цены выкупаемых акций, действовавших с ним сообща.

Запрет по общему праву на выход участника из ООО. Нормативное основание: подп. 1 п. 1 ст. 94 ГК РФ, ст. 26 Закона об ООО.

1. Главный бенефициар: любой из остающихся участников ООО (любой участник, вне зависимости от доли корпоративного контроля, который не намерен выходить или не успел выйти ранее другого участника ООО).

2. Как обозначен приоритет интересов: участник, желающий выйти из ООО вне зависимости от согласия иных участников, имеет такое право лишь при условии, что на это согласились все прежние или наличные участники ООО через соответствующую запись в уставе ООО. Соответственно, любой из участников ООО при внесении в устав поправок, дозволяющих право выхода, получает право вето — заблокировать принятие такого решения. Право на выход в таком случае становится возможным лишь при полном консенсузе всех участников, абсолютном совпадении их интересов в части права на выход из ООО. Интерес любого участника, имеющего желание выйти из ООО, всцело подчинен интересу любого иного участника, противящегося праву на выход из ООО.

3. Как должен применяться институт: изменение состава участников ООО по общему праву не затрагивает ранее избранную опцию в части права на выход — единогласие всех участников необходимо лишь на момент принятия решения. Если последующие участники желают изменить устав в этой части, то они вправе это сделать по общим правилам изменения устава, если же ранее такой опции в уставе не было предусмотрено, то для ее активации необходимо единогласие всех наличных участников. Поскольку данный институт фактически предполагает, что участники, включающие опцию выхода, понимают, с какими негативными последствиями она сопряжена (ООО в будущем может быть просто разделено на части), никто из участников, блокирующих принятие такого решения, не может привлечь к ответственности (в виде возмещения убытков или прекращения участия в корпорации) за свое поведение.

Искключение участника из непубличной корпорации. Нормативное основание: абз. 4 п. 1 ст. 67 ГК РФ, ст. 10 Закона об ООО.

1. Главный бенефициар: любой участник непубличной корпорации (ООО, непубличного АО, хозяйственного товарищества), обладающий минимально допустимой долей корпоративного контроля, желающий устранить из корпорации другую.

В случае с ООО это доля минимум 10% от уставного капитала, принадлежащая участнику или группе участников ООО, ставящих вопрос об исключении другого участника (ст. 10 Закона об ООО). Для непубличных АО такой порог в настоящее время не установлен, однако можно ожидать, что в будущем, при очередном изменении Закона об АО к приведению его в соответствие с новейшими положениями ГК РФ (абз. 4 п. 1 ст. 67), видимо, нечто похожее будет предусмотрено также и для непубличных АО. Для хозяйственных товариществ, однако, данный вопрос остается открытым, поскольку ГК РФ не содержит каких-либо особых правил на сей счет, а принятие специальных законов для хозяйственных товариществ не предполагается в принципе.
него участника с противоположными интересами (в ООО, как указывалось выше, в настоящее время допускается даже исключение мажоритарного участника по иску миноритариев, правила, при условии, что уставом конкретного ООО не предусмотрено право выхода из такого общества).

2. Как обозначен приоритет интересов: поскольку данный институт жестко не увязан с противопоставлением мажоритарного и миноритарных участников, приоритизация интересов идет по линии того, кто внешне не препятствует деятельности корпорации, и того, кто своим недальновидным поведением тормозит деятельность корпорации (через причинение существенного вреда корпорации, а значит, всем ее участникам) либо «затрудняет деятельность [корпорации] и достижение целей, ради которых [она создавалась]». Инymi словами, в роли того, кого могут исключить из непубличной корпорации, может оказаться любой участник, если какой-либо акт его поведения в качестве участника подпадает под признаки, описанные в законе и детализированные в судебной практике. Аналогичным образом участником, интерес которого получает приоритет над интересом исключаемого участника, может быть любой участник, имеющий минимально допустимую долю корпоративного контроля, если он не блокировал деятельность корпорации.

3. Как должен применяться институт: иск об исключении участника обозначен в законе как косвенный, поскольку формальным основанием для исключения является установление факта нарушения обязанностей, которые участник несет не в пользу других участников, а корпорации, либо наступление негативных последствий, опять-таки отразившихся на корпорации. Вместе с тем обсуждение вопроса о том, есть ли такие основания в конкретном деле, будет производиться с позиций абстрактного миноритария юридического лица при схожих обстоятельствах. От исключения участника выигрывают все остающиеся участники, которые заинтересо-

69 См.: п. 1–9 информационного письма Президиума ВАС РФ от 24.05.2012 «Обзор практики рассмотрения арбитражными судами споров, связанных с исключением участника из общества с ограниченной ответственностью».

70 В этом моменте — описании противостоящих интересов для целей института исключения участника из непубличной корпорации — заключена самая слабая его сторона: при наличии корпоративного конфликта внутри корпорации обе (все) противоборствующие стороны рано или поздно приходят к тому, что каждая из сторон конфликта может быть обвинена в аналогичных по сути нарушениях. Как правило, такого рода корпоративные конфликты наблюдаются в закрытых корпорациях с двумя участниками (двумя группами участников), у каждого из которых есть примерно равные возможности по части корпоративного контроля. Даже если можно обнаружить одного из участников, кто «первый начал», то впоследствии, по ходу развития корпоративного конфликта, противоположная сторона начинает совершать деяния, которые выставляют ее не в самом лучшем свете. Напротив, изначально «плохой» участник, чтобы не оказаться исключенным из корпорации, начинает совершать внешне легитимные действия. Тем самым со временем стороны приходят к некому медленному значению — тои условий, что каждая из сторон в корпоративном конфликте неизбежно нарушает свои обязательства и интересы, что приводит к тому, что исключение участника из корпорации может быть обосновано в судебной практике, работают для случаев единичных нарушений, причем, как правило, носящих вопиющий характер. Однако для более инкарнированных ситуаций они оказываются совершенно неподходящими, поскольку не учитывают того, как поведение продвинутых участников коммерческого оборота может мимикрировать под внешне правомерное, и по сути приводящее к тем последствиям, с которыми изначально желали бороться создатели данного института. Институт исключения участника из непубличной корпорации как нельзя лучше показывает подвижность предпочтений участников корпорации и сложность формализации интереса, подлежащего защите в таком случае.
ваны в сокращении числа членов корпорации и готовы нести издержки, связанные с выплатой действительной стоимости доли за счет корпорации, а значит, согласные на соразмерное уменьшение стоимости их долей. Интересы иных участников, в том числе недовольных поведением исключаемого участника, но не желающих тратить средства корпорации на выплату действительной стоимости доли, игнорируются. Этот институт является грубой альтернативой — в отсутствие иных, более проработанных механизмов — для разрешения дедлоков между участниками непубличной корпорации, причем альтернативой, упреждающей развитие дедлоков (исключение одного или нескольких участников позволяет продолжить существование корпорации). Доля корпоративного контроля имеет (для ООО) и может иметь (для всех прочих непубличных корпораций) определяющее значение для потенциальных истцов, но неважна для участников, которые подвергаются риску быть исключенными.

**Вытеснение миноритарных акционеров из публичного АО.** Нормативное основание: ст. 84* Закона об АО.

1. Главный бенефициар: мажоритарный акционер публичного АО (до приведения Закона об АО в соответствие с ГК РФ — акционер ОАО), владеющий единолично или совместно со своими аффилированными лицами более 95% акций такого АО.

2. Как обозначен приоритет интересов: если (вне зависимости от желания миноритарных акционеров) мажоритарий приобрел акции с соблюдением процедуры, описанной в законе, и совершил необходимую для вытеснения последовательность действий, миноритарии лишаются статуса участника корпорации — их акции выкупаются, мажоритарий становится единственным акционером такого АО. Лишение статуса участника корпорации для миноритарных акционеров не предполагает совершения ими каких-либо формальных нарушений, а мотивы вытеснения, которыми руководствуется мажоритарный акционер, иррелевантны: интересы миноритариев всецело подчинены дискретному усмотрению мажоритария.

3. Как должен применяться институт: мажоритарий обязан раскрыть информацию о факте превышения порогового значения, после чего соблюсти процедуру вытеснения. Аналогично иным институтам, связанным с прекращением участия в корпорации, применение этого института должно максимально предотвращать злоупотребления в части правильности определения цены выкупа, любые манипулирования ценой со стороны мажоритария или подконтрольных ему органов юридического лица, третьих лиц (оценщиков, регистраторов, трансфер-агентов и т.д.) должны толковаться против мажоритария. По прекращении статуса акционера публичного АО лицам, уже не связанным с АО, должны предоставляться самые широкие возможности компенсации убытков — как против мажоритария, так и всех лиц, способствовавших занижению цены выкупаемых акций. Вместе с тем миноритарии не могут ссылаться в ходе или после вытеснения на то, что вытеснение противоречит интересам АО — в данной ситуации интересы АО всецело поглощаются интересами контролирующего акционера. Кроме того, сложно ожидать объективности от органов управления и контроля подобного АО: при столь высокой концентрации корпоративного контроля в руках одного акционера все прочие органы превращаются в проводников его воли, а потому средства защиты миноритарных акционеров в конечном счете должны быть направлены против мажоритарного акционера, инициировавшего вытеснение.
Право акционера на доступ к информации, обусловленное величиной корпоративного контроля.

Нормативное основание: п. 4 ст. 51 Закона об АО (абз. 16 п. 3 ст. 8 Федерального закона от 22.04.1996 № 39-ФЗ «О рынке ценных бумаг»), п. 1 ст. 91 Закона об АО.

1. Главный бенефициар: контролирующий акционер и менеджмент (лица, входящие в исполнительные органы и члены совета директоров / наблюдательного совета, участвующие в управлении) любого АО.

2. Как обозначен приоритет интересов: только у акционера, обладающего некоторой долей голосующих акций, есть право на доступ к отдельным документам, которые могут иметь коммерческую ценность или особое значение при голосовании на общем собрании акционеров. Так, только лицо, включенное в список лиц, имеющих право на участие в общем собрании акционеров, может знакомиться с таким списком, но при условии, что ему принадлежит не менее 1% голосов. Только акционер (акционеры), имеющий в совокупности не менее 25% голосующих акций, имеет право доступа к документам бухгалтерского учета АО и протоколам заседаний его коллегиального исполнительного органа. Тем самым права миноритарных акционеров ограничиваются, интерес акционеров, обладающих сравнительно крупными пакетами акций, получает приоритет над интересами прочих акционеров, не отвечающих установленным критериям корпоративного контроля, необходимого для доступа к информации.

3. Как должен применяться институт: миноритарии, не отвечающие указанным критериям, лишаются права на информацию в части, описанной в законе. Наоборот, мотивы, по которым запрашивается информация, если лицо отвечает установленным критериям, не имеют какого-либо определяющего значения. Ограничение права на предоставление информации в силу положений корпоративного договора не предусмотрено; ограничение права на информацию не подлежит распространительному толкованию на иные организационно-правовые формы юридических лиц, если закон не устанавливает для них специальных правил.

Признание реорганизации корпорации несостоявшейся.

Нормативное основание: ст. 60 ГК РФ.

1. Главный бенефициар: любой участник корпорации, от которого был скрыт факт голосования, когда принималось решение о реорганизации, либо не знал о подлоге решения, а равно любой миноритарий, который в силу незначительной доли корпоративного контроля был не в состоянии заблокировать принятие решения о реорганизации, если впоследствии в документы о реорганизации были включены заведомо недостоверные сведения.

71 См. также п. 2 Указания Банка России от 22.09.2014 № 3388-У «О дополнительных требованиях к порядку предоставления документов, предусмотренных пунктом 1 статьи 89 Федерального закона «Об акционерных обществах», и порядку предоставления копий таких документов».

72 См. п. 1 информационного письма Президиума ВАС РФ от 18.01.2011 № 144 «О некоторых вопросах практики рассмотрения арбитражными судами споров о предоставлении информации участникам хозяйственных обществ».
2. Как обозначен приоритет интересов: интерес участника корпорации, реорганизуемой или реорганизованной на основании решения о реорганизации, которое на самом деле не принималось законным составом участников, или на условиях, впоследствии намеренно искаженных в документах, представленных для государственной регистрации, получает приоритет как над интересами тех, кто способствовал такой фиктивной реорганизации, так и над интересами прочих участников вновь созданных (продолживших существование) юридических лиц, поскольку наделяется безусловным правом на иску по развороту такой реорганизации и приведению к состоянию, которое существовало до нарушения его прав и законных интересов. Соответственно, интересам такого участника подчинены даже интересы добросовестных участников корпорации, в том числе получивших статус участника корпорации уже после окончания фиктивной реорганизации.

3. Как должен применяться институт: в ходе судебного разбирательства интерес пострадавшего участника оценивается с позиций конкретного участника — истца по иску. Данное средство защиты намеренно не ограничено какими-либо специальными сроками исковой давности (чрезвычайно сокращенные сроки исковой давности столь типичны для корпоративной сферы), чтобы оказывать дестимулирующее воздействие на недобросовестных участников оборота и препятствовать использованию подложных документов и проведению такого рода жульнических реорганизаций.

Возможность инициировать ликвидацию юридического лица при дедоле между участниками непубличной корпорации. Нормативное основание: подп. 5 п. 3 ст. 61 ГК РФ.

1. Главный бенефициар: любой участник (на деле, скорее всего, миноритарий, в силу незначительной доли корпоративного контроля не способный заблокировать принятие тех или иных управленческих решений, которые он полагает невыгодными для себя, тем не менее его доля (доли лиц, находящихся с ним в коалиции либо его доля плюс фактическая возможность определять деятельность корпорации) позволяет эффективно блокировать текущую деятельность корпорации, при этом не совершая формально нарушений закона, которые давали бы в иной ситуации основание для исключения из непубличной корпорации).

2. Как обозначен приоритет интересов: в данном случае интересу одного из участников, инициирующих ликвидацию, подчиняются интересы не только всех прочих участников корпорации, но и юридического лица вообще, а равно и контрагентов такой корпорации. Очевидно, что если заявленное требование о ликвидации будет удовлетворено судом, то интересы прочих участников и мифический интерес самой корпорации будут принесены в жертву интересу участника, заявившего такой иск.

3. Как должен применяться институт: поскольку рассматриваемый институт переводит любую иерархию интересов участников корпоративных отношений в терминальную стадию, за которой уже никаких интересов не остается в принципе, подобный механизм должен применяться как исключительное средство, когда недоступны все прочие способы защиты разнонаправленных интересов. Для этих целей, видимо, суды не должны механистически подходить к рассмотрению такого рода дел: даже если будет установлена невозможность «достижения целей, ради которых юридическое лицо было создано, в том числе в случае, если осуществление деятельности юридического лица становится невозможным или существенно
затрудняется», судам следовало бы давать участникам корпорации некоторое вре-
меня (скажем, от двух до шести месяцев) для возможного мирного урегулирования
dелока. Лишь после истечения такого периода — если стороны сами не пришли к
согласию либо пока в законодательстве не появится иных механизмов разрешения
dелоков — суд мог бы принять решение о принудительной ликвидации юридиче-
ского лица. Кроме того, аналогично статусу истца по искам об исключении участ-
ника непубличной корпорации, de lege ferenda следовало бы подумать о введении
фильтра в виде минимально допустимого уровня корпоративного контроля, т.е.
минимальной доли, которой должен обладать истец по такого рода делам, иначе
в существующем виде закон фактически допускает диктат сколь угодно незначи-
tельного миноритария над интересами всех прочих участников, а также прочих
участников оборота — контрагентов корпорации. Напротив, доля корпоративного
контроля противостоящих участников здесь не имеет какого-либо принципиаль-
ного значения: если правопорядок допускает саму возможность ликвидации кор-
порации в такой ситуации, то интересы мажоритарных участников уже имплицит-
но подчинены интересам потенциального истца.

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Примеры из позитивного права, приведенные выше, конечно, не покрывают всего
корпоративного права, однако представляют собой наиболее яркие иллюстрации
столкновения интересов различных участников корпоративных отношений. Более
того, если обратиться к российской судебно-арбитражной практике или научной
литературе, то именно вокруг этих институтов идет наибольшее число споров в
рамках отечественного правового поля, что, в общем, не удивительно: там, где есть
столкновение интересов и их ранжирование, всегда возможны конфликты.

Что интересного обнаруживается, когда все рассмотренные выше институты опи-
сываются с точки зрения защищаемого интереса? Ответ, пожалуй, очевиден: от-
сутствие какой-либо единой, выдержанной логики защиты интересов какой-либо
одной группы участников корпоративных отношений. В одних случаях приоритет
получают интересы наличных участников корпорации, в других — бывших ак-
ционеров, где-то преимущество имеют интересы контролирующего акционера,
а где-то — предпочтения миноритариев. Наконец, хотя законом вводится figura
юридического лица как носителя некоего абстрактного интереса, который дол-
жен учитываться, на деле оценка этого интереса, как правило, сводится к поиску
и установлению интереса некоего абстрактного миноритарного участника корпо-
рации — той организации, интересы которой якобы защищаются в конкретном
dele, или даже абстрактной коммерческой корпорации, находящейся в аналогич-
ном положении. При этом чем более абстрактным оказывается интерес участни-
ка корпорации, точнее, критерии его определения (кто этот акционер, что это за
корпорация и т.д.), тем большую роль в агрегировании предпочтений различных
участников корпоративных отношений начинают играть судьи.

В ситуации, когда суд должен проводить ранжирование интересов на основе прин-
ципов справедливости, добросовестности, а тем более когда по тому или иному
вопросу отсутствует устоявшаяся судебная практика, судьи фактически прерыва-
ются в того самого диктатора, который своим волевым решением разрывает по-
рочный круг циклических предпочтений и задает приоритет интересов, который
полагает оптимальным. В общем, судья в таком случае поступает примерно так же,
как... законодатели, когда они отдают приоритет одному лицу перед другим, вводя новый институт в корпоративное право. Таким образом, чем более артикулирован приоритет интереса одного лица над интересами других лиц в позитивном праве, тем меньше дисcretion судей в агрегировании предпочтений и больше диктат отдельного участника корпоративных отношений, и наоборот.

V. Какими критериями можно было бы руководствоваться в ходе политико-правового выбора?

Общим моментом для всех примеров, описанных выше, является то, что ранжирование интересов различных участников корпоративных отношений во всех без исключения рассмотренных ситуациях задается как бы извне: участники корпорации не пытаются сами установить, предпочтения кого из них должны иметь определяющее значение, они просто полагаются на ту модель, которая дана им позитивным правом, точнее сказать, им не остается ничего другого, как полагаться на то, что кто-то был назначен диктатором для целей применения конкретного института корпоративного права. Эта заданная нормой позитивного права модель выполняет в таком случае функцию агрегирования общего интереса. Однако агрегированием общего интереса это сложно назвать, поскольку на деле, как было показано выше, каждый раз просто обозначается диктатор, предпочтения которого будут рассматриваться как предпочтения группы по тому или иному вопросу. В каждом из рассмотренных институтов обнаруживается предустановленность извне того или иного интереса как предпочтения отдельного участника (группы участников) отношений, получающего приоритет. Таким образом, появление нормы права, точнее, института, закрепленного в позитивном праве, это, грубо говоря, и есть приоритизация интереса: если есть такой, а не иной вариант исполнения института в позитивном праве, то именно такой, а не иной интерес получил приоритет, а значит, и правовую защиту.

Закономерно возникает вопрос: как происходит политико-правовой выбор, совершаемый за рамками позитивного права (а в редких случаях — судебного прецедента)? Если закон есть лишь слепок с того, что в итоге решили правотворцы, когда выбирали из нескольких кандидатов на роль потенциального диктатора, предпочтения которого будут определяющими для группы участников, как они пришли к подобному выбору, почему выбрали диктатором одного, а не другого? Более того, если принять точку зрения, которая отстаивалась на протяжении всей настоящей работы, что любые правовые дискуссии (от судебных баталий до политико-правовых споров и научных диспутов) не имеют ничего общего с «интересом юридического лица вообще», даже если из интересы юридического лица описывается конкретный институт (например, все производные иски), нужно определить, кому в таком случае следует отдавать приоритет, какой группе участников корпорации или участников корпоративных отношений (быть может, участников оборота вообще)?

Возможно, ответы на указанные вопросы кому-то покажутся несколько пессимистичными или отдающими агностицизмом, но с учетом того, что на сегодняшний день известно о том, каким образом осуществляется агрегирование предпочтений группы с числом участников от трех и выше, можно предложить три возможные
опции. Для политико-правового выбора, который осуществляется в ходе введения нового правового института корпоративного права, предполагающего приоритет одного интереса над другим, возможны варианты обоснования такого выбора: 1) через создание функции агрегирования предпочтений группы, которая не была бы диктаторской, т.е. не предполагала навязывание группе предпочтений одного лица и не выдавалась бы при этом за предпочтения всех или значительной части членов группы; 2) маркирование того или иного лица как диктатора, т.е. присвоение ему полномочий лица, предпочтения которого будут являться определяющими, что находит отражение в приоритете его интереса над интересами иных членов группы; 3) некое паллиативное решение, в основе которого будет содержаться элемент тех же предпочтений диктатора (опция (2)), несколько сбалансированное системой сдержек и противовесов, например через учет мнения иных участников группы, последующий судебный контроль и т.п.

Первая из указанных опций в настоящее время — это, мягко говоря, нереалистичный вариант. Очевидно, что тот, кто создаст подобную функцию агрегирования предпочтений группы, совершит небывалый прорыв в науке, за который мало дать Нобелевскую премию по экономике и Филдсовскую медаль по математике. Пока, увы, признаков скорого открытия такой функции агрегирования предпочтений группы с числом участников более двух не видно73. Так что в этой части нам остается, видимо, полагаться на то, что открыл Эрроу, — невозможность создания функции агрегирования, которая бы не была по сути диктаторской.

Третья из названных опций принципиально мало чем отличается от модели диктаторских предпочтений: да, в ней есть некие элементы, позволяющие обуздать произвол одного лица74, но определяющими в конечном счете все равно оказываются предпочтения и интересы того лица, кто избирается в качестве диктатора — отдельный участник корпорации или судьи, к которому рано или поздно попадет спор, где вопрос о приоритете придется решать, даже если позитивное право его внятно не решило. При этом помимо позитивного права, задающего такую систему сдержек и противовесов, гипотетически она может задаваться средствами договорного права, когда участники достигают «договоренностей на берегу» и

73 Другой нобелевский лауреат, получивший премию за работу в сопредельной с Эрроу области, профессор Сен, тем не менее довольно оптимистичен: в своей лекции по случаю вручения премии он призывает рассматривать теорему Эрроу лишь как отправной пункт для дальнейших исследований, называя ее не более чем основой для разумного скепсиса, поскольку якобы создание недиктаторской функции агрегирования так или иначе возможно в перспективе (см.: Amartya Sen, The Possibility of Social Choice, 89 Am. Econ. Rev. 349 (1999)).

детально фиксируют в специальных документах (уставе, внутренних документах, корпоративных договорах, решениях собраний, эмиссионной документации) модели поведения, ориентированные на самые различные ситуации, которые могут возникнуть в будущем. Однако последний вариант описания сдержек и противовесов вряд ли будет идеальным: в реальной жизни любой контракт неполный, ни в одном документе нельзя описать все варианты решения спорных ситуаций на будущее, можно лишь пытаться приблизиться — пусть с крайне высокими издержками на создание такого контракта — к всеобъемлющему согласию, однако исключить все лакуны нельзя, а значит, уже для целей настоящей статьи, можно заключить, что никакой контракт не решает проблему цикличности предпочтений, а может лишь так или иначе ее минимизировать.

Таким образом, после долгого изучения разных аспектов данной проблемы оказывается, что и в области политики права вариант поиска оптимальной правовой конструкции сводится к довольно волюнтаристскому выделению отдельного лица (его предпочтений) в качестве диктатора. Да, выбор такого лица может основываться на критерии эффективности Парето или критерии Калдора — Хикса, но принципиально это не меняет ключевую модель: интересы разных участников корпоративных отношений не собираются воедино, приоритет отдается интересу лишь отдельного лица, а все прочие интересы лишь соподчиняются ему.

Аналогичная логика применима не только к созданию новых правовых институтов, но и к изменению или отмене (признанию фактически недействующими) существующих. В данном случае эту работу в большей степени проводят суды, а не создатели позитивного права, однако логика приоритизации интересов через маркирование диктатора здесь ничем не отличается от политико-правового выбора, который в иной ситуации совершают законодатели, когда волюнтаристским образом отдают приоритет интересам одного лица в ущерб интересам всех иных членов группы.

Иными словами, любой спор о том, чьи интересы должны получать наибольшую защиту, быть приоритетными по отношению к предпочтениям иных лиц, во-первых, всегда является политико-правовым, а значит, вести его в рамках позитивного права бессмысленно, иначе будет совершаться логическая ошибка обоснования idem per idem, во-вторых, если этот спор в конечном итоге сводится к выделению диктатора, предпочтения которого будут обозначены как превалирующие для целей конкретного института, то аргументы в пользу того, кто должен получить роль диктатора, в таком случае будут преимущественно не правовыми, а лежащими в области экономики (вэлфер-экономика и утилитарность, микроэкономика в части издержек и корректировки экстерналий, политическая экономика), политической теории (группы влияния и медианный избиратель), морально-нравственных концепций.

Можно назвать несколько институтов, обсуждать которые с подобных позиций российским юристам, вероятно, придется в самом скором будущем: механизмы

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расшивки дедлоков в непубличных корпорациях, общая конструкция компенсационной ответственности одного участника корпорации перед другим (ответственность акционера перед акционером), ограничение на голосование так называемыми квазиказначейскими акциями (акциями, принадлежащими подконтрольным компаниям, которыми они владеют в головной компании), корпоративные договоры и право на доступ к информации о деятельности непубличной корпорации, сделки с особым порядком одобрения (заинтересованные и крупные) на уровне дочерних и зависимых компаний внутри холдингов.

Заключение

Итак, не стоит искать в законе какой-либо глубинной логики, почему интерес того или иного участника корпоративных отношений получает защиту. Максимум, что дает в закон в таком случае, — это возможность понять, чей интерес защищается конкретным институтом права. Никакой единой логики защиты превалирующего интереса в корпоративном законодательстве просто нет. Закон — финальный продукт политико-правового процесса, а потому если логика и есть, то ее следует искать в каждом конкретном политико-правовом выборе. Однако даже в каждом таком выборе логика не вполне оптимальна: скорее, это выбор между субоптимальным и совсем плохим, худшим вариантом, поскольку политико-правовой выбор, пытающийся решить проблему агрегирования предпочтений большинства, есть всего лишь маркировка диктатора, предпочтения которого будут навязаны иным участникам соответствующих отношений, где есть множество субъектов.

Представленная выше методология исследования, в основе которой лежат отдельные ключевые идеи вэлфаристской экономической теории, может быть использована для изучения иных областей права, где проявляются те же проблемы, связанные с агрегированием предпочтений групп индивидов. Так, в договорном праве (как только оно отходит от модели двустороннего договора, построенного по модели «ты мне — я тебе»), в институтах коллективных инвестиций, банкротстве и, конечно, в публичном праве применение подобной методологии позволяет совершенно по-новому подойти к решению многих вопросов. Очевидно, что проблематика общего учения о многосторонних сделках и многосторонних договорах — это та область, к изучению которой подвигают выводы, содержащиеся в настоящей работе.

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Information about the author

Stepanov Dmitry (Moscow) — PhD in Law, Partner at Egorov, Puginsky, Afanasiev & Partners Law Offices (119017, Moscow, Bol. Ordynka St., 40/5; email: dmitry_stepanov@epam.ru).
Researchers and shareholder advisers have devoted much attention to developing metrics for assessing the governance of public companies around the world. These important and influential efforts, we argue, suffer from a basic shortcoming. The impact of many key governance arrangements depends considerably on companies’ ownership structure: measures that protect outside in-

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1 William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, Harvard Law School.

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vestors in a company without a controlling shareholder are often irrelevant or even harmful when it comes to investor protection in companies with a controlling shareholder, and vice versa. Consequently, governance metrics that purport to apply to companies regardless of ownership structure are bound to miss the mark with respect to one or both types of firms. In particular, we show that the influential metrics used extensively by scholars and shareholder advisers to assess governance arrangements around the world—the Corporate Governance Quotient (CGQ), the Anti-Director Rights Index, and the Anti-Self-Dealing Index—are inadequate for this purpose.

We argue that, going forward, the quest for global governance standards should be replaced by an effort to develop and implement separate methodologies for assessing governance in companies with and without a controlling shareholder. We also identify the key features that these separate methodologies should include and discuss how to apply such methodologies in either country-level or firm-level comparisons. Our analysis has wide-ranging implications for corporate-governance research and practice.
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INTRODUCTION

Researchers, investors, and policymakers around the world have been focusing increasingly on corporate governance. There is now widespread recognition that adequate investor protection can substantially affect not only the value of public firms and their performance but also the development of capital markets and the growth of the economy as a whole. This view has naturally led to heightened interest in identifying and bringing about corporate-governance improvements at both firm- and countrywide levels.

These developments also have sparked substantial demand for reliable metrics for evaluating the quality of corporate governance in public firms. Such metrics can facilitate research on corporate governance, inform investment decisions by institutional investors, and guide efforts to improve governance by both private and public decision makers. Both academic researchers and shareholder advisers have made considerable efforts to develop such metrics. These met-
rics in turn have been used by more than one hundred academic studies, have been extensively utilized by practitioners, and have had a large impact on corporate-governance research and practice.\(^7\)

The notion of a single set of criteria to evaluate the governance of firms around the world is undoubtedly appealing. Both investors and public firms are, after all, operating in increasingly integrated global capital markets. This Article argues, however, that the quest for a single, global governance metric is misguided.

The incidence of controlled and widely held firms varies considerably around the world.\(^8\) In the United States and the United Kingdom, most public companies do not have a controlling shareholder.\(^9\) In most other countries, companies with a controller dominate.\(^10\) The literature has recognized the fundamental differences both in the nature of the agency problems underlying controlled and widely held firms and in the means for addressing these problems.\(^11\) But the critic--

\(^7\) See Bhagat et al., supra note 5. In Part I, we review the impact of academic and commercial efforts to develop governance-ranking systems.

\(^8\) For purposes of this Article, we define a controlling shareholder as one who owns or controls sufficient votes to effectively determine vote outcomes and influence corporate decision making. \(Cf.\) Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984) (defining domination as “direction of corporate conduct in such a way as to comport with the wishes or interests of [those] doing the controlling” (quoting Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971)), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

\(^9\) See Rafael La Porta et al., Corporate Ownership Around the World, 54 J. FIN. 471, 491-93 (1999) (stating that most firms in the United States and United Kingdom are widely held). \(But see\) Clifford G. Holderness, The Myth of Diffuse Ownership in the United States, 22 REV. FIN. STUD. (forthcoming 2009) (manuscript at 1), available at http://rfs.oxfordjournals.org/cgi/reprint/hhm069v1.pdf (“The ownership of U.S. firms is similar to and by some measures more concentrated than the ownership of firms in other countries.”). Our analysis holds even if U.S. companies with controlling shareholders are more prevalent than previously thought.


\(^11\) For works discussing differences between the agency problems in widely held and controlled companies, see, for example, Luca Enriques & Paolo Volpin, Corporate
cal implications of these differences have not been adequately reflected in either the design or the use of governance metrics.\footnote{But see Katharina Pistor, The Standardization of Law and Its Effect on Developing Economies, 50 AM. J. COMP. L. 97, 122-123 (2002) (noting that the OECD principles of corporate governance focus on the problems underlying widely-held firms).}

Because the fundamental governance problems of controlled and widely held firms differ significantly, the effect of many governance arrangements critically hinges on whether the company has a controlling shareholder. Arrangements that enhance investor protection in companies without a controlling shareholder are often inconsequential—or even detrimental—to outside investors in companies with a controlling shareholder, and vice versa. As a result, as we explain in this Article, governance-rating methodologies that use a single metric for assessing investor protection worldwide, at either the firm or the country level, are likely to produce an inaccurate or even distorted picture. Indeed, we demonstrate that this is the case with respect to the most influential and widely used global governance metrics.

Academics and practitioners, we argue, should abandon the effort to develop a single governance metric. Rather, they would do better to develop separate methodologies for assessing the governance of companies with and without a controlling shareholder. Such a two-track approach would best serve researchers, investors, and policymakers in assessing investor protection at either the country level or the firm level. We further identify the key features that these separate methodologies should have, thereby providing the necessary framework for developing and applying a new approach for assessing corporate governance around the world.

Our analysis has wide-ranging implications for corporate-governance research and practice. Among other things, it indicates that researchers may need to reexamine the findings of the large number of academic studies based on existing global governance metrics and reevaluate the governance ratings currently used by institutional investors and shareholder advisers. Furthermore, our analysis
provides an approach that can facilitate and improve future governance assessments by researchers and practitioners.

We begin in Part I with an overview of the quest for global governance standards and the most influential global governance metrics. Among academics, the most influential effort has been made by a team of financial economists who put forward successively two indices for measuring countries’ level of investor protection, the Anti-Director Rights Index and the Anti-Self-Dealing Index. These indices have been applied by more than one hundred academic studies and have had considerable influence on corporate-governance research. Among practitioners, the most influential effort to date has been RiskMetrics’s Corporate Governance Quotient (CGQ) system for rating firms’ corporate governance arrangements. The CGQ system has been widely used by investors and public firms, and its use among academics is growing.

In Part II, we discuss the relationship between firms’ ownership structures and the governance arrangements that would best protect their investors. We begin by describing the basic differences between controlled and widely held firms in terms of the governance problems that their outside investors face. We then analyze the implications

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that these differences have for key sets of governance arrangements: those regulating control contests, voting procedures, the allocation of power between directors and shareholders, the distribution of power among shareholders (i.e., the allocation of power between majority and minority shareholders), director independence, and corporate transactions that may divert value to insiders.

With respect to each of these important areas, we show that the impact of governance arrangements on outside investors depends significantly on whether the firm has a controlling shareholder. As a result, the failure of the Anti-Director Rights Index, the Anti-Self-Dealing Index, and the CGQ system to properly take into account the relationship between ownership structure and corporate governance substantially undermines the indices’ ability to serve as effective metrics for the governance quality of firms or countries worldwide.

Consider, for example, antitakeover defenses such as the poison pill. These arrangements determine the extent to which a widely held company is subject, for better or worse, to the discipline of the market for corporate control. In companies with a majority shareholder, however, a hostile takeover is not feasible even in the absence of antitakeover impediments. Thus, even though takeover defenses are consequential for outside investors in widely held firms, they are unimportant in controlled companies. Using a single metric for assessing both firms with and firms without a controller will therefore (1) overlook an important issue for widely held firms to the extent that the metric does not give sufficient weight to antitakeover considerations, (2) give weight to a largely irrelevant issue for controlled firms to the extent that the metric gives significant weight to antitakeover considerations, or (3) produce some combination of both outcomes. Likewise, using a single metric for comparing countries where concentrated ownership is prevalent to those where widely-held firms dominate, or more generally, countries that have a different mix of these two types of firms, is likely to produce results that would be inaccurate for many purposes.

Our analysis should be distinguished from another type of criticism that can be raised against existing governance metrics. Some writers question the value of any attempt to assess firms’ corporate governance based on objective, externally verifiable criteria. They ar-

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gue that any useful governance evaluation must take into account a rich set of dimensions (such as the character of the individuals involved) that can only be assessed subjectively.\(^{19}\) In contrast, we do not question the feasibility of developing a methodology for large-scale governance assessments based on objective criteria. Rather, our critique is constructive: we seek to advance the project of developing governance metrics based on objective and generally applicable criteria, not to abandon it altogether.

We therefore discuss in Part III how the assessment of corporate-governance arrangements should proceed. We argue that academics and practitioners should seek to develop separate systems—one for controlled and another for widely held firms—with each based on a set of objective and externally verifiable dimensions. We contribute to this effort by identifying, for both controlled and widely held firms, which governance dimensions should occupy an important role and—no less important—which dimensions should not. When assessing an individual company, one should use the rating methodology that fits the company’s ownership structure. We also discuss how one should use these separate systems to assess investor protection at the country level. Specifically, we explain why keeping separate scores for how a country protects investors in companies with and without a controlling shareholder is valuable for researchers, policymakers, and investors.

For ease of exposition, we shall refer throughout to companies with a controlling shareholder as “CS companies” and to those without a controller as “NCS companies.” At the outset, we should acknowledge that some public companies lie in the gray area between these two pure types because they have a dominant shareholder with substantial influence but not a complete lock on control. We leave for another day the refinement of our analysis necessary for extending it to such companies. Here we wish to focus on the task that we view as most important and pressing given current practices: designing appropriate evaluation systems for the numerous public companies

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\(^{19}\) See, e.g., Bhagat et al., supra note 5, at 1808 (“[T]here is no one ‘best’ measure of corporate governance: The most effective governance institution depends on context and on firms’ specific circumstances.”); Paul Rose, The Corporate Governance Industry, 32 J. CORP. L. 887, 908 (2007) (arguing that one-size-fits-all methodologies “may not capture relevant nuances in corporate governance policies and behaviors”); see also J. Harold Mulherin, Corporations, Collective Action and Corporate Governance: One Size Does Not Fit All, 124 PUB. CHOICE 179, 180 (2005) (“The multidimensional nature of corporate governance indicates that the focus in many reform proposals on a narrow set of mechanisms ignores the substitutability and complementarity provided by the broad set of forces operating on the corporation.”).
around the world that can easily be classified as either CS or NCS. These companies should be subject to the separate evaluation systems that we advocate, not to a single, global governance metric.

I. THE QUEST FOR GLOBAL STANDARDS

A. The Demand for Global Standards

In recent years, corporate governance has become an important topic for academics, institutional investors, and policymakers. There is a widespread belief that the quality of corporate governance and investor protection can affect the performance of firms and economies. At the firm level, inadequate investor protection may reduce firm value and increase firms’ cost of capital. At the country level, inadequate investor protection may impede stock market development and undermine financial growth.

Not surprisingly, the growing recognition of corporate governance’s importance has sparked substantial interest in measuring the quality of corporate-governance arrangements across firms and countries. Scholars have sought such measures to study the link between corporate governance and economic outcomes for both firms and economies. Policymakers—including those affiliated with the World Bank, the Organisation for Economic Co-operation and Development (OECD), and the International Monetary Fund (IMF)—have been attracted to the promise of metrics that can facilitate efforts to improve countries’ investor-protection systems and to assess their progress in doing so. Finally, the growth of institutional investing and investors’

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20 See Doidge et al., supra note 17, at 2 (“Better governance enables firms to access capital markets on better terms, which is valuable for firms intending to raise funds.”).
23 For example, the World Bank’s “Doing Business” survey, which provides objective measures of business regulations and their enforcement across 181 economies, relies on the Anti-Self-Dealing Index, which we discuss below, to measure countries’ level of investor protection. See Doing Business, Protecting Investors, http://www.doingbusiness.org/MethodologySurveys/ProtectingInvestors.aspx (last visited Mar. 15, 2009). The IMF’s Financial Sector Assessment Program uses the World
increased attention to corporate governance has induced shareholder advisers to develop governance metrics that could inform investment decisions in companies around the world.24

A comprehensive effort to survey all existing metrics and methodologies for assessing governance arrangements around the world would require substantial space and, we believe, is unnecessary for establishing our main points. It will be useful, however, to illustrate these points by reference to commonly used metrics. Section B discusses the most influential ranking system developed by a shareholder adviser—RiskMetrics’s CGQ system. Section C describes the most influential global metrics developed by academics—the Anti-Director Rights Index and the Anti-Self-Dealing Index.

B. Shareholder Advisers’ Efforts: The CGQ System

RiskMetrics is the world’s dominant provider of shareholder-advisory services to institutional investors.25 Prior to being acquired by RiskMetrics in 2007, its shareholder-advisory services operated independently as Institutional Shareholder Services (ISS).26 When going public in 2007, RiskMetrics reported that it “served approximately 1150 financial institutions that together manage an estimated $20 trillion,”27 provided research coverage on more than 7400 U.S.-based companies and approximately 22,000 non-U.S. companies,28 and had issued vote recommendations for more than 38,000 shareholder meetings across

25 See, e.g., U.S. GOV’T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 8 (2007), available at http://www.gao.gov/new.items/d07765.pdf (describing ISS as “the dominant advisory firm” and perhaps even “a potential barrier to competition in this industry”); Rose, supra note 19, at 889-90 (reporting some executives’ belief that RiskMetrics—then ISS—“may control a third or more of the shareholder votes” in the industry).
27 Id. at 87.
28 Id. at 88.
100 countries during the preceding year. It is widely assumed that RiskMetrics’s voting recommendations can affect vote outcomes and academic studies on the effects of shareholder advisers commonly focus on RiskMetrics’s recommendations.

Since 2002, ISS and RiskMetrics have offered a corporate-governance-rating system named the Corporate Governance Quotient. RiskMetrics currently rates the governance arrangements of more than 7400 companies in more than thirty markets. Many institutional investors receive these ratings as part of their subscription to RiskMetrics’s services. Given the dominance of RiskMetrics in the proxy-advisory market, it is not surprising that its CGQ ratings receive much attention in the marketplace.

29 Id. at 87.
31 See, e.g., Stephen Choi et al., Director Elections and the Influence of Proxy Advisors 1 (NYU Ctr. for Law, Econ., & Org. Working Paper No. 08-22, 2008), available at http://ssrn.com/abstract=1127282 (noting that ISS was “claimed to sway” between twenty and thirty percent of proxy votes); Cindy R. Alexander et al., The Role of Advisory Services in Proxy Voting 2 (2006) (unpublished manuscript), available at http://ssrn.com/abstract=966181 (quoting one Merrill Lynch analyst describing an ISS recommendation, “If it had gone the other way, the deal would have been dead. Now, it’s a horse race.”).
33 See Daines et al., supra note 6, at 2, 4 (reporting varied empirical accounts of the influence of governance ratings and noting that RiskMetrics was the largest commercial rater).
34 See Rose, supra note 19, at 898-99 (“Proxy advisers generally base their decisions on corporate governance standards that are derived from the same policies as those used to formulate governance ratings and related governance advice.”); see also INSTITUTIONAL S’HOLDERS’ SRVS., ISS US CORPORATE GOVERNANCE POLICY 2007 UPDATES 24 (2007), available at http://www.riskmetrics.com/sites/default/files/2007_US_Policy_Update.pdf (describing steps taken to align governance ratings with the company’s voting policy).
company clients on how to improve their CGQ scores, public companies with high CGQ scores boast about them. RiskMetrics offers public companies fee-based consulting services for improving their CGQ scores, and the popular “Yahoo! Finance” web site includes CGQ scores in companies’ online profiles.

Although the CGQ system was developed by a commercial-shareholder adviser, academics increasingly use it as a measure of the quality of firms’ governance arrangements. Researchers, for example, have analyzed the link between RiskMetrics’s governance scores and firm performance, tried to assess which CGQ factors affect firm valuation, and used companies’ CGQ scores to study governance differences between banking and nonbanking firms.

Although RiskMetrics has one set of criteria (also referred to as factors) for rating U.S. firms and another set for rating non-U.S. firms, the two sets largely overlap. Both divide corporate-governance factors into eight categories: board (including board size and the nominating committees); audit; charter/bylaws (including features such as poison pills and special meetings); antitakeover provisions; executive and director compensation; progressive practices (for example, CEO-succession planning); ownership (including board-performance re-

41 See Chenchuramaiah Bathala et al., Industry Differences in Corporate Governance: The Case of Banking and Non-Banking Firms, 13 ICFAI J. Applied Fin. 17 (relying on CGQ scores to study governance differences between bank and nonbank firms).
view and stock ownership by directors); and director education. Both
sets include similar criteria within each of the eight areas.  

The CGQ system rates the performance of any given company
with respect to each factor and then uses this rating to produce both a
raw score for the company and a relative score that rates the company
in comparison to others in the same investment index or industry
group. For our purposes, the key feature of the CGQ system is that it
applies the same criteria to companies that do and do not have a con-
trolling shareholder. As we shall show in subsequent sections, this
uniform approach is unwarranted.

Perhaps because RiskMetrics is headquartered in the United
States, where CS companies are less common, a significant fraction of
the CGQ factors may be valuable for outside investors in NCS compa-
nies but are irrelevant, or even harmful, for investor protection in CS
companies. Whatever the reason for this feature, we shall show that
the CGQ system clearly illustrates the problems that arise when a sin-
gle metric is used for assessing governance around the world.

C. Academics’ Efforts: The Anti-Director Rights Index
and the Anti-Self-Dealing Index

Among academic researchers, the most influential metric for
evaluating governance arrangements worldwide has been the Anti-
Director Rights Index, developed by a team of four financial econo-
mists. More recently, three members of this team joined a World Bank
economist to construct a new metric, the Anti-Self-Dealing Index, as
an alternative to the Anti-Director Rights Index.

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1. The Anti-Director Rights Index

In a 1998 article titled *Law and Finance*, four financial economists—La Porta, Lopez-de-Silanes, Shleifer, and Vishny (commonly referred to in subsequent work as LLSV)—developed the Anti-Director Rights Index and used it to study and compare investor protection across forty-nine countries. Their findings sparked a vast academic literature. Indeed, academics have thus far used the Anti-Director Rights Index in almost one hundred cross-country quantitative studies, for example, to examine the association between investor protection and firm valuation, voting premia, firm-level corporate-governance mechanisms, the prevalence of earnings management, and the depth of financial crises. The use of the index has not been

\[44\] La Porta et al., *supra* note 13; see also Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 24 (2000) (arguing that strong investor protection is empirically linked with “valuable and broad financial markets”); La Porta et al., *supra* note 3, at 1132 (“We compare external finance across 49 countries as a function of the origin of their laws, the quality of legal investor protections, and the quality of law enforcement.”). See generally Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 286-87 (2008) [hereinafter La Porta et al., *Economic Consequences*] (developing a “Legal Origins Theory” based on historical differences between various legal traditions).

\[45\] See Spamann, *supra* note 14, at 1-3 (reporting that the Anti-Director Rights Index has been used in almost one hundred such studies but challenging the accuracy of the underlying data).

limited to corporate-finance research but has extended to the study of other issues, such as financial integration and the relationship between risk sharing and industrial specialization.

The Anti-Director Rights Index consists of six components. Three focus on shareholder voting rights: the requirement that shareholders deposit their shares before a shareholder meeting, the ability of shareholders to cast a vote by mail, and the minimum percentage of share ownership that allows a shareholder to call a special shareholder meeting. A fourth component focuses on shareholders’ preemptive rights—whether the law grants shareholders the first opportunity to buy new issues of stock (unless the shareholders have waived their right by a vote). A fifth component focuses on cumulative voting—whether there is a mechanism by which minority interests may name a proportional number of directors to the board. The final component, often referred to as “oppressed minority mechanisms,” focuses on whether minority shareholders objecting to fundamental changes (such as mergers, asset dispositions, and changes to the articles of incorporation) have a right to challenge those decisions in court or to “exit” by requiring the company to purchase their shares.

As we will explain, the Anti-Director Rights Index cannot provide an adequate measure of investor-protection levels around the world. Most notably, three of the index’s components—shareholders’ ability to vote by mail, to vote without depositing shares, and to call a special meeting—are largely irrelevant to companies with a controlling shareholder: in such companies, regardless of the voting arrangements in place, minority shareholders normally will lack effective power either to pass resolutions that the majority shareholder opposes or to block resolutions that the majority shareholder favors.

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49 See La Porta et al., *supra* note 13, at 1127-28.

50 Id. at 1127.

51 Id. at 1128.

52 Id.

53 Id. In addition to the Anti-Director Rights Index, LLSV also take into account two variables: “one share, one vote” and “mandatory dividends.” See La Porta et al., *supra* note 13, at 1122-23.
To be sure, as we will discuss in Part II, these voting arrangements may not be the most important governance provisions even in NCS companies, but they do provide some protection for outside investors in such companies. This is not the case for CS companies. Thus, the Anti-Director Rights Index well illustrates our thesis concerning the problems involved in using investor-protection measures that purport to apply to all companies regardless of their ownership structure.54

2. The Anti-Self-Dealing Index

Three of the designers of the Anti-Director Rights Index recently teamed with a World Bank economist (together commonly referred to as DLLS) to develop a new index.55 The DLLS team offered this Anti-Self-Dealing Index as a superior alternative to the Anti-Director Rights Index.56 Although relatively new, the Anti-Self-Dealing Index has already been used significantly in research by financial economists.57

54 Commentators have questioned the Anti-Director Rights Index on a variety of grounds. Some argue that the index does not capture all the arrangements that are important for investor protection. See John C. Coffee, Jr., The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control, 111 YALE L.J. 1, 4 n.6 (2001) (arguing that the shareholder rights captured by LLSV “supply only partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium”). Others argue that the index adopts a U.S.-centric approach. See Priya P. Lele & Mathias M. Siems, Shareholder Protection: A Leximetric Approach, 7 J. CORP. L. STUD. 17, 20-21 (2007) (noting that the inclusion of variables like cumulative voting and the exclusion of variables like director entrenchment reflect a U.S. bias). Lawyers have been skeptical of the attempt to use a single measure for evaluating the quality of legal protection across countries and have identified some mistakes. See, e.g., Udo C. Braendle, Shareholder Protection in the USA and Germany—“Law and Finance” Revisited, 7 GERMAN L.J. 257, 258 (2006) (arguing that LLSV did not adequately consider German company law); Luca Enriques, Do Corporate Law Judges Matter? Some Evidence from Milan, 3 EUR. BUS. ORG. L. REV. 765, 769-83 (2002) (U.K.) (evaluating differences between corporate law on and off the books and the impact of enforcement). Others explore the methodological difficulties associated with coding such legal variables. See, e.g., Spamann, supra note 14 (attempting, and failing, to replicate the data presented by LLSV). Our thesis, however, is markedly different. We argue that any attempt to develop a single measure for evaluating corporate governance for both controlled and widely held firms is inherently misguided.

55 Djankov et al., supra note 13.

56 See id. at 432 (discussing improvements vis-à-vis the Anti-Director Rights Index).

This index focuses on the extent to which outside investors are protected from expropriation by insiders using self-dealing transactions, and it includes measures such as disclosure, public enforcement, approval of self-dealing transactions by disinterested shareholders, shareholders’ legal standing to challenge a self-dealing transaction in court, and the ability to hold controlling shareholders and directors liable for self-dealing transactions. The DLLS team argued that the Anti-Self-Dealing Index is theoretically grounded and found it to be a more robust predictor of the development of stock markets than the Anti-Director Rights Index.

As we shall explain below, however, the Anti-Self-Dealing Index also cannot provide an adequate yardstick for assessing investor protection around the world. Whereas the Anti-Director Rights Index was shaped largely by reasoning relevant to investor protection for NCS companies, the Anti-Self-Dealing Index focuses on measures relevant primarily to CS companies. As a result, the Anti-Self-Dealing Index ignores dimensions that are quite important for investor protection in NCS companies. To be sure, CS firms are presumably dominant in most countries. Yet, as Part III will explain, researchers assessing a country’s level of investor protection should keep separate scores for how well it protects outside investors at CS firms and how well it protects such investors at NCS firms.

II. INVESTOR PROTECTION AND OWNERSHIP STRUCTURE

We now turn to analyzing the relationship between ownership structure—that is, the presence or absence of a controlling shareholder—and investor protection. As we will explain, differences in ownership structure affect the nature of problems that outside investors face and, in turn, the measures that could be most effective in addressing these problems.

Section A begins by describing the fundamental differences between CS and NCS companies. We then analyze the implications of these differences for different areas of corporate governance. Specifi-
cally, we discuss control contests (Section B), voting procedures (Section C), the allocation of power between the board and shareholders (Section D), the allocation of power between majority and minority shareholders (Section E), director independence (Section F), and arrangements governing potential value diversion (Section G).

A. Some Fundamental Differences Between CS and NCS Companies

We begin with some general observations about the fundamental dissimilarities between CS and NCS companies. In particular, we focus on differences in terms of (1) the nature of the agency problem for outside investors, (2) the contestability of control, (3) the ability of a majority of shareholders to exercise their formal power, and (4) the main ways in which opportunism benefits insiders.

1. Nature of the Agency Problem

When outside investors provide capital to a public firm, they face the risk that the insiders who influence the firm’s decisions will act opportunistically and advance their own private interests. Although this general problem exists in both CS and NCS firms, these firms differ in the identity of the insiders from whom outside investors need protection.

In NCS companies, shareholders’ inability to use effectively their power to monitor officers and directors (to whom we refer collectively as “management”) provides management with a significant measure of de facto control. Because management’s interests may diverge from those of shareholders, the fundamental concern that governance arrangements need to address is management’s potential to behave opportunistically at the expense of shareholders.

In CS companies, in contrast, controlling shareholders commonly have both the effective means to monitor management and the incentives to do so. Thus, to the extent that the controllers have some interests in common with those of outside investors, the controller’s

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61 See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv. L. Rev. 1641, 1651 (2006) (“[A] controlling shareholder may police the management of public corporations better than the standard panoply of market-oriented techniques employed when shareholdings are widely held.”).
presence lessens the concern that management will act contrary to these interests. Controllers, however, may also have interests that do not overlap with those of outside investors, and they may use their power to advance such interests. In CS companies, therefore, the fundamental concern that needs to be addressed by governance arrangements is the controlling shareholder’s opportunism.

2. Contestability of Control

In CS companies, control is not contestable. The controlling shareholder has a lock on control by virtue of its ownership of a majority of the voting rights—or at least a sufficient percentage of voting rights to secure an effective lock on control. In NCS companies, in contrast, control is at least in theory contestable, though the extent to which it is contestable in practice depends on the governance arrangements that we will discuss later.

The difference in contestability has important implications for corporate governance. When an active market for corporate control exists, insiders are subject to the threat of removal if they fail to maximize shareholder value. This disciplinary mechanism, the strength of which depends on the governance arrangements in place, can enhance share value and reduce the need for other mechanisms for constraining management. In CS companies, however, the threat of a control contest does not exist and cannot constrain insider opportunism.

3. Ability of a Majority of Shareholders to Exercise Their Formal Power

In NCS companies, governance arrangements must be assessed against the background of collective action and free-rider problems that often prevent outside shareholders from effectively using whatever formal powers that they have to constrain and influence management. Consider a shareholder with a one-percent stake who is contemplating whether to take an action that would enhance share value. The shareholder may be discouraged by the prospect of having to bear the full cost of taking such an action while capturing only one percent

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62 See also Enriques & Volpin, supra note 11, at 117 (“[C]oncentrated ownership can create conditions for a new agency problem, because the interests of controlling and minority shareholders are not aligned.”).
of the benefits. The arrangements governing NCS companies must be assessed against the background of collective action and free-rider problems. Put differently, one generally cannot assume that outside shareholders holding a majority of the shares collectively will use their formal powers to advance the course of action that they prefer.

In CS companies, in contrast, the controller is likely to use its formal powers to maximize the value of the shares it owns. The controller will generally capture at least a significant share of the appreciation in value that these actions produce and thus will have significant incentives to exercise power. Accordingly, it is reasonable to assume that controllers will make significant use of their formal powers to advance the course of action that they prefer.

4. The Main Ways in Which Opportunism Benefits Insiders

CS and NCS companies differ not only in the identity of the insiders whose potential opportunism should be constrained, but also in the main ways in which insider opportunism is manifested. Compared to professional managers in NCS companies, controllers often have extra avenues for diverting significant value.

Controllers are often individuals or firms that have businesses other than the public firm in question and considerable outside wealth. This is especially true in the many countries in which a relatively small number of dominant families controls many public companies through pyramids and other forms of business groups. In contrast, professional managers at NCS companies are less likely to own—fully or partly—significant businesses outside the public company that they manage. The ownership of significant outside businesses provides controllers with additional ways to divert value. For controlling shareholders, large self-dealing transactions with other en-

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64 Moreover, for a holder of the majority of the votes, the cost of monitoring and disciplining management is likely to be lower than it is for outside shareholders. For example, directors and officers are more likely to provide a controlling shareholder with information concerning the company’s performance, and the controller does not need to communicate with other shareholders to secure a majority of the votes.

65 See, e.g., Faccio & Lang, supra note 10, at 390 tbl.8 (presenting evidence on the prevalence of pyramidal ownership structures in Western Europe); Khanna & Yafeh, supra note 10, at 332 (“[I]n virtually all emerging markets, group affiliated firms tend to be relatively large and economically important.”).

ties affiliated with them and freezeout transactions often provide an important channel for extracting private benefits.  

Diversion of value through executive compensation, however, is a concern of lesser importance in CS companies than in NCS companies. First, to the extent that the company’s executives are professional managers not affiliated with the controller, the controller generally has an interest in setting executive compensation to maximize shareholder value. Second, even when individuals affiliated with the controller serve in a managerial capacity, the controller may well elect not to maximize diversion through excessive compensation, given its ability to extract private benefits on a larger scale through other means, such as related-party transactions.

There is yet another related difference in the ways that insider opportunism manifests itself in CS and NCS companies. Managerial shirking and empire building are more serious concerns in NCS companies than in CS companies. Such practices provide insiders with

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67 For evidence on self-dealing involving companies within the same business groups, see, for example, Kee-Hong Bae et al., Tunneling or Value Added? Evidence from Mergers by Korean Business Groups, 57 J. FIN. 2695 (2002); Marianne Bertrand et al., Ferreting Out Tunneling: An Application to Indian Business Groups, 117 Q. J. ECON. 121 (2002). For a comprehensive analysis of legal issues that arise in the context of freezeout transactions, see generally Guhan Subramanian, Fixing Freezeouts, 115 YALE L.J. 2 (2005).

68 Controllers might use generous compensation arrangements to induce managers to facilitate controllers’ value diversion through self-dealing and other transactions. Controllers, however, are often quite influential in making a decision to hire or terminate managers. This means that managers who want to get hired or keep their job have an incentive to cater to the controller preferences even without being paid for their cooperation with value diversion.

69 Another difference is the role of directors’ stock ownership. In NCS companies, stock ownership can incentivize outside directors to monitor management. See, e.g., Michael C. Jensen, The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, 48 J. FIN. 831, 864 (1993) (arguing that encouraging directors to hold substantial equity interests would provide better oversight incentives). But see Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, 105 MICH. L. REV. 1677, 1682-83 (2007) (arguing that equity pay for directors “cannot substitute for direct monitoring incentives”). In CS firms, however, directors’ stock ownership might be less important. If the director is the controller or its affiliate, then equity ownership is unlikely to provide incentives beyond those already provided by owning the control block. Even when the director is independent, however, the incentives provided through stock ownership are likely outweighed by the controller’s influence over director elections.

nonpecuniary benefits while reducing share value, and a controller with a large ownership stake will bear a substantial fraction of the costs. A controlling shareholder therefore has an incentive to avoid such actions when managing the company and to prevent them when the company is run by professional managers. Thus, in the presence of a controller with a large ownership stake, managerial shirking and empire building are relatively less important concerns.

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With these four fundamental differences in mind, we now consider the relationship between ownership structure and several key sets of governance arrangements. As our analysis will demonstrate, one should distinguish between CS and NCS companies when assessing each of these key sets of governance arrangements.

B. Control Contests

1. The Difference Between CS and NCS Companies

One important difference between CS and NCS companies concerns the potential role of battles for corporate control—that is, hostile takeover bids and proxy contests. Although such contests and the governance arrangements regulating them are quite important for NCS companies, they are largely irrelevant to CS companies.

Anyone approaching governance arrangements from a U.S. perspective finds it natural to assume that the arrangements governing control contests are a key element in the governance of public companies. After all, these arrangements have long occupied a central role in discussions of corporate and securities laws by academics and policymakers in the United States. Textbooks or treatises on United States corporate law devote substantial space to arrangements govern-

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71 See Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323, 323 (1986) ("Managers have incentives to cause their firms to grow beyond the optimal size.").

72 See David Yermack, Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns, 80 J. FIN. ECON. 211 (2006) (finding that firms whose CEOs personally use company jets underperform market benchmarks).

73 See Lucian Arye Bebchuk, The Case Against Board Veto in Corporate Takeovers, 69 U. CHI. L. REV. 973, 974 (2002) ("In the last thirty years, takeover law has been the subject most hotly debated by corporate law scholars.").
ing takeovers and proxy fights. 74 Lawmakers have devoted considerable legislative effort to enacting antitakeover statutes and promulgating regulatory rules governing tender offers and control contests. 75 The Delaware courts have developed an extensive body of takeover case law. 76 Numerous studies by legal scholars, as well as financial economists, focus on the arrangements governing hostile bids and proxy fights. 77 And investors have devoted considerable attention to antitakeover defenses and have made them the subject of a large fraction of all shareholder proposals. 78

The dominant view among U.S. scholars and shareholder advisers is that firms should adopt governance arrangements that facilitate control contests. 79 Because the threat of a hostile takeover or a proxy fight is commonly viewed as providing an important market-based check on management, a vibrant market for corporate control can reduce the agency problem underlying NCS firms. 80 This view is supported by a substantial body of empirical evidence indicating that exposure to the threat of a hostile takeover is associated with higher firm value and better performance. 81 Such evidence has led U.S. academics

74 See, e.g., MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 315-24, 1040-1114 (9th ed. 2005).
79 We share this view. See Bebchuk & Hamdani, supra note 75, at 1805-07.
80 See Henry G. Manne, Op-Ed., Bring Back the Hostile Takeover, WALL ST. J., June 26, 2002, at A18 (“New scandals will continue until we bring back the most powerful market mechanism for displacing bad managers: hostile takeovers.”).
81 See, e.g., Marianne Bertrand & Sendhil Mullainathan, Is There Discretion in Wage Setting? A Test Using Takeover Legislation, 30 RAND J. ECON. 535, 545 (1999) (finding that the adoption of antitakeover statutes led to higher labor costs); Kenneth A.
to use the extent to which control is contestable as a standard measure of a firm’s quality of corporate governance.\(^{82}\)

For similar reasons, proxy contests also can play an important role in disciplining managers of NCS companies. U.S. law provides a variety of arrangements to regulate and facilitate such contests, including allowing insurgents to reimburse their expenses in the event that they gain control, providing shareholders with some access to the company’s proxy machinery, and preventing fraud and manipulation of voting.\(^{83}\) And Delaware courts have expressed their willingness to intervene when management has tried to adopt measures impeding proxy contests.\(^{84}\)

To be sure, some U.S. scholars and practitioners believe that exposing managers to control contests may be counterproductive and produce short-termism as well as wasteful distraction for management.\(^{85}\) But even those who support insulating boards from control contests share the views that the arrangements governing hostile bids and proxy challenges are important and that the choice of such arrangements can significantly affect—for better or worse—firm value.

In contrast, the arrangements governing control contests are largely irrelevant to CS companies. When a company has a majority
shareholder, or at least a controller with an effective lock on control, the management team supported by the controller cannot be replaced even in the absence of any impediments to hostile bids and proxy fights: the controller simply has enough votes to prevent the team’s removal.86 For the level of investor protection at CS companies, therefore, the presence of arrangements providing protection against a hostile takeover or a proxy fight is neither good nor bad, but simply irrelevant.87

2. Treatment by Governance Standards

We have seen that the arrangements governing control contests are important for NCS companies but not for CS companies. These arrangements should therefore get substantial weight in assessing the governance of NCS companies but not of CS companies. It follows that any governance-rating system that assigns a given weight to the arrangements that govern control contests, without distinguishing between CS and NCS companies, is bound to overweight this factor in assessing CS companies, underweight it in assessing NCS companies, or both.

Consider first RiskMetrics’s CGQ system. Regardless of a company’s ownership structure, this system assigns considerable weight to companies’ antitakeover arrangements. Antitakeover provisions are one of the eight categories of factors in the CGQ’s list of rated factors.88 The factors included in this category represent a significant fraction of the rated factors for both U.S. and non-U.S. firms: for U.S. firms, six out of more than sixty factors focus on poison pill features,

86 See Gilson, supra note 61, at 1667-68 (discussing the economic implications of inefficient controllers’ failure to relinquish control); Randall K. Morck et al., Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease?, in CONCENTRATED CORPORATE OWNERSHIP 319 (Randall K. Morck ed., 2000) (same).

87 Although the rules governing control contests do not affect significantly the level of investor protection at CS firms, it should be noted that such rules can affect founders’ initial decision whether to retain a control block. When control is contestable, entrepreneurs with substantial private benefits of control are less likely to relinquish control to the market when taking their companies public. See Lucian Arye Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control (Nat’l Bureau of Econ. Research, Working Paper No. 7203, 1999), available at http://ssrn.com/abstract=203110.

88 See RISKMETRICS, NON-U.S. CRITERIA, supra note 42, ¶ 34. The U.S. CGQ criteria refer to this category as “State of Incorporation.” See RISKMETRICS, U.S. CRITERIA, supra note 42.
while seven other factors focus on state antitakeover provisions. For non-U.S. firms, seven rating provisions out of fifty-five in the list of rated factors focus on features of the company’s poison pill and takeover defenses.

Although the CGQ systems attach substantial weight to antitakeover provisions in rating both U.S. and non-U.S. firms, in neither case do they distinguish between CS and NCS firms. In both cases, a company with a controlling shareholder can receive a perfect score on all the antitakeover variables, thus substantially increasing its overall governance ranking, even though the absence of defenses against a hostile bid is irrelevant in protecting outside investors in such a company.

Like the CGQ system, the Anti-Director Rights Index also gives significant weight to arrangements that could affect control contests. As noted earlier, it assigns considerable weight to three arrangements concerning shareholder voting: shareholders’ rights to call a special meeting, to vote by mail, and to vote without depositing shares. Although each of these arrangements can sometimes facilitate the wresting of control from the incumbent directors of an NCS company, these provisions are probably not the most important arrangements with respect to control contests; the Anti-Director Rights Index does not consider, for example, whether management can use a poison pill. But while the three arrangements given weight by the index can affect the extent to which control contests are facilitated and are thus relevant to assessing the governance of NCS companies, they have little relevance to assessing the governance of CS companies.

The Anti-Self-Dealing Index suffers from the opposite shortcoming. Unlike the Anti-Director Rights Index, it includes none of the governance arrangements that affect the extent to which control contests are facilitated or impeded. This feature does not undermine the index’s usefulness for assessing the governance of CS companies, but does undermine it in the case of NCS companies.

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89 See RiskMetrics, U.S. Best Practices, supra note 42, ¶¶ 27–32, at 18-21 (giving standards for poison pill adoption, shareholder approval, and trigger level, among other things); id. ¶¶ 40–46, at 26-27 (giving standards for state antitakeover law).
90 See RiskMetrics, Non-U.S. Criteria, supra note 42, ¶¶ 22–27, 34. Note that we do not have information concerning the relative weight that RiskMetrics assigns to each governance measure for purposes of generating a company’s ultimate CGQ score.
91 See La Porta et al., supra note 13, at 1122 tbl.1; see also supra subsection I.C.1.
92 See Djankov et al., supra note 13, at 454 tbl.1.
C. Voting Procedures

1. The Difference Between CS and NCS Companies

Corporate law statutes typically include detailed procedures that govern shareholder voting. These often-technical rules aim to facilitate the ability of a majority of shareholders to express their preferences by voting on certain issues. These rules affect the cost of casting a vote—for example, by allowing shareholders to vote by mail or proxy or by requiring shareholders to deposit their shares before voting. They also affect the extent to which voting outcomes accurately reflect the undistorted opinions of a majority of shareholders—for example, by regulating broker-voting and confidential-voting arrangements. In addition, the rules affect shareholders’ ability to act in a timely manner by calling a special meeting or by acting by written consent. Finally, voting rules can facilitate shareholders’ ability to influence management by specifying the conditions under which shareholder proposals must be included in the company’s proxy materials and the issues on which such proposals may be submitted.

The arrangements that govern shareholder voting can be quite important for investor protection at NCS companies. In these companies, shareholders’ power to elect directors and to vote on other fundamental issues has long been considered one of the key mechanisms for aligning management’s and shareholders’ interests. Although some of the rules governing shareholder voting may appear to deal mainly with technicalities, they can affect voting outcomes significantly. For example, a shareholder with a limited stake may not initiate a proposal to amend the company’s bylaws—even if the proposal is likely to win majority support—unless the shareholder has the right to have the proposal included in the company’s proxy materials. For similar reasons, shareholders may not bother to vote for a pro-

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93 For a review of the arrangements governing shareholder voting under U.S. federal law and state corporate statutes, see generally ALLEN ET AL., supra note 83, ch. 7.
94 See, e.g., Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Voting, 96 GEO. L.J. 1227, 1250 (2008) (discussing the ability of brokers to use their discretion to vote shares when proxy materials are not delivered).
posal that they support (or against a proposal that they oppose) if casting a vote is too costly or burdensome. Because some outside shareholders may decide not to vote their shares, brokers can have a significant influence on vote outcomes. Finally, confidential voting may make a difference when some shareholders fear retaliation if they vote against the company’s incumbent directors.

Given the foundational role of shareholder voting, some U.S. scholars and shareholder advisers believe that it is desirable to facilitate the ability of a majority of the shareholders to express their views. To be sure, some of those who support insulating boards from control contests hold the opposite view. But all commentators would agree that the arrangements governing shareholder voting are likely to be consequential, one way or another, especially with the recent increase of institutional-shareholder activism.

In CS companies, in contrast, the rules governing voting procedures are likely to be inconsequential. Controllers—unaffected by the collective action and free-rider problems that discourage action by dispersed shareholders—will exercise their voting power even without rules to facilitate shareholder voting. Furthermore, as long as a controller has enough votes to determine voting outcomes, even rules that facilitate voting by minority shareholders will not enable them to pass resolutions not favored by the controller.

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97 But see Roberta Romano, Does Confidential Proxy Voting Matter?, 32 J. LEGAL STUD. 465, 465-67 (2003) (reporting evidence that the adoption of confidential voting has no significant effect on voting outcomes).


99 See, e.g., Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 HARV. L. REV. 1735 (2006) (challenging the proposal to empower shareholders as not inherently value enhancing and arguing to retain the current regime of limited shareholder voting rights).

100 See, e.g., Jeffrey N. Gordon, Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy, 61 VAND. L. REV. 475, 477 (2008) (“The ability of . . . institutional actors to coordinate at a much lower cost changes the collective action equation and rejuvenates a shareholder activism that depends on voting as a credible mechanism for shareholder influence, even outside of a control contest.”); Kahan & Rock, supra note 94, at 1229 (“Never has voting been more important in corporate law.”).

101 We discuss majority-of-minority voting conditions in the next Section.
2. Treatment by Governance Standards

The CGQ rating system includes two factors concerning voting procedures—shareholders’ ability to call a special meeting and shareholders’ ability to act by written consent.\textsuperscript{102} Similarly, the Anti-Director Rights Index includes three components related to shareholder voting—voting by mail, voting without depositing shares, and the minimum ownership required to call a special shareholder meeting.\textsuperscript{103}

As explained above, shareholder voting arrangements are important for investor protection at NCS companies but not at CS companies. Measures that enable minority shareholders to call a special meeting, act by written consent, vote by mail, or vote without depositing shares are unlikely to provide effective constraints on opportunism by controlling shareholders. The fact that the CGQ system and the Anti-Director Rights Index give significant weight to voting procedures thus undermines their effectiveness in assessing governance in CS companies (or countries with a significant presence of CS companies).

In contrast to the CGQ rating system and the Anti-Director Rights Index, the Anti-Self-Dealing Index gives no weight to voting arrangements.\textsuperscript{104} That feature of the index does not affect its usefulness for assessing governance of CS companies. It does, however, undermine its effectiveness in assessing corporate governance at NCS companies (or countries in which NCS companies are common).

D. Allocation of Power Between the Board and Shareholders

1. The Difference Between CS and NCS Companies

In recent years, researchers and investors have paid significant attention to mechanisms strengthening shareholders’ ability to have their preferences followed by the board—that is, measures reducing the extent to which the board is insulated from shareholder wishes.\textsuperscript{105} Because the primary agency problem in NCS companies is that management’s interests may diverge from those of shareholders, arrange-

\textsuperscript{102} See RISKMETRICS, NON-U.S. CRITERIA, supra note 42, ¶¶ 30–31.

\textsuperscript{103} See supra text accompanying notes 49-54.

\textsuperscript{104} See Djankov et al., supra note 13, at 434 tbl.1.

\textsuperscript{105} See Bebchuk, supra note 98, at 870 (arguing that the current system of corporate governance, in which shareholder-initiated change is ruled out, demands reform); see also Lisa M. Fairfax, Making the Corporation Safe for Shareholder Democracy, 69 OHIO ST. L.J. 53, 55 (2008) (“Recently shareholders have launched an aggressive campaign to increase their voting power within the corporation.”).
ments making it difficult for the board to disregard shareholder preferences can enhance investor protection in such companies.

Indeed, the arrangements facilitating hostile takeovers and proxy fights, which we discussed in Section B, can be viewed as mechanisms that enable shareholders to have their preferences followed when they wish to sell the company or replace its management. The prospect of removal in a control contest or a proxy fight may induce directors to follow shareholder preferences on various other matters. Nonetheless, directors and officers may be more likely to follow shareholder preferences if shareholders can express those preferences on matters other than takeovers or director elections.106

Scholars, shareholder advisers, and policymakers have advocated a variety of measures that strengthen shareholders’ ability to influence board decisions. One set of proposals aims at enhancing shareholder influence on the “rules of the game”—the company’s governance arrangements.107 Examples include measures preventing the board from amending the bylaws (or at least shareholder-adopted bylaws) without shareholder approval, enabling shareholders to place proposals for governance changes on the company’s proxy statement, or encouraging the board to implement majority-passed shareholder proposals.

Other measures concerning the allocation of power between shareholders and the board are those that provide shareholders with a say on specific business decisions. For example, the so-called “say on pay” arrangements, which were adopted by legislation in the United Kingdom and Australia,108 as well as by some companies in the United States,109 enable shareholders to express their views on the company’s compensation policy. The same approach has been adopted in the

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106 See Bebchuk, supra note 98, at 856-61 (explaining why the power to replace management is insufficient to allow shareholders to have their wishes followed).


109 See Claudia H. Deutsch, Say on Pay: A Whisper or a Shout for Shareholders?, N.Y. TIMES, Apr. 6, 2008, at BU9 (“The votes on compensation may be nonbinding, but they are still popular.”); Gretchen Morgenson, Verizon Shareholders To Vote on Pay for Top Executives, N.Y. TIMES, Nov. 2, 2007, at C8 (reporting Verizon’s decision to put its executive-compensation arrangements to a shareholder vote).
United States by stock-exchange requirements that shareholders approve certain option plans.¹¹⁰ Finally, some measures empower shareholders to influence the composition of the board without a control contest. This category includes majority voting (enabling shareholders to oppose the election of underperforming directors even though there are no challengers on the ballot),¹¹¹ shareholder access to the ballot (empowering shareholders to use the company’s proxy statement to nominate a small number of directors),¹¹² and shareholder power to determine the size of the board or to fill board vacancies.

Some opponents believe that such measures may adversely affect outside investors in NCS companies.¹¹³ Yet there is no dispute that the allocation of power between boards and shareholders can have a substantial impact (for better or worse) on outside investors in such companies. These arrangements are likely to significantly influence corporate decisions by affecting the extent to which directors and officers are attuned to the preferences of the majority of shareholders.

In CS companies, in contrast, such arrangements are unlikely to have significant consequences. Given their ability to elect directors, controllers can usually have boards follow their preferences even without the measures designed to enable dispersed shareholders to overcome their collective action problems. Consider, for example, shareholders’ rights to have their governance proposals or board nominees appear on the company’s proxy materials for a shareholder meeting. Given the collective action problems that they face, dispersed share-


¹¹¹ For a comprehensive analysis of majority voting and the legal issues that this regime raises, see J.W. Verret, Pandora’s Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined, 62 BUS. LAW. 1007 (2007).

¹¹² See McDonnell, supra note 107, at 211-12 (reviewing recent efforts by institutional shareholders to propose bylaw amendments concerning director nomination).

¹¹³ See Iman Anabtawi, Some Skepticism About Increasing Shareholder Power, 53 UCLA L. REV. 561, 574 (2006) (arguing that increasing shareholder power might encourage shareholders to advance what is in their own—not the company’s—best interests); Stephen M. Bainbridge, Response, Director Primacy and Shareholder Disempowerment, 119 HARV. L. REV. 1735, 1749 (2006) (arguing that active shareholder involvement would disrupt the centralization of decision-making authority in the board of directors); Leo E. Strine, Jr., Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America, 119 HARV. L. REV. 1759, 1764-66 (2006) (expanding on the traditionalist view that the incentives of institutional investors differ significantly from those of individual stockholders).
holders may not engage in the costly process of soliciting proxies for their proposal or board nominee, even when such a proposal is likely to receive significant shareholder support. Controlling shareholders, on the other hand, typically have no difficulty making the board include their proposals or nominees on the company's ballot, and can in any event bring the proposals that they favor to a vote at the shareholder meeting even if, for some reason, those proposals were not included in the company's proxy materials.

Similarly, even without formal requirements of shareholder approval or advisory vote, directors in CS companies are unlikely to decide important issues, such as the CEO's compensation package, without getting the controller's implicit or explicit consent or at least a sense of the controller's views on the matter. Likewise, even without formal requirements to give weight to shareholder preferences expressed in a nonbinding proposal, a board effectively elected by a controlling shareholder is unlikely to disregard such shareholder's preferences (or at least those preferences that the controller chooses to express).  

Most importantly, whereas making directors follow the preferences of the majority of shareholders may enhance the protection of outside investors in NCS companies, it cannot be expected to do so in CS companies. In CS companies, outside investors' main concern is not that management will make decisions that diverge from the interests of the majority of the shareholders, but rather that management will make decisions that divert value from outside investors to the controlling shareholder. Given the nature of the agency problem in CS companies, measures that increase the board's adherence to the majority shareholder's preferences would exacerbate—rather than alleviate—the risk of controller opportunism. Thus, in CS companies, giving the majority of shareholders more power vis-à-vis the board would operate to weaken—not enhance—the protection of outside investors.

The measures that we considered earlier in this Section therefore cannot improve the protection of minority shareholders in CS companies. Indeed, they might even undermine it. By contrast, measures that insulate the board of an NCS company from following the preferences of the majority of shareholders might actually enable the board

\[114\] In some rare cases, a conflict may arise between the board and controlling shareholders. See Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1088-89 (Del. Ch. 2004) (approving board action to install a poison pill in order to prevent the controlling shareholder—who was suspected of fraud—from selling its control block), aff'd, 872 A.2d 559 (Del. 2005).
of a CS company to counterbalance the controller’s power and even constrain controller opportunism.\textsuperscript{115}

2. Treatment by Governance Standards

We now examine how the leading governance metrics treat measures that increase the power of the majority of shareholders to influence corporate decision making. The CGQ system grades positively the presence of four arrangements concerning shareholder power: requiring that shareholders annually ratify management’s selection of an auditor,\textsuperscript{116} requiring that shareholders vote on new poison pills and material amendments to existing ones,\textsuperscript{117} requiring shareholder approval for any bylaw amendments,\textsuperscript{118} and requiring responsiveness to shareholder proposals passed with majority support.\textsuperscript{119}

Although such measures may benefit outside investors in NCS companies, they are likely to have little practical relevance for CS companies. Consider the provisions calling for shareholders to ratify the choice of auditors or board actions to amend the bylaws. Even when directors of a CS company have the formal power to select auditors or amend the bylaws without shareholder approval, they are unlikely to make decisions in these matters that are opposed by the controller.\textsuperscript{120} Furthermore, even assuming that formal approval requirements would provide the controller with more power over auditor

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{115} This might be especially true for arrangements that make it difficult for a controller to fire directors quickly. While they might lead to entrenchment and exacerbate the problem of insider opportunism in an NCS company, measures that make it difficult for the majority of shareholders to fire the board might provide the board in a CS company with some independence from the controller.
\item \textsuperscript{116} See RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, supra note 42, ¶ 21, at 13 (“Shareholders should be permitted to ratify management’s selection of auditors each year.”).
\item \textsuperscript{117} See id. ¶ 22, at 13 (“Shareholders should be permitted to approve shareholder rights plans (i.e., poison pills).”).
\item \textsuperscript{118} See id. ¶ 32, at 17 (“Management should not be permitted to amend the bylaws without shareholder approval.”).
\item \textsuperscript{119} See id. ¶ 14, at 10 (“Management should take action on all shareholder proposals supported by a majority vote within 12 months of the shareholders’ meeting.”). Though the standard calls on the board to take action within twelve months, the action does not have to be implementation. Either partial implementation or issuance of an analysis explaining why the board does not implement seems to be within the take-action standard. What the standard opposes is just ignoring the passed proposal.
\item \textsuperscript{120} We should note, however, that there are rare cases in which boards decide to take active steps against controlling shareholders. See supra note 114.
\end{itemize}
\end{footnotesize}
selection or bylaw amendments, it is doubtful that such a change would enhance the protection of outside investors.

The CGQ rating system also grades positively several provisions that strengthen the ability of the majority of shareholders to determine who will serve on the board. These provisions include annual board elections, shareholder approval for changes in board size, shareholder power to fill board vacancies, shareholder power to act by written consent, and shareholder power to call a special meeting. These provisions—which we discussed earlier as facilitating control contests—also enhance shareholder influence over board composition in the absence of a control contest. Thus, they increase the extent to which directors are accountable to the majority of shareholders. But even though making directors more accountable to the majority of shareholders may constrain management’s opportunism in NCS companies, it cannot address controller opportunism in CS companies, and it may even undermine the ability and willingness of directors in such companies to serve as a check on the controller.

One of the six key provisions of the Anti-Director Rights Index focuses on shareholder power to call a special meeting. This power enhances the ability of the majority of shareholders to have their preferences followed. But having the power to call a special meeting does not materially affect the balance of power in CS companies. The fact that the Anti-Director Rights Index gives significant weight to the presence of an arrangement that is largely inconsequential for outside investors in CS companies undermines the index’s effectiveness as an accurate measure of investor protection in countries where such companies dominate.

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121 See RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, supra note 42, ¶ 5, at 7 (“Directors should be accountable to shareholders on an annual basis.”).
122 See id. ¶ 7, at 7 (“Shareholders have the right to vote on changes to expand or contract the size of the board.”).
123 See id. ¶ 16, at 10-11 (“Shareholders should be given an opportunity to vote on all directors selected to fill vacancies.”).
124 See id. ¶ 30, at 16 (“Shareholders should be permitted to act by written consent.”).
125 See id. ¶ 31, at 16-17 (“Shareholders should be permitted to call special meetings.”).
E. Allocation of Power Between the Majority and the Minority

1. The Difference Between NCS and CS Companies

We have thus far assumed that empowering shareholders as a group to make a decision means that a majority of shareholders will have the effective power to make the decision. But whether the majority of shareholders can exercise the power held by shareholders generally depends on the governance arrangements in place. Corporate law or the company’s governance arrangements can limit the majority’s ability to exercise shareholder voting power and can empower the minority to make certain decisions or exercise veto power over others. A corporate action may require supermajority approval, for example, or even approval by a majority of the minority shareholders. We will refer to any arrangement that prevents the majority from exercising the full power that shareholders acting unanimously would wield as an arrangement that empowers minority shareholders.

The impact of measures that limit the power of the majority of shareholders depends on the company’s ownership structure. This variance is again due to the fundamental difference between CS and NCS companies with respect to the agency problems that confront outside investors. In NCS companies, because the main agency problem is opportunism on the part of management, and because shareholders face collective action problems, arrangements that make it difficult for the majority to act may undermine shareholders’ ability to constrain insider opportunism.

In contrast, in CS companies, making it easier for the majority of shareholders to have its way cannot alleviate, and may exacerbate, the key concern of controller opportunism. Indeed, one strategy for addressing this agency problem is constraining the voting power of the majority of shareholders or empowering minority shareholders as a group to influence certain decisions. Delaware case law, for example, encourages controllers to subject self-dealing transactions to a majority-of-minority vote. And some jurisdictions condition self-dealing transactions on the approval of a majority of disinterested shareholders.

126 Specifically, a majority-of-minority requirement shifts the burden to the minority to show that the transaction is unfair. See Kahn v. Lynch Commc’n Sys., 638 A.2d 1110, 1117 (Del. 1994) (“[A]n approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of
2. Treatment by Governance Standards

The CGQ system disfavors two arrangements that require super-majority approval for fundamental changes: the supermajority voting requirement for mergers and the supermajority requirement for charter amendments. This negative treatment of supermajority voting arrangements may be sensible for NCS companies, and its presence may reflect the NCS mindset of those designing the CGQ system. In NCS companies, supermajority requirements can insulate the board from shareholder intervention and serve as an antitakeover device. Indeed, a study coauthored by one of us that focused on NCS companies in the U.S. market finds that such supermajority requirements are negatively correlated with firm value.

Supermajority voting arrangements are likely to have different effects in CS companies, however. When the company has a controlling shareholder, these arrangements limit the controller’s ability to pass proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.”).

127 See FINANCIAL SERVICES AUTHORITY HANDBOOK § 11.1.7(4) (2007), available at http://fsahandbook.info/FSA/handbook/LR/11/1.pdf (requiring companies listed on the London Stock Exchange to ensure that the related party does not vote on the resolution and to take reasonable steps to ensure that the related party’s associates do not vote); Pierre-Henri Conac et al., Constraining Dominant Shareholders’ Self-Dealing: The Legal Framework in France, Germany, and Italy 10-12 (European Corp. Governance Inst., Working Paper No. 88/2007, 2007) (describing how the legal systems in France, Italy, and Germany regulate self-dealing transactions and noting that in France self-dealing transactions require an ex ante approval by the board of directors and ratification at the annual shareholder meeting). But see Gerard Hertig & Hideki Kanda, Related Party Transactions, in THE ANATOMY OF CORPORATE LAW, supra note 11, at 101, 122 (noting that the requirement for a minority vote on controller transactions has not been adopted by most major jurisdictions).

128 See RISKMETRICS, NON-U.S. INDICATOR DEFINITIONS, supra note 42, ¶¶ 28–29, at 15-16 (“A simple majority vote should be required to amend the charter/bylaws and to approve mergers or business combinations.”). Note that we do not consider here the optimal scope of minority empowerment—that is, what issues should be left for the minority to vote on. Rather, we claim that empowering shareholders as a group to vote cannot enhance minority protection in CS companies.

129 See Bebchuk et al., supra note 22, at 784-85 (finding a negative correlation between these arrangements and firms’ Tobin Q). This study thus included these arrangements in its entrenchment index, which subsequent researchers have used as a measure of corporate governance. See, e.g., Amy Dittmar & Jan Mahrt-Smith, Corporate Governance and the Value of Cash Holdings, 83 J. Fin. Econ. 599, 603 (2007) (using degree of managerial entrenchment caused by takeover defenses and large-shareholder monitoring as measures of corporate governance).
resolutions, thereby empowering minority shareholders and potentially limiting controller opportunism.\textsuperscript{130}

The Anti-Director Rights Index does not include provisions for supermajority voting or similar arrangements that empower minority shareholders. The Anti-Self-Dealing Index, however, does take into account one type of minority-empowering provision—a requirement that related-party transactions be approved by a majority of “disinterested” shareholders.\textsuperscript{131} Such majority-of-the-minority votes, which are not given weight in the CGQ system, should be taken into account in assessing investor protection in CS companies. Such requirements, however, are not practically relevant to the protection of outside investors in NCS companies.

The arrangements that we have thus far discussed concern decisions that are not “divisible”—that is, either the majority or the minority of the shareholders will have its way. With respect to director elections, however, some arrangements provide minority shareholders with partial power, enabling these shareholders to influence the selection of some—but not all—directors. Cumulative voting, for example, enables minority shareholders to elect some directors even against the controller’s wishes.\textsuperscript{132} Both the CGQ and the Anti-Director Rights Index treat cumulative-voting arrangements favorably.\textsuperscript{133}

\textsuperscript{130} Supermajority voting requirements will fail to protect the minority when the controller has enough voting power to overcome even the supermajority requirement. For example, a requirement for a seventy percent vote would not contain controllers holding eighty percent of the voting power.

\textsuperscript{131} See Djankov et al., supra note 13, at 434 tbl.1.

\textsuperscript{132} Cf. Bernard Black et al., Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness: Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea (2000), reprinted in 26 J. Corp. L. 537, 564-65 (2001) (recommending that Korea strengthen cumulative voting to protect minority shareholders); Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 1911, 1947-49 (1996) (describing the virtues of cumulative voting as including enhancing shareholder access to company information, increasing the independence of directors from managers, and supporting the idea that directors have a primary duty to shareholders and not to officers); Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 Colum. L. Rev. 124, 127-28 (1994) (arguing that large institutional shareholders should advocate cumulative-voting systems and suggesting that cumulative-voting systems improve corporate governance and benefit overall shareholder welfare).

\textsuperscript{133} See RiskMetrics, U.S. Best Practices, supra note 42, ¶ 8, at 8 (“Shareholders should have the right to cumulate their votes for directors.”); supra text accompanying note 32.
Assessing the advantages and disadvantages of cumulative voting in CS and NCS companies is outside the scope of this Article. For our purposes, what is most important is that the impact of cumulative voting on investor protection could well depend on ownership structure. Cumulative voting, we suggest, is more important for investor protection in CS companies than in NCS companies.

In an NCS company, a challenger enjoying the support of a majority of the outside shareholders will be able to get board seats (indeed, all the board seats up for election), even under the winner-takes-all system of elections. Moreover, in an NCS firm, cumulative voting may impede a challenger’s ability to quickly replace the incumbent board by giving minority shareholders (who may be aligned with the incumbents) the ability to elect some board members. In contrast, in a CS company, a challenger enjoying the support of minority shareholders will not be able to get any board seats without cumulative voting. Thus, even if one takes the view that cumulative voting is desirable in both CS and NCS companies, its value, and thus the weight given to its presence, should differ between CS and NCS companies.

F. Director Independence

1. The Difference Between CS and NCS Companies

Legal systems around the world increasingly require boards to have a significant number of independent directors. These independent directors are often assigned the task of deciding matters that raise potential conflicts of interest between corporate insiders and outside investors.

Independent directors may be less willing to go along with insider opportunism in both CS and NCS firms. Indeed, a growing body of empirical research shows that independent directors who serve on the

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board or on certain key committees could enhance investor protection even in countries where concentrated ownership is prevalent.136

But even though independent directors may improve governance at both NCS and CS companies, assessing director independence should proceed differently in these two types of companies. The critical question is from whom should directors be independent? In NCS companies, the principal concern is managerial opportunism, so it is important to ensure directors’ independence from the company and its management. Indeed, a director affiliated with a significant outside blockholder may be especially likely to act independently of management, because such a director may have stronger incentives to enhance share value by monitoring management effectively and constraining insider opportunism.

In contrast, the principal concern in CS companies is controller opportunism, so assessment of their governance should focus on director independence from the controller. Ties between directors and the controller (or entities affiliated with it) may make the directors less effective in limiting controller opportunism.

To be sure, under the assumption that the controlling shareholder dominates the company, a director’s close ties with the company would normally imply her lack of independence from the controller as well. But the opposite does not hold: independence from the company does not necessarily imply independence from the controller. Seemingly independent directors may depend, for example, on another business controlled by the company’s controlling shareholder. In sum, when one evaluates the governance of CS companies, significant weight should be given to director independence from (or dependence on) the controlling shareholder.

2. Treatment by Governance Standards

Both the Anti-Director Rights Index and the Anti-Self-Dealing Index give no weight to director independence, thus overlooking a factor that is relevant for both CS and NCS companies. In contrast, the

136 See Black et al., supra note 2, at 407-10 (finding that, even in developing countries with emerging markets, there is a strong connection between board independence and market value); Jay Dahya et al., supra note 46, at 96 (conducting a study of firms in twenty-two countries and concluding that a dominant shareholder in a country that provides little legal protection for shareholders can increase the market value of a firm by electing independent directors).
CGQ rating system does attach significant weight to the presence of independent directors and their decision-making role.

The CGQ system grades boards with at least a two-thirds membership of independent directors and boards with nominating, compensation, and governance committees consisting solely of independent directors. In evaluating director independence, however, the CGQ rating system focuses almost exclusively on ties between directors and the firm on the board of which they serve. In discussing director independence for purposes of the CGQ rating system, RiskMetrics notes directors’ “adequate independence from management” but does not explicitly refer to director independence from controlling shareholders.

RiskMetrics also provides various measures of independence that seek to cover a range of possible links between a director and the company, but it does not cover to the same extent the possible relationships between a director and a controlling shareholder. Under RiskMetrics’s definition of independence, for example, a company employee would likely be defined as an “inside director,” but an employee of another company that the controller owns would not be so defined. Given the prevalence of business groups around the world, this failure to take into account directors who depend on other firms controlled by the company’s controlling shareholder is problematic. Similarly, under RiskMetrics’s definition of independence, a controller sitting on the board would be defined as an inside director if she has more than fifty percent of voting power but not, for example, if she has forty-five percent of voting power.

Several other components of the CGQ system reinforce the impression that its designers were mostly concerned with director independence from management, not controlling shareholders. The CGQ system includes several provisions that address the relationship between the board and the CEO: former CEOs are discouraged from serving on the board; the positions of CEO and board chair should be

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137 **RiskMetrics, Non-U.S. Indicator Definitions, supra note 42, ¶¶ 1–4, at 4-6.** Note that neither the Anti-Director Rights Index nor the Anti-Self-Dealing Index lists director independence as one of the criteria for evaluating investor protection. These indices thus assign no weight to a factor that, albeit in different ways, could be useful for both CS and NCS companies.

138 **Id. ¶ 1, at 4-5.**

139 **Id. (designating three categories of directors—inside, affiliated, and independent—and emphasizing the need for board independence from management).**

140 **Id.**

141 **Id.**
separated; and directors are encouraged to meet without the CEO present.\footnote{Id. ¶¶ 11–12, at 53.} The view underlying these provisions is that the CEO is the key, powerful insider who needs to be monitored by directors.\footnote{See Gordon, supra note 134, at 1472 (“[A]n increasingly important element of the independent board’s monitoring role came to be the appropriate use of market signals . . . in CEO termination decisions.”).} But the situation in CS companies run by professional managers is often different.\footnote{A “professional CEO” connotes a CEO who is neither the controlling shareholder nor related in any meaningful way to the controlling shareholder.} In such companies, the key, powerful figure whose opportunism needs to be constrained may well be the controller. Where this is the case, it is unlikely that having CEO-chair separation with the controller serving as the chair will enhance the protection of outside investors.

G. Arrangement Governing Potential Value Diversion

1. The Difference Between CS and NCS Companies

An important set of governance arrangements directly regulates actions and transactions that might divert value from outside investors to corporate insiders. As we explained earlier, controlling shareholders may divert value from outside investors by using channels different from those through which NCS company insiders might attempt to do so. Accordingly, limiting insider-value diversion effectively may require different sets of arrangements in NCS and CS companies.

Specifically, assessing the governance of CS companies requires close attention to the arrangements governing freezeouts, related-party transactions with the controller or entities affiliated with it, and taking corporate opportunities.\footnote{Establishing a case against controlling shareholders for taking corporate opportunities might be a complicated task, especially when the controller is another corporation that operates within the same industry. See, e.g., Sinclair Oil Corp. v. Leven, 280 A.2d 717, 722 (Del. 1971) (finding that an international oil company did not usurp corporate opportunities that belonged to its Venezuelan subsidiary).} These types of actions are relatively less important in NCS companies, as professional managers commonly have fewer opportunities to engage in related-party transactions or to take corporate opportunities on a large scale.\footnote{Management can also divert value from shareholders by buying a public company from its outside investors and taking it private in a management buyout. See generally Louis Lowenstein, Management Buyouts, 85 COLUM. L. REV. 730 (1985).} In contrast, an assessment of the governance of NCS companies should...
assign an increased weight to the arrangements governing executive compensation.\textsuperscript{147}

2. Treatment by Governance Standards

Beginning with the modes of value diversion that are relatively more important for NCS companies, we should note that more than ten components of the CGQ system—almost one-fifth of all the components—deal with executive compensation and stock ownership by directors and officers.\textsuperscript{148} Although this approach may be appropriate for NCS companies, where executive compensation is a central issue, it is inappropriate for CS companies, where concerns about value diversion through executive compensation typically do not occupy such a central role. It is especially inappropriate in CS companies with a professional manager who is not affiliated with the controller, where one can expect the controller to monitor executive pay and constrain excessive pay arrangements.

Turning to CS companies, it is important to note that the CGQ system assigns little weight to the regulation of freezeouts and related-party transactions involving controlling shareholders. The non-U.S. system has only one provision related to this important set of insider actions, and it applies only to transactions involving the CEO.\textsuperscript{149} In CS companies, however, the related-party transactions that deserve most attention are those involving the controller (directly or indirectly).

Furthermore, the CGQ system’s provisions do not focus on the scope of related-party transactions. The provisions presumably reflect the view that the sheer existence of such transactions is a sign of governance problems. But in many CS companies, especially those that are part of a business group or a holding company structure, some related-party transactions are common, and the mere existence of such transactions is not an important signal of governance failures. What is important for assessing the quality of governance in such companies is the scope of self-dealing transactions and the mechanisms for monitoring them. These considerations further reinforce the conclusion that the CGQ system does not provide a good measure of governance problems in CS companies.

\textsuperscript{147} When the controller is hired by the firm, her executive compensation could be classified as controller self-dealing.\textsuperscript{148} \textsuperscript{riskmetrics}, Non-U.S. Indicator Definitions, supra note 42, ¶¶ 3, 35–44, at 6, 19-23.\textsuperscript{149} \textit{Id.} ¶ 17, at 11.
In contrast, the Anti-Director Rights Index and the Anti-Self-Dealing Index do pay significant attention to potential value diversion by controllers, but they pay little attention to executive compensation. One of the six key components of the Anti-Director Rights Index concerns oppressed-minorities mechanisms, broadly defined to include measures that grant minority shareholders rights either to challenge controller opportunism in court or to have their shares redeemed in the presence of such opportunism.\textsuperscript{150} The Anti-Self-Dealing Index, in turn, focuses exclusively and in detail on measures that regulate related-party transactions.\textsuperscript{151} Thus, these two indices, and especially the Anti-Self-Dealing Index, pay close attention to value-diversion channels that are important for CS companies,\textsuperscript{152} but they tend to overlook executive-compensation issues that are relatively important for NCS companies.

This conclusion is especially strong in the case of the Anti-Self-Dealing Index. This index focuses on the regulation of a paradigmatic related-party transaction between a public company and a private company owned by the public company’s controlling shareholders.\textsuperscript{153} The constraints on such a transaction might well be vital for CS companies, but they are far less important for assessing governance at NCS companies. Thus, although the index was intended to serve, and has been used, as a metric for investor protection around the world, its design renders it ineffective as a measure of the quality of investor protection in NCS companies.

III. GOING FORWARD

As we stressed at the outset, we do not wish to undermine the important project of developing objective metrics for measuring the quality of corporate governance around the world; we would like to see the project pursued more effectively, not abandoned. Nor do we wish to limit ourselves to pointing out the shortcomings in past work

\textsuperscript{150} La Porta et al., supra note 13, at 1122 tbl.1.

\textsuperscript{151} See supra text accompanying notes 57-58.

\textsuperscript{152} We should note here that, although the title of this provision refers to “minority oppression,” its definition is so broad that it could perhaps also include remedies that would be available for shareholders at NCS companies. See Spamann, supra note 14, at 9 (referring to this provision as being “extremely broad”).

\textsuperscript{153} See Djankov et al., supra note 13, at 432-33 (setting forth an example of a stylized self-dealing transaction and using the Anti-Self-Dealing Index to measure whether a hypothetical controlling shareholder will be able to get away with the transaction).
by academics and practitioners; rather, we seek to identify ways to improve the development of governance metrics.

In Section A, we discuss the proper approach for evaluating companies’ governance arrangements. In Section B, we consider the desirable approach for assessing countries and legal systems.

A. Evaluating Companies

Our thesis is that different sets of standards should be used to evaluate the governance of CS and NCS companies. In this Section, we outline several key elements of these separate rating systems.

We fully recognize that, as noted in the Introduction, some companies belong to a gray area and cannot be easily classified as CS or NCS. These are companies in which a shareholder has a block large enough to make control difficult to contest but not large enough to make control de facto uncontestable. For these companies, it would be necessary to appropriately combine elements of the two rating systems that we discuss below. We defer this additional task to another day and focus instead on the more fundamental task: putting forward standards for assessing corporate governance at the large number of public companies that can easily be classified as either a CS or an NCS company.\footnote{Another complication arises because a company may change from one type to another over time. Thus, an NCS company might turn into a CS company if a majority of shareholders accepts a tender offer for its shares. When a controlling shareholder emerges, the company’s governance and the value of minority shares will have to be assessed according to the CS standard. Thus, shareholders trying to estimate the value of minority shares in the event of a takeover would do well to use a CS standard rather than the NCS standard applicable to the company pretakeover. Governance arrangements can also affect the transition from one ownership structure to another. See generally Lucian Arye Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control (Nat’l Bureau of Econ. Research, Working Paper No. 7203, 1999), available at http://ssrn.com/abstract=203110. Finally, governance arrangements such as supermajority vote requirements also can affect the percentage ownership that would allow a shareholder to become a controlling shareholder.}

We begin by outlining the basic elements necessary for assessing corporate governance at NCS firms and then discuss the necessary elements for assessing CS firms. We do not purport to provide a complete and fully detailed account of the two evaluation systems. Rather, we identify the type of governance arrangements on which each evaluation system should focus.
I. NCS Companies

a. Control Contests

As we explained earlier, an active market for corporate control has an important effect on management of NCS companies. Any system for assessing the corporate governance of NCS companies should thus assign substantial weight to the arrangements governing hostile takeovers and proxy fights, even though scholars and practitioners may differ in their views on which arrangements concerning such control contests are optimal.

b. Shareholder Voting Procedures

In NCS companies, shareholder voting power is one of the primary mechanisms for aligning the interests of directors and officers with those of shareholders. The extent to which shareholders’ voting power is not only formal but also effective depends on the detailed set of procedures that governs shareholder voting. A system for evaluating corporate governance at NCS companies should thus give significant weight to the existence of arrangements that facilitate the ability of a majority of shareholders to express its will on certain key issues through voting. Thus, among other things, governance evaluation at NCS companies should give weight to arrangements such as shareholder ability to (1) vote by mail, proxy, or written consent, (2) vote without depositing shares, (3) place governance proposals and board nominees on the company’s ballot, and (4) be protected by confidential voting.

c. Allocation of Power Between the Board and Shareholders

In addition to voting procedures, governance in NCS companies depends significantly on the scope of shareholders’ voting power—or what shareholders can vote on. A system for evaluating corporate governance at these companies should therefore take into account such issues as shareholders’ effective power to initiate governance changes, as well as the existence of requirements for a shareholder vote on fundamental transactions, firm-governance arrangements, and manager-compensation packages. Again, there may be room for reasonable disagreement about the most desirable allocation of power between shareholders and the board. But there is a good basis for agreement that the nature of the arrangements governing such allocation should be given weight in assessing the governance of NCS firms.
d. Executive Compensation

Suboptimal compensation arrangements can be a main channel for insider opportunism at NCS companies. Therefore, a system of governance assessment for these companies should consider the extent to which compensation arrangements are consistent with the goal of enhancing firm value. The assessment could include not only the substantive aspects of compensation arrangements but also the process for setting executive-pay schemes—for example, the composition of the compensation committee, the committee’s decision-making process, and the requirements (if any) for shareholder ratification of option plans or other pay package components. And while any evaluation of governance in NCS companies should pay some attention to the arrangements governing self-dealing transactions with officers and directors, the weight given to self-dealing should be less than that accorded in a system that evaluates governance in CS companies.

e. Director Independence

Director independence can enhance the protection of outside investors at both CS and NCS companies. A company’s ownership structure, however, determines the type of relationships that should be considered when assessing director independence. In NCS companies, that assessment should focus on the ties between directors and management, and (assuming management’s control over the company) the ties between directors and the company on whose board they serve. In contrast, ties between directors and outside blockholders who are not themselves tied to management might be beneficial, making directors more attentive to, and focused on, shareholder interests.

2. CS Companies

a. Allocation of Power Between the Majority and the Minority

In CS companies, the distribution of power among shareholders is important. Is the majority able to wield all the power reserved for shareholders, or does the minority have a say? One important way to protect outside investors at CS companies is to empower minority shareholders to block certain corporate transactions and other actions. In particular, such power might be desirable when the interests
of the controller and minority outside investors diverge.\textsuperscript{155} A system for rating corporate governance at CS firms should thus pay attention to arrangements that empower minority shareholders (or limit the power of the majority shareholders) with respect to certain decisions—for example, the extent to which minority shareholders are in a position to block related-party transactions between the controller and the company. In addition, assessments of governance in CS companies should take into account the existence of arrangements, such as cumulative voting, that provide minority shareholders with the ability to influence board composition.

b. \textit{Self-Dealing and Freezeouts}

In CS companies, self-dealing transactions that involve controlling shareholders or their affiliates provide a principal channel for diverting value from the firm and its outside shareholders. The risk of value diversion through self-dealing is exacerbated when dominant families control a relatively large number of public companies through pyramids and other similar structures. To be sure, the quality of the mechanisms that govern self-dealing should not serve as the exclusive metric for evaluating corporate governance at CS companies.\textsuperscript{156} Yet a system for evaluating corporate governance at such firms should assign considerable weight to the mechanisms—such as disclosure, voting requirements, and fiduciary duties—that govern self-dealing transactions in general and “going private” freezeouts in particular. Moreover, the relative weight of these mechanisms when assessing the overall governance of CS firms should be significantly higher than their weight when assessing the governance of NCS firms.\textsuperscript{157}

\textsuperscript{155} In NCS firms, in contrast, arrangements that require more than a standard majority vote would tend to protect managers, undermine their accountability to the majority of shareholders, and even discourage hostile takeovers. A system for evaluating governance at NCS firms should thus treat negatively any supermajority voting requirements.

\textsuperscript{156} As we explained earlier, the Anti-Self-Dealing Index focuses exclusively on measures for regulating controlling shareholders’ self-dealing transactions. See \textit{supra} subsection I.C.2.

\textsuperscript{157} Other types of arrangements that should be evaluated in CS firms are those that prevent controllers from selling their control block when the sale would likely increase the diversion of value from the firm to the new controller. See, e.g., Einer Elhauge, \textit{The Triggering Function of Sale of Control Doctrine}, 59 U. CHI. L. REV. 1465, 1473 (1992) (“[C]ourts have sometimes held controlling shareholders liable when a control transaction effectively ‘diverts’ a corporate or collective opportunity.”).
c. Director Independence

As stressed earlier, independent directors can enhance investor protection in both CS and NCS companies. In CS companies, however, directors can be genuinely independent only when they have no ties to the controlling shareholder or its affiliates. Thus, an assessment of director independence that focuses only on ties between directors and the company on the board of which they serve may miss the mark. Moreover, in evaluating director independence at CS companies, one should also consider the extent to which the controller can influence the process of nominating and electing independent directors. Relatedly, CS companies should get little credit, if any, for having directors meet for “executive” sessions in which management is not present but the controller or its representative is.

d. Control Contests

Because control in CS companies is not contestable, any assessment that credits CS companies for the presence of arrangements facilitating control contests would introduce substantial noise and might make overall governance scores less accurate and informative. The absence or unavailability of a poison pill, for example, has virtually no impact on the likelihood of a hostile takeover in a company with a majority shareholder. A system for rating CS companies should therefore not include elements based on the presence of arrangements that facilitate or impede hostile bids and proxy contests.\(^{158}\)

e. Shareholder Voting Procedures

The procedures governing shareholder voting are substantially less important for CS than for NCS companies. To be sure, there is no good reason why even CS companies should have procedures that impede, discourage, or distort voting by outside shareholders. Given the ability of a controller to determine the outcome of votes, however, the absence of such procedures does not necessarily improve the protection of outside investors in CS companies. Thus, any methodology for assessing governance in CS companies should generally assign little weight (if any) to arrangements governing voting procedures, such as shareholder ability to vote by mail, proxy, or written consent; share-

\(^{158}\) The presence of such arrangements—and especially those included in the by-laws or charter—might have some indirect impact to the extent that a CS firm might become an NCS firm in the future.
holder right to vote without depositing shares and by secret ballot; and shareholder ability to place proposals on the company’s proxy statement.

The discussion above focuses on matters subject to a majority-vote rule. As we explained earlier, however, shareholder voting can play a valuable role in enhancing minority protection at CS companies when the requirement for shareholder approval is combined with measures to empower the minority, such as majority-of-minority voting requirements. In the case of such votes, procedures that facilitate undistorted voting by minority shareholders may well be consequential, and their presence or absence should be duly taken into account when evaluating governance.

d. Allocation of Power Between Boards and Shareholders

In CS companies, measures that expand the scope of issues on which shareholders can vote or strengthen the ability of the majority of shareholders to influence board decisions would be unlikely to enhance the protection of outside investors. Indeed, as we explained earlier, measures that insulate directors from the controller—for example, making it difficult to fire directors—may sometimes enhance the protection of minority shareholders at CS companies. It follows that a system for evaluating governance in CS companies should not give significant positive weight to the presence of arrangements, such as requirements for a shareholder ratification of auditor selection or shareholder advisory vote on executive compensation, that expand the formal scope of shareholder voting power.

g. Executive Compensation

As explained earlier, even though excessive-compensation arrangements could be an issue in CS companies, they are probably less important in such companies than in NCS companies. Accordingly, in evaluating corporate governance, the substantive and procedural limitations on executive compensation should occupy a less central role in CS companies than in NCS companies.

159 See supra text accompanying notes 68-69 (noting a controller’s interest in maximizing shareholder value).
h. **Controlling Minority Shareholders**

Controlling shareholders may use arrangements such as pyramids, dual-class shares, and other mechanisms to separate cash-flow and voting rights. When such arrangements are in place, the controller can have an absolute lock on control even though it has less—and sometimes substantially less—than half of the company’s cash flows. Other things being equal, the interests of the so-called controlling minority shareholders overlap with those of outside investors to a lesser degree than do the interests of a controlling majority shareholder. As a result, concerns about insider opportunism should increase when control is locked in the hands of controlling minority shareholders. Indeed, evidence indicates that firm value decreases as the difference between equity ownership and voting control increases.

A system of governance assessment at CS companies should thus take into account the presence of controlling minority shareholders and the degree to which voting rights and cash-flow rights are separated.

B. **Evaluating Legal Systems**

Our analysis has thus far focused on the appropriate approach for comparing the quality of corporate governance across firms. But another important task for academics, investors, and policymakers is to evaluate the extent to which countries differ in terms of the level of protection that they provide—through their legal rules and institutional arrangements—to outside investors in their public firms.

Thus far, research conducting cross-country comparisons has generally been based on a single standard for measuring countries’ levels of investor protection. To date, there have been more than one hundred cross-country studies based on either the Anti-Director Rights Index or

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160 For an analysis of these devices and their corporate-governance implications, see Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity*, in *Concentrated Corporate Ownership*, supra note 86, at 295.

161 The term “controlling minority” was introduced by Bebchuk et al., *id.* This study shows that agency costs can be expected to increase, and to do so at an increasing rate, with declines in the fraction of cash-flow rights owned by the controlling minority shareholder.

the Anti-Self-Dealing Index. As in the case of companies, however, our analysis suggests that the use of a single metric is inappropriate.

Because many rules and arrangements have different effects on investor protection in CS and NCS companies, a given country may provide outside investors in CS and NCS companies with different levels of protection. For example, one country may do much better than others in protecting outside investors in NCS companies but do a relatively poor job of protecting them in CS companies. Researchers, investors, and policymakers, we suggest, should not assign each country a single score for its quality of investor protection, but rather two scores: one for the quality of protection accorded to investors in NCS companies (the country’s NCS score) and one for the quality of protection accorded to investors in CS companies (the country’s CS score).

At first glance, it might appear that assigning two different scores should be only an intermediate step, followed by combining the two into a single score representing the country’s overall quality of investor protection. One could, for example, simply average the country’s NCS and CS scores. Such an approach, it might be argued, would provide a single, easy-to-use metric for cross-country comparisons while taking into account the relationship that we have analyzed between ownership structures and corporate governance. For many important purposes, however, keeping two separate scores and not combining them would be far more useful for researchers, investors, and policymakers.

Consider first a researcher or policymaker who wants to know how two countries compare in their overall level of investor protection. The combined measure considered above could be misleading to the extent that controlled and widely held structures are not equally represented in each country’s public equity market. For example, if most of the countries’ companies have controlling shareholders, basing the comparison on the countries’ CS scores would be more appropriate than basing it on the countries’ combined CS and NCS scores. If NCS companies dominate in both countries, basing the comparison on NCS scores would be more appropriate. And if NCS companies dominate in one country and CS companies dominate in the other, then the comparison may be best when based on comparing the NCS score of the first country with the CS score of the second.

Next, consider a researcher or an investor who is interested in only a limited subset of particular companies. In this case, it would be

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163 See supra notes 5-7 and accompanying text.
best to use the country’s CS score to examine companies that have a controller and its NCS score to review companies that do not. Clearly, even if NCS companies dominate in a country, using the country’s NCS score to analyze investor protection in a set of CS companies would be inferior to using the country’s CS score and vice versa. Accordingly, a researcher comparing firms from around the world and seeking to control for the level of investor protection in each firm’s country should use a country’s CS score as a control for a CS firm in this country and the country’s NCS score as a control for an NCS firm in this country.

Consider now researchers or policymakers seeking to improve a country’s level of investor protection or to track improvements in this level over time. As our discussion above indicates, looking separately at each of the CS and NCS scores would commonly provide a better picture than using a single, combined measure. For example, an increase in the country’s combined CS and NCS score would not represent a meaningful improvement to the extent that it resulted from an increase in the country’s NCS score when most of the country’s public companies have controlling shareholders.

Similarly, those interested in the political economy of investor protection would do well to keep a country’s CS and NCS scores separate. Consider a researcher or a policymaker who is interested in understanding the forces that produced a country’s current arrangements and identifying possible impediments to reform. The country’s existing ownership structures determine what type of insiders—controllers of CS companies or professional managers of NCS companies—wield more power in the country’s interest-group politics. Controllers and professional managers, in turn, do not focus on the same corporate-governance issues.

In a country where CS companies dominate, the corporate insiders with the most political power—controlling shareholders—may well care more about the country’s protection of outside investors at CS firms than at NCS firms; they thus may be more open to reform that

\footnote{For a detailed analysis of the impact of political economy on corporate governance, see Lucian A. Bebchuk & Zvi Nemtsov, *Investor Protection and Interest Group Politics*, 22 REV. FIN. STUD. (forthcoming 2009).

\footnote{Controlling shareholders may have substantial political power when they are wealthy families that control a large number of public companies through pyramids. See, e.g., Randall Morck et al., *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 655 (2005) (arguing that disproportionate control of large areas of an economy can result in “greatly amplified political influence”)}.
will increase the country’s NCS score but not its CS score. Conversely, in a country where NCS companies dominate, professional managers, who wield significant political power, may well be more focused on the country’s NCS score.

It is worth noting, however, that even though it might be easier politically to adopt measures to improve the NCS score of a country in which CS companies dominate, such a reform would be less useful for the country’s overall investor protection and thus for the development of its financial markets. Conversely, even though it might be more politically palatable to adopt reforms increasing the CS score in a country dominated by NCS companies, such reforms would have limited consequences for the country’s overall investor protection. Clearly, it is important to keep a country’s NCS and CS scores separate in order to obtain a good understanding of all the forces shaping that nation’s investor-protection system and impeding reforms in this area.

We conclude that researchers, shareholder advisers, and policymakers should not overlook the rich and useful information provided by keeping separate scores for a country’s level of protection for investors in CS and NCS companies. Doing so is vital for assessing how well the country’s system protects investors in particular companies or in public companies generally, how this protection has evolved over time, what forces have led to prevailing arrangements, and which reforms would be more or less difficult to obtain.

CONCLUSION

We have shown in this Article that any attempt to assess the governance of public firms around the world should depend critically on ownership structure. Some arrangements that benefit outside investors in companies without a controlling shareholder are either practically irrelevant or even counterproductive in the presence of a controlling shareholder, and vice versa.

Because of this fundamental difference between companies with and without a controlling shareholder, any governance-rating methodology that applies a single metric to companies or countries worldwide is bound to produce an inaccurate or even distorted picture. We have demonstrated that this problem afflicts—and undermines the effectiveness of—the CGQ system and the Anti-Director Rights and the Anti-Self-Dealing indices, the most influential and widely used global governance metrics.
Going forward, the quest to design a single, global rating methodology should be replaced by an effort to design two separate methodologies for assessing the governance of companies with and without a controlling shareholder. We have identified in this Article the key elements that should and should not be included in each of these methodologies. When assessing an individual company, one should use the rating methodology that fits the company’s ownership structure. When assessing the quality of investor protection in a given country, one should keep separate scores on how well the country protects investors in companies with and without a controlling shareholder. We hope that our analysis will provide researchers, policymakers, and investors with a useful framework for evaluating and improving the governance of public companies around the world.
The Cult of Efficiency in Corporate Law

Stephen E. Ellis
Grant M. Hayden

Maurice A. Deane School of Law at Hofstra University
THE CULT OF EFFICIENCY IN CORPORATE LAW

Stephen E. Ellis† and Grant M. Hayden‡

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† Associate Professor of Philosophy, University of Oklahoma. B.A., M.A. University of Kansas; Ph.D. Rutgers University.

‡ Professor, Hofstra Law School. B.A., M.A., University of Kansas; J.D. Stanford Law School. The authors would like to thank Margaret Blair, Matthew Bodie, Dan Greenwood, and Sander Zagzebski for their helpful suggestions. Thanks also to the participants at the 2009 Law and Society Association Annual Meeting.

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This paper challenges a fundamental assumption of corporate law scholarship. Corporate law is heavily influenced by economics, and by normative economics in particular. Economic efficiency, for example, is seen as the primary goal of good corporate governance. But this dependence on standard notions of economic efficiency is unfortunate, as those notions are highly problematic. In economic theory, efficiency is spelled out in terms of individual preference satisfaction, which is an inadequate foundation for any sort of normative analysis. We argue that on any account of the good, people will sometimes prefer things that aren’t good for them on that account. Giving people what they want, then, isn’t necessarily an accomplishment, and thus the normative assessment of economic outcomes is much more complicated than economists recognize. This fact is something that should be reflected in corporate law scholarship, and would greatly expand the range of possible considerations when restructuring corporate law.

INTRODUCTION

The standard view in corporate law holds that corporations are organized to maximize shareholder wealth. This focus is supposed to be economically efficient in the sense that no alternative arrangement can better satisfy any corporate stakeholder without satisfying another stakeholder to a lesser extent. This efficiency claim has both a descriptive and a normative dimension: focus on shareholder wealth maximization (subject to the business judgment rule) is the corporate standard because of pressures to satisfy stakeholder wishes; it is also supposed to be a good thing precisely because it improves the satisfaction of some stakeholders’ desires without diminishing the satisfaction of others.

The normative argument here is problematic. Economic efficiency is ultimately a matter of how preference satisfaction is distributed. Preference satisfaction, however, is a deficient foundation for moral claims: giving people what they want isn’t necessarily a good thing. This is not merely the result of particular judgments based on traditional moral views. On any account of the good, people will sometimes want things that aren’t good for them on that account. Economic efficiency looks at the wrong sort of thing for a normative view. Given this problem, the moral foundation of corporate law is undermined.

This Article proceeds in three stages. The first Part reviews some of the basic notions of economic efficiency, from Pareto optimality to the more forgiving Kaldor-Hicks version. The second Part examines how corporate
scholars of almost every variety have reflexively relied upon standard notions of efficiency to provide the normative underpinnings for their particular visions of corporate governance. The third Part, comprising the bulk of the essay, argues that efficiency is normatively irrelevant and, as such, is not a proper basis for evaluating the structures of corporate governance. This conclusion undercuts many of the arguments against corporate reform, opening the debate over corporate governance to a much wider, and ultimately more illuminating, array of considerations.

I. ECONOMIC EFFICIENCY – A QUICK REVIEW

When economists discuss efficiency, they are typically referring to Pareto optimality, also known as Pareto efficiency or allocative efficiency. To understand Pareto optimality, one must first understand the notion of a Pareto improvement. A situation $x$ is a Pareto improvement over a situation $y$ just in case no one (strictly) prefers $y$ to $x$ and at least one person (strictly) prefers $x$ to $y$.1 The definition of a Pareto improvement is sometimes put in terms of utility: $x$ is a Pareto improvement over $y$ just in case the utility of $x$ is at least as great as the utility of $y$ for everyone and the utility of $x$ is greater than the utility of $y$ for at least one person.2 Since utility, in the sense intended, is simply a numerical index of individual preference satisfaction, the two accounts are equivalent3—either way, Pareto improvements are defined in terms of preference satisfaction. A situation is Pareto optimal just in case no other situation is a Pareto improvement over it.4 If, for example, $z$ is a Pareto optimal situation, and someone (strictly) prefers $x$ to $z$ then there must be someone else who prefers $z$ to $x$. In other words, if a situation is Pareto optimal and someone wants to change it, then either someone else opposes the change or you weren’t at a Pareto optimal situation to begin with. A Pareto optimal situation is often thought to be desirable because it is the end result of a series of Pareto improvements, which are thought to be good. In other words, Pareto optimality is valued because it implies that as much uncontested (and thus

1. See, e.g., DANIEL M. HAUSMAN & MICHAEL MCPHERSON, ECONOMIC ANALYSIS, MORAL PHILOSOPHY, AND PUBLIC POLICY 65 (2d ed. 2006). On the standard terminology, this is a weak Pareto improvement; $x$ is a strong Pareto improvement over $y$ if and only if everyone (strictly) prefers $x$ to $y$. We frame the discussion in terms of weak Pareto improvements, but the arguments apply to strong Pareto improvements too, mutatis mutandis.


3. See HAUSMAN & MCPHERSON, supra note 1, at 53–54.

4. Id. at 65.
uncontroversial) preference satisfaction has been achieved as possible from a given starting point.

The uncontested nature of Pareto improvements is what makes them so appealing to economists. So long as a given situation is a Pareto improvement over what preceded it, one never has to balance one person’s gains in satisfaction with another’s losses (since, by definition, nobody prefers the former situation and hence nobody loses satisfaction). This allows economists to avoid making interpersonal utility comparisons, which are thought to be fraught with difficulties. The main difficulty with such comparisons is that there is no objective scale upon which to compare the level of preference satisfaction of two different people. As Lionel Robbins recognized in the early 1930s:

There is no means of testing the magnitude of A’s satisfaction as compared with B’s. If we tested the state of their blood-streams, that would be a test of blood, not satisfaction. Introspection does not enable A to measure what is going on in B’s mind, nor B to measure what is going on in A’s. There is no way of comparing the satisfactions of different people.

Economists, seeking to ground their claims on neutral empirical evidence, thus limited themselves to measuring the desirability of various situations in terms of Pareto improvements and Pareto optimality.

Dodging the problem of interpersonal utility comparisons, however, comes at a price—economists are left with a relatively stripped-down metric. People and institutions are rarely in situations where, all things considered, they are in position to make a decision that produces a Pareto improvement—more frequently, there are winners and losers. It is also far from clear that anyone would want to limit policymakers to decisions that produced Pareto improvements. As Amartya Sen pointed out:


6. See Hayden, supra note 5, at 244–47.


An economy can be optimal in this sense even when some people are rolling in luxury and others are near starvation as long as the starvers cannot be made better off without cutting into the pleasures of the rich. If preventing the burning of Rome would have made Emperor Nero feel worse off, then letting him burn Rome would have been Pareto-optimal. In short, a society or an economy can be Pareto-optimal and still be perfectly disgusting.9

Thus, Pareto measures, at best, incompletely capture most decision-making situations and may even counsel against some very good options (extinguishing the fires of Rome, for example). They have, in other words, both descriptive and normative shortcomings.

Economists have responded to these shortcomings by relying upon another, related measure of efficiency—Kaldor-Hicks efficiency.10 A situation x is a Kaldor-Hicks improvement over situation y just in case the winners under x could compensate the losers such that, after compensation, nobody would prefer y to x and at least one person would prefer x to y.11 In other words, states of affairs are Kaldor-Hicks efficient just in case they would be Pareto improvements if compensation were actually paid.12 For this reason, some have called Kaldor-Hicks efficiency a “potential Pareto” criterion.13

Using Kaldor-Hicks efficiency has helped economists get around the fact that the Pareto criterion has little to offer in analyzing most situations, where the realistic options produce both winners and losers. This enables them to get some work done while maintaining the fiction that they are doing so in a “neutral” way. It is a fiction, of course, because the Kaldor-Hicks criterion is useful only because it reintroduces interpersonal utility comparisons and their messy, unfounded value judgments.14 That said, many economists, and the corporate law theorists who follow them, spin their theories praying for Pareto efficiency and settling for Kaldor-Hicks. At any rate, Kaldor-Hicks efficiency is concerned with utility, which is to say preference satisfaction. If we are right about the inadequacy of preference satisfaction based normative claims, Kaldor-Hicks efficiency falls along with Pareto efficiency.

13. See GUIDO CALABRESI & PHILIP BOBBITT, TRAGIC CHOICES 85–86 (1978); see also HAUSMAN & MCPHERSON, supra note 1, at 65.
Preference-based claims of efficiency play both a descriptive and normative role in economic theory. Economists appeal to Pareto optimality in order to describe the outcomes that result from (or are at least approached by) certain economic interactions; they also see such efficient outcomes as desirable. Economists focus on these outcomes precisely because they see them as good.\(^{15}\) The descriptive account that features efficiency claims holds that, absent constraints, people will engage in voluntary trading in order to achieve their goals. Under certain (not-wholly-implausible) conditions, voluntary transactions are Pareto improvements. In order for a trade to happen, for example, at least one participant must (strictly) prefer it and no participant will prefer that it not happen; further, most third parties are likely to be indifferent.\(^{16}\) Voluntary transactions will proceed until no one wants to trade anymore, resulting in a Pareto optimal situation. This is the core of the argument that perfectly competitive markets are efficient.\(^{17}\)

The normative role of Pareto efficiency is even easier to see. Almost all economists accept some version of the Pareto principle, which holds, roughly, that if a situation \(x\) is a Pareto improvement over a situation \(y\) then \(x\) is better than \(y\).\(^{18}\) The argument for the Pareto principle involves two key principles.


\(^{16}\) This assumes that the preferences of people who aren’t part of the transaction aren’t “entangled” with those of traders. While this is generally false (for example, repugnant markets, envy, altruism, etc.), it is at least plausible for many interactions among strangers.

\(^{17}\) Perfect competition involves a set of conditions that are sufficient to guarantee that voluntary transactions are Pareto improvements.

Unambiguous Welfare Gain ("UWG"): The existence of a Pareto improvement implies that there is welfare gain for someone without a decrease in anyone's welfare.

Minimal Benevolence ("MB"): It is (morally) good to increase welfare, other things equal. 19

UWG holds that preference satisfaction is connected with well-being; MB ties well-being to morality. If both principles hold true, then Pareto improvements increase welfare and increasing welfare is good, ceteris paribus. 20 This argument involves a dual appeal to dominance reasoning—that if something is better along one set of dimensions and no worse along any other, then it must be better with respect to those dimensions all together. If \( x \) is a Pareto improvement over \( y \), \( x \) is supposed to be better than \( y \) with respect to one facet of the good—welfare—because it improves the well-being of at least one person and leaves no one worse off. Further, if other non-welfare values are the same, then \( x \) is better than \( y \) simpliciter. A number of thinkers are leery of the Pareto principle on the grounds that moral analysis goes beyond issues of well-being. They allow, for example, that \( x \) might be a Pareto improvement over \( y \) and still be worse than \( y \) because well-being is not the only morally relevant issue in evaluating \( x \) and \( y \). 21 They usually conclude that Pareto improvements are still morally appealing because, even if particular Pareto improvements are not, on balance, good, Pareto improvements are moral improvements, other things equal. 22 Even on this account, every inefficient outcome is worse with respect to welfare than any Pareto improvement over it. The maximum amount of welfare obtainable is reached by some Pareto optimal outcome. This allows, of course, for non-welfare distinctions among Pareto efficient outcomes, but it is often thought that being Pareto optimal is a necessary condition for something to be a best outcome.

19. See Hausman & McPherson, supra note 1, at 65.
22. See Hausman & McPherson, supra note 1, at 138; Sen (1985), supra note 18, at 10; Chang, supra note 18, at 177, 196.
II. EFFICIENCY IS CENTRAL TO CORPORATE LAW

The study of corporate governance is concerned with control over corporate decision-making: it investigates who has such control, the extent of that control, and the purpose that the control serves. These questions raise important issues about both the ontology and teleology of corporations. There seems to be considerable debate, for example, about what corporations actually are: artificial persons, entities (partially abstract) that can be owned, or sets of interconnected contracts. There is, however, general agreement about certain features of corporate control. Virtually everyone agrees that shareholders have relatively little direct control over corporate policy. Shareholders do, however, have the right to receive residual profits as well as the right to elect the board of directors. The directors are, in turn, the locus of authority within the corporation—they are the representatives of the firm when human counterparts to the fictional form are required. The board, however, does not generally run the business—directors generally delegate this power to the officers of the corporation, who have day-to-day control over a firm’s decision-making. It is one of the stylized facts about corporate governance that this corporate structure separates ownership from control. And it seems to be a condition on the adequacy of any theory of the corporation that it accounts for these principal features of corporate governance.

There is also considerable agreement about not only the proximate goal at which corporate decision-making aims—shareholder wealth maximization—but also the further end served by focusing on this goal—allocative

24. See Bainbridge, supra note 23, at 4–6, 19–20; Easterbrook & Fischel, supra note 23, at 1, 4–6.
26. See Bainbridge, supra note 23, at 4. See generally, Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 277 (1932), whose discussion of the separation of ownership and control has arguably led to much of the later work in the field. Cf. Edward B. Rock & Michael Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation, 149 U. Pa. L. Rev. 1619, 1624 (2001) (“It was as if everyone already knew (from Berle and Means) that the master problem of corporate law was agency costs, and along came an economic model and a vocabulary to elaborate that view.”).
27. See Bainbridge, supra note 23, at 3; Easterbrook & Fischel, supra note 23, at vii.
efficiency. As we will see, while theorists disagree about how the relationships among corporate stakeholders lead to Pareto improvements, they generally agree that they do lead to such improvements. As is usually the case where economic reasoning is involved, this kind of appeal to efficiency plays both descriptive and normative roles: the focus on shareholder wealth is both explained and justified as the result of Pareto improving transactions.

On the traditional account of the corporation, shareholders own the firm. Managing operations through anything like ownership consensus, however, is exceedingly difficult because shareholders have different perspectives, degrees of interest, and levels of expertise. Given this difficulty, shareholders find it advantageous to their interests to hire a manager, and often to set up a management hierarchy. Such a course achieves both the lower transaction costs of unified decision-making and the higher outputs of having the firm controlled by someone with special expertise. The (expected) increased profits make it at least possible for the corporation to offer more attractive deals to other stakeholders, so no one should lose utility.

The shareholder-ownership/management-control account involves a classical principle-agent situation—the owners relinquish control for the benefits of expertise and unitary decision-making. As an employee of the shareholders, a manager has a duty to look out for their interests. There are no advantages to be gained, however, unless the shareholders actually relinquish control and the managers actually exercise it. This relationship is set forth in the business judgment rule.

There are drawbacks to any such arrangement, of course. A manager/agent will not have exactly the same incentives as her shareholders/principals. She might, therefore, be tempted to cheat, or at least give less than her full effort. The oversight provided by assigning her a fiduciary duty tends to ameliorate such problems, as does the market for

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29. See Bainbridge, supra note 23, at ix–xii; Easterbrook and Fischel, supra note 23, at vii–viii.
30. See Bainbridge, supra note 23, at 6–7, 32–33; Friedman, supra note 23, at 33.
31. See Bainbridge, supra note 23, at 4–6, 37–45; Easterbrook & Fischel, supra note 23, at 8–10; Friedman, supra note 23, at 122.
32. See Lee, supra note 21, at 537–38.
33. See Friedman, supra note 23, at 33.
34. See Bainbridge, supra note 23, at 106–14; Easterbrook & Fischel, supra note 23, at 93–100; Lee, supra note 21, at 551–52.
35. See Bainbridge, supra note 23, at 73–74; Easterbrook & Fischel, supra note 23, at 91.
corporate control and her concern for her own reputation, but too much
direct monitoring undermines the point of the arrangement. 36

Does this imply that there is an inefficiency built into the usual corporate
structure? No, or at least not an allocative inefficiency. A corporation would
achieve greater profits if managers had the same interests as shareholders; in
that sense, the corporation isn’t achieving as much as it could. Allocative
efficiency is concerned, however, with the preferences of agents: in general, a
manager won’t want to act exactly as shareholders would have her; to
incentivize her to do so, shareholders would need to monitor her in a way
they would rather not. Dividing ownership from control is a compromise
from the perspective of both shareholders and managers, but it is also a
Pareto improvement over shareholder control.

A more recent account of corporate governance holds that a corporation
is best understood as set of voluntary, intersecting agreements, i.e., as a nexus
of contracts. 37 Given that this model is based on a series of contracts, and
each of those contracts is posited to involve a Pareto improvement (for all
parties consenting to a contract prefer the state of affairs under the contract),
it should come as no surprise that the resulting corporation is viewed to have
a strong basis in efficiency. Once this underlying story is in place, the details
take care of themselves. On this account, corporations have unified control
for exactly the same reasons as on the more traditional view: all contracting
parties prefer unified decision-making by experts. The distribution of
corporate proceeds to various stakeholders is also supposed to be efficient.
Shareholders, in particular, as the residual claimants, are assigned what is left
after all fixed claims on corporate proceeds have been paid. 38 Managers and
directors are assigned, by contract or statute, a fiduciary duty to shareholders
in order to make the residual attractive. 39 Total proceeds are supposed to be
higher if the residual claims are assigned to one group. 40 Shareholders get the
nod over other stakeholders in lieu of contractual claims because that is the
best way to induce them to put their money at risk while also relinquishing
any real control over how it is used. 41 Again, the result is a combination of

36. See BAINBRIDGE, supra note 23, at 75, 100–04, 112–13; EASTERBROOK & FISCHEL, supra
37. See BAINBRIDGE, supra note 23, at 17, 23–24, 28–30, 33–37, 43–47; EASTERBROOK &
FISCHEL, supra note 23, at 12, 14, 90–91.
38. See BAINBRIDGE, supra note 22, at 57–59, 65–72; EASTERBROOK & FISCHEL, supra note 22,
at 30, 67–68.
39. See BAINBRIDGE, supra note 22, at 68, 71–72; EASTERBROOK & FISCHEL, supra note 22, at
90–93.
40. See BAINBRIDGE, supra note 22, at 66–67; EASTERBROOK & FISCHEL, supra note 22, at 38.
41. See BAINBRIDGE, supra note 22, at 67–72; EASTERBROOK & FISCHEL, supra note 22, at 36–
37.
managerial control (as expressed by the business judgment rule) and shareholder interest (expressed by charging the managers with maximizing shareholder wealth) that is supposed to be a Pareto improvement over both shareholder control and a system that tries to promote all stakeholder interests.

Not all legal scholars are advocates of shareholder wealth maximization. Most, however, seem to accept that it is, as a descriptive matter, the primary goal of most corporations. Some who argue that shareholder wealth maximization isn’t an appropriate goal do so on efficiency grounds. Margaret Blair and Lynn Stout, for example, believe that the board should directly advance the interests of all corporate constituents, and needs to be somewhat insulated in order to do that (as to avoid domination, at a minimum, by shareholder interests). The interests of the corporation, in their view, “can be understood as a joint welfare function of all the individuals who make firm-specific investments and agree to participate in the extracontractual, internal mediation process within the firm.” The directors, as mediating hierarchs in this system, make decisions in order to maximize preference satisfaction of all stakeholders (according to the joint “welfare” function) and so to increase allocative efficiency (at least in the Kaldor-Hicks sense).

Indeed, efficiency is regarded with such reverence that even those who criticize shareholder wealth maximization for non-efficiency (e.g., moral) reasons still allow that efficiency is an important consideration. Susan Stabile, for example, believes that the economic interests of a corporation should be subordinated to the promotion of human dignity. Her particular vision is grounded Catholic social thought, which “emphatically rejects the idea that social welfare is merely a question of giving people what they want without regard to what it is that people want.” That said, Stabile doesn’t wholly abandon economic efficiency as a normative goal; instead she limits her criticism to the “exclusive” focus on shareholder wealth maximization, noting that profit remains a “legitimate” corporate pursuit.

43. See generally Lee, supra note 21, for a discussion of Blair’s and Stout’s team production account for and Elhauge’s argument for profit-sacrificing discretion.
45. Id. at 288.
47. Id. at 189.
48. See id. at 190–91.
III. EFFICIENCY AND ITS SHORTCOMINGS

A. Some Existing Criticisms of Efficiency

Over the years, this single-minded focus on efficiency has attracted a fair amount of criticism. Scholars have taken aim at everything from its cramped view of the content of peoples’ preferences to its overreliance on revealed preferences to its disdainful exclusion of other considerations (such as fairness). We briefly catalogue some of the main criticisms in order to distinguish the argument made in this paper.

One set of criticisms is that standard economics, and hence corporate law scholarship, paints an incomplete picture of the content of people’s interests and preferences. Standard economics imagines people as self-interested utility maximizers and sometimes, more specifically, wealth maximizers. This certainly underpins much of the economic reasoning in corporate law—many scholars, for example, assume that shareholders have a single-minded interest in profit maximization and build their theories of corporate governance accordingly. There is little room in standard economics for people who are concerned about fairness, justice, and similar “other-regarding” outcomes.

But real people, the critics maintain, are not and should not be like this. Real people want all sorts of things, including outcomes that appeal to their conceptions of fairness or justice. Even the archetypes of Homo economicus—shareholders—are interested in more than just increasing the monetary value of their shares. The economics underlying corporate theory, to the extent it says differently, is both descriptively inaccurate and normatively bankrupt.

Economists have a ready answer to this criticism. Utility is just a mathematical representation of preferences, and it ultimately reflects a person’s desires. To the extent people desire states of affairs that promote something beyond their narrow, financial self-interest, those desires get built

50. The assumption that shareholders have relatively homogeneous preferences with respect to wealth maximization is important to many theories of corporate governance. See Grant M. Hayden & Matthew T. Bodie, One Share, One Vote and the False Promise of Shareholder Homogeneity, 30 CARDOZO L. REV. 445, 448 (2008); Grant M. Hayden & Matthew T. Bodie, Shareholder Democracy and the Curious Turn Toward Board Primacy, WM. & MARY L. REV. 2071, 2085 (2010); Mitchell, supra note 49, at 229.
53. See Hayden & Ellis, supra note 51, at 640.
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back into their utility functions. (As Louis Kaplow and Steven Shavell put it, people may have a "taste" for fairness that is reflected in their preferences.) This response, while no doubt true, does undercut some of the claims made by corporate theorists on the basis of shareholder preference homogeneity. More importantly for our purposes, though, this move by economists to capture a broader range of human desires does little to take them outside of people's preferences. If anything, it solidifies the role of preference satisfaction in descriptive accounts and, indirectly, the sanctity of preference satisfaction in normative accounts.

A second set of criticisms of efficiency take aim at the source of information about people's preferences. In order to discern the content of preferences, most economists rely exclusively upon people's actual choices. Indeed, the choices themselves are identified as "revealed" preferences. This reliance upon observable behavior, much like the use of Pareto efficiency to begin with, is supposed to take the guesswork out of preference assessment. The claim that people choose what they prefer is treated as a virtual tautology, so choice gives us all of the information we could want about preferences.

This account has been questioned in a number of ways. Initially, economists are criticized for ignoring other sources of information about preferences. One may deduce preferences from actual choices, but one may also come across preference information through introspection (for one's own preferences) or communication (asking others about their desires). A second criticism is that reliance upon actual choices may be especially problematic where it is used most—in market contexts—where choices are often constrained by the ability to pay. For example, an economist would be hard pressed, in analyzing our purchase decisions, to come up with much

55. See LOUIS KAPLOW & STEVEN SHAVER, FAIRNESS VERSUS WELFARE 21, 431 (2002).
57. See id. at 4–6. Hovenkamp argues that discovering preferences is so problematic that it can never be correctly described as objective. Id. at 6.
59. Willingness to pay, as measured by actual choices, is a function of both utility and budget constraint. Steve isn't willing to pay a million dollars to see his children thrive, not because he wouldn't pay anything to see them do well but because he does not have the million dollars to spend. See Hovenkamp, supra note 56, at 13; Thomas F. Cotter, Legal Pragmatism and the Law and Economics Movement, 84 GEO. L.J. 2071, 2127 (1996).
information about our very real desires for front-row seats to all Kansas basketball games.60

These criticisms of revealed preference undermine any analytic link between choice and preference, and have been subject to discussion elsewhere.61 Our critique, however, is more fundamental. Regardless of the source of our information about the preferences that sustain efficiency claims, we maintain that those preferences are ill-suited to fill the normative role assigned to the Pareto principle. No pattern of actual preference satisfaction is sufficient to establish any welfare claim.

B. Efficiency is Normatively Irrelevant

The problem with the Pareto principle is that it relies on the controversial UWG claim.62 Economists routinely identify welfare with utility (and so ultimately with preference satisfaction).63 This is especially true of law and economics scholars and their corporate law disciples. Louis Kaplow and Steven Shavell, for example, have touted the superiority of a welfare or well-being approach in evaluating the effect of legal rules.64 They explicitly define welfare in terms of utility and expected utility, which incorporates everything that one may find valuable (or distasteful).65 They straightforwardly rely on preferences as revealed by behavior to identify those wants (and aversions).66 Their central thesis is that their welfare-based approach is superior to one in which notions of fairness drive our assessment of legal rules.67

61. See, e.g., Daniel M. Hausman, Revealed Preference, Belief, and Game Theory, 16 Econ. & Phil. 99 (2000).
62. Recall that the Unambiguous Welfare Gain claim is that the existence of a Pareto improvement implies that there is welfare gain for someone without a decrease in anyone's welfare. The accompanying claim of Minimal Benevolence is comparatively weak: it asserts only that well-being is one dimension of value. This is generally recognized as a reasonable view, so we won't discuss it here.
63. See, e.g., Koszegi & Rabin, supra note 20, at 1821, 1823–24; Julianne Nelson, Business Ethics in a Competitive Market, 13 J. BUS. ETHICS 663, 663–64 (1994); Sugden, supra note 21, at 507. There is a Libertarian argument for market exchange, but it isn't based on the value of facilitating preference satisfaction. Voluntary trades are supposed to be good because they respect freedom, whether or not they enhance welfare. See Walter E. Williams, The Argument for Free Markets: Morality vs. Efficiency, 15 CATO J. 179, 182 (1996).
65. See KAPLOW & SHAVELL, supra note 55, at 18.
66. See id. at 409.
67. See id. at 3–4.
Although Kaplow and Shavell define welfare by way of preference satisfaction, they acknowledge that there are "possible differences" between individual preference and "true well-being." This gap is, of course, important, and the success of their normative claim rides on their ability to bridge it. But when it comes to so-called "objectionable" preferences, they end up admitting that, under their approach, there is no basis for ignoring them or, indeed, even defining them. Instead, they tend to limit the category of such preferences, spending a fair amount of time on the preferences of rapists, bigots, and sadists, which allows them to dodge the issue by arguing that such preferences are rare enough that they will most often be outweighed in the utility calculus and thus will not lead to laws that allow their satisfaction. When it comes to cognitive shortcomings, they make a similar fudge, explaining that when individuals do not fully understand what is good for them, one may use their "actual well-being"—what they would prefer if they correctly understood how they were affected. Of course, there is little explanation how one, relying upon revealed preferences, is to get this information.

Corporate law scholars further muddle up this issue. Stephen Bainbridge, for example, just skips preferences and defines Pareto improvements in terms of well-being. He holds that x is a Pareto improvement over some y just in case x makes at least one person better off than she would be at y without making anyone worse off than they would be at y. He leaves out preferences, however, not because he thinks there is reason to doubt that satisfying a person's preferences will make her better off. Instead, he seems to so closely identify preference satisfaction with well-being that he feels comfortable conflating the two. As a result, Bainbridge's "better off" formulation isn't a version of the economic notion of Pareto improvement at all.

Economists and corporate law scholars, then, regularly equate well-being with preference satisfaction. We should be unwilling to follow suit. The clearest illustrations of how preference and well-being come apart involve appeal to moral and prudential intuitions. Rachel, for example, lost everything she ever loved to her methamphetamine addiction. To hold that she was better off in some way for fulfilling her desire for meth doesn't make sense—preferring a pleasant stupor to a (quite satisfactory) family life was an
error for Rachel. A moment’s reflection suggests that people often want things that are not good for them: inexperienced drivers want vehicles they can’t handle; the overconfident want to avoid correction; the self-loathing want to be inappropriately punished; the bigot desires to avoid those she sees as inferior. When someone gets what she wants in such cases it doesn’t count as any sort of welfare gain because the desires satisfied are just inappropriate or mistaken.75

At a practical level, it is inevitable that people will want things that don’t enhance their welfare. People make mistakes in forming preferences, even when they reason from their own views about welfare. And, importantly, satisfying mistaken preferences won’t be conducive to an agent’s well-being even by her own lights.

In the most prosaic (and common) cases, people have false beliefs that lead them to want one thing when it would make sense for them to want another. Steve might, for example, desire money and so come to want shares in CompuGlobalHyperMegaNet (CGHMN) because he believes (erroneously, it turns out) that an investment in CGHMN will make money.76 Steve’s proximate desire for shares of CGHMN does not track his more basic desire for money and so satisfying his desire for shares doesn’t make him better off by his own view.77 It follows, then, that erroneous beliefs can give rise to Pareto improvements where at least one person will actually be worse off by her own lights. Someone must be selling shares of CGHMN if Steve is able to buy them. A transaction between them might well be a Pareto improvement: Steve wants to buy, the seller wants to sell, and no one else really cares. In general (e.g., special circumstances and portfolio effects aside), people prefer to buy shares when they think their value will go up and sell when they think their value will go down. No matter what happens to CGHMN stock, one of the parties will fail to achieve their ends: if the price goes down, Steve will regret his purchase; if the price goes up, the seller will regret the sale. Both want to make the transaction but one will fail to get what he or she really wants.78 This sort of possibility shows that Pareto improvements wouldn’t guarantee welfare gains even if what people sought were actually good.

False beliefs aren’t the only source of mistaken preferences. Psychology tells us that people have other trouble bridging the gap between their

76. Most of our desires are derived from more basic desires and beliefs in this way.
77. Actually getting money might not be what it is cracked up to be either. It is possible for someone to end up where she ought to be by failing to get what she wants.
overarching goals and the situation-specific preferences that guide their behavior: they have a hard time resisting nearer but lesser goods, overweight the influence of small probabilities, are too risk-averse for possible gains, and are too willing to gamble in order to avoid even trivial losses.79 People are sometimes attracted to things in an irrational way: they find forbidden fruit more appealing, suffer from sour-grapes reasoning, or fall prey to group-think.80 People often form beliefs, desires, and preferences without attending to all of the elements of the situations they consider important.81 Reasoning goes awry in many ways, so on any account of the good it is practically certain that people will desire things that are not beneficial on their own view of the good.82 These sorts of possibilities show that Pareto improvements would not guarantee welfare gains even if people were ultimately motivated to achieve what is actually good.83 Given the many ways in which actual preferences can be based on mistakes, it is a poor idea to read welfare conclusions off of the mere existence of Pareto improvements.

The point of the preference-versus-welfare criticism is not merely that utility is imperfectly correlated with well being. The real lesson, rather, is that every account of the good must distinguish what someone thinks is good from what is good. A person’s preferences capture what she thinks is good, or at least what she thinks is worth doing.84 Welfare, on the other hand, is


80. See HAUSMAN & MCPHERSON, supra note 1, at 128–29.

81. See FREDERIC SCHICK, UNDERSTANDING ACTION 55–88 (1991); Stephen Ellis, Market Hegemony and Economic Theory, 38 PHIL SOC. SCI. 513, 522–29 (2008); Hayden & Ellis, supra note 51, at 629, 661–75. I might, for example, form the intention to go for a cup of coffee with a colleague without attending to either a previously scheduled engagement or my recently diagnosed ulcer. Even important values will not influence a person’s action-guiding preferences where those values aren’t activated.

82. See Sen (1976), supra note 18, at 220–26, 232. This is why there is a standard distinction between manifest (revealed) preferences and true (normative) preferences. See John Beshears et al., How Are Preferences Revealed?, 92 J. PUB. ECON. 1787, 1787 (2008); Chang, supra note 18, at 193; Rescher, supra note 18, at 176–77. A person is motivated to act by her manifest preferences, but those preferences may not track what she ultimately wants. This also explains the appeal of laundered or amended preferences in normative analyses. See HAUSMAN & MCPHERSON, supra note 1, at 128–29; Chang, supra note 18, at 183.

83. This is one reason why Kaplow and Shavell’s appeal to what people would prefer under full information, see KAPLOW & SHAVELL, supra note 55, at 16, doesn’t help their view. Even when people can formulate a view of the good (e.g., they can see what they would prefer if they knew more), they can’t ensure that their proximate preferences track that view.

84. This shows that preference satisfaction and welfare are connected after a fashion, albeit not in a way that helps the Pareto principle. This is also why (even though they are not
concerned with what is actually good, or at least part of the good. No one who reflects on the difference between thought to be good and good can understand satisfying even her own preferences (i.e., doing what she thinks is good) as simply equivalent to doing what is good because people are prone to mistakes—there is always a conceptual gap. Investigating what people want is simply distinct from investigating well-being. Appealing to the Pareto principle to make welfare assessments is sort of like taking a poll to find the answer to a math problem. In both cases you learn what people think, but the method itself can’t determine whether they have the correct answer. The conceptual distance between good and thought to be good implies that preference satisfaction isn’t even a satisfactory indicator of welfare. We can’t reach welfare conclusions from on preference-satisfaction evidence where a person is wrong about what is good or worthy of choice. Intuitions may diverge about exactly how likely such cases are, but we must have an independent examination of what is good for people, and so what they should want, to determine which intuitions are more accurate. If we had information about what was good for someone, of course, we wouldn’t care about the status of her proximate preferences in the first place. As with the math problem analogue, there isn’t much point in taking a poll once you’ve done the calculations carefully. Mere preference, then, has no real role to play in normative assessment.

The foregoing criticism of UWG, that preference satisfaction is not well-being, is quite persuasive. Despite this fact, most economists still rely on the Pareto principle and most philosophers seem willing to let them. Defenders of the Pareto principle respond to the critique in two different ways. The first attacks the argument itself as depending on controversial premises. The second response holds that while UWG is, strictly speaking, false, it is approximately true: the existence of a Pareto improvement is prima facie evidence that someone has experienced a welfare gain without anyone’s welfare being decreased.

With regard to the first response, some defenders of the Pareto principle hold that any distinction between welfare and preference satisfaction must depend on a controversial view of the good. A critic, it seems, must go outside of an agent’s view of the good to argue that she desires something

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85. This is not to say that there is no reason to have people check your reasoning, especially if it is complex. The point, rather, is that the reasoning is the focus, not simply the end result.

86. As we saw before, some supporters of the Pareto principle overlook its dependence on UWG and so they fail to even register the criticism.

87. See Sen (1985), supra note 18, at 10; Rescher, supra note 18, at 175–77.
that is not beneficial for her: after all, she sees what she wants as worth pursuing. Arguments across conceptions of the good, however, are notoriously intractable. There is no agreement about what is good, so criticisms of preferences are inevitably tendentious. Given disagreements about morality, it seems best to leave welfare (and other facets of the good) in the eye of the beholder. This view is usually amplified by the claim that it is not an economist's job to work on moral truths anyway. As an initial matter, this defense of UWG based on controversial views of the good involves some questionable burden shifting. The fact that people disagree about the nature of the good does not show that a given view about the good is not the right one. At a minimum, philosophical argument seems to rule out some conceptions of the good as inadequate (for example, divine command theories of ethics). And while figuring out ethics may not be a job for economists, this doesn't imply that economists can ignore philosophical insights.

A number of popular views of the good, some of them quite defensible, imply that people often want the wrong things. Many religious views of the good, for instance, hold that people do not generally want good things. Buddhists have a problem with desire in general—as the Second Noble Truth has it, suffering is caused by attachment. Many Christians think that Original Sin leads to depraved desires—people pursue things that are actually bad for themselves. Deontological views of ethics, such as Kantian views, rule out certain desires as inappropriate. Even views that tie the good

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88. See Kaplow & Shavell, supra note 55, at 426; Rescher, supra note 18, at 175–76.
89. See Hausman & McPherson, supra note 1, at 119; Gravel, supra note 18, at 164; Sugden, supra note 21, at 507. There is a more positive case for UWG that involves a contractarian argument. Contractarians hold that rules are justified if they can command unanimous consent. Everyone can agree to a Pareto improvement—some (those who prefer it) will advocate for it, no one will block it (since no one prefers the alternative). See Cudd, supra note 20, at 7; Sugden, supra note 21, at 507. Everyone would agree to Pareto principle (and a bit more) behind a veil of ignorance. See Sugden & Wcale, supra note 18, at 113. In this sense, at least, rationality endorses Pareto improvements—they are what rational people can achieve.
91. Arguably, economists have already committed to a philosophical position by holding UWG.
closely to human nature generally hold that it is difficult to determine what actions and attitudes are appropriate under various circumstances. UWG is inconsistent with these common views of the good. Economists can defend their usual approach to welfare economics, then, only if they are willing to enter the debate about the good. They remain unwilling, however, to even address such philosophical issues.

Burden of proof issues aside, the controversial-views-of-the-good defense of UWG is misdirected. As it is drawn above, the distinction between preference satisfaction and welfare doesn’t depend on any particular view of the good. The criticism of UWG is not that there is one true view of the good such that people want things that are not in fact good. Rather, it holds that for any (remotely plausible) conception of the good, even someone who holds it will prefer some things that are inconsistent with that conception. There are a number of reasons why a person’s preferences might come apart not only from what is objectively valuable (if there is such a thing) but also from her own deepest subjective values.

As we saw before, perfectly normal reasoning can lead people to actually want things they wouldn’t want if they knew the facts. People have false beliefs, sometimes due to poor information and sometimes due to poor (for example, non-Bayesian) information processing. Likewise, the psychological evidence tells us that there will always be a gap between agents’ values and their behavior-guiding preferences. People don’t, and as a practical matter can’t, evaluate specific situations in a way that is fully consistent with even their own considered views of the good. The preference-satisfaction-is-not-well-being criticism of UWG doesn’t depend on any particular view of the good, much less a controversial one.

sustainer of its own laws . . . that they expect nothing from the inclination of human beings but everything from the supremacy of the law and the respect owed it or, failing this, condemn the human being to contempt for himself and inner abhorrence.” Id. at 35; 4:425–26.


96. See HAUSMAN & MCPHERSON, supra note 1, at 67, 119–20; Rescher, supra note 18, at 176.

97. To some, this might evoke the debate between objective and subjective views of the good. Our argument, however, doesn’t hinge on that discussion. It probably would be easier to make the case that people sometimes want harmful things if “there [were] things that are good in themselves for an individual independently of her desires and attitudes toward them[.]” Richard J. Arneson, Perfectionism and Politics, 111 ETHICS 37, 37 (2000). Still, it is possible to reason poorly about the good and so have misguided preferences even if “the things that are intrinsically good for an agent . . . acquire this status only in virtue of how she happens to regard them[.]” Id.

98. See Koszegi & Rabin, supra note 20, at 1827–28.
The mitigation response to the criticism that preference satisfaction isn’t the same as well-being maintains that although the connections among choices, preferences, and welfare aren’t certain, they are close enough to validate most economic claims. UWG, then, is approximately true: the existence of a Pareto improvement is prima facie evidence that someone has experienced a welfare gain without anyone’s welfare being decreased. Koszegi and Rabin’s recent paper, “Choices, Situations, and Happiness,” is a prime example of this approach. Koszegi and Rabin note that on the traditional economic approach, “observed behavior is assumed to reflect fully rational maximization of utility, and . . . welfare is higher in one situation than another if it lets a person attain the outcome she seems most inclined to choose.” They acknowledge, however, that this account has conceptual deficiencies.

Preferences, for instance, are more complicated than is usually assumed. Someone might prefer to have help quitting smoking, other things being equal, but prefer to pass up an opportunity to receive aid because she hates to ask for it. Koszegi and Rabin are primarily interested in drawing a methodological lesson here: choice behavior alone cannot isolate complex preferences of this sort. A pattern of choices can’t, for example, exclude the possibility that someone would get more utility from a painful, unavoidable death than anything she actually chooses over death—she chooses only with respect to avoidable deaths and so we have no basis for assessing her preference for unavoidable ones. Common sense suggests, of course, that people don’t want to suffer a painful, unavoidable death and this is good enough to exclude a preference for such outcomes. In order to fix preferences, then, choice evidence must be supplemented with some ancillary assumptions. Koszegi and Rabin admit that economics always relies on such choice-unobservable principles.

Like the critics of UWG, Koszegi and Rabin also allow that people make mistakes in the pursuit of their ends: for example, they misunderstand the stock market, commit the gambler’s fallacy, or make other cognitive errors. They are focused on a methodological lesson here as well: choices aren’t

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99. Id.
100. Id. at 1821.
101. See id. at 1821–24. Preferences of this sort violate what Koszegi and Rabin call “Menu Independence of Welfare.” Id. at 1824.
102. See id. at 1823–27. Different sets of preferences lead to the same sorts of choices (for example, people continue to smoke for different reasons) so no set of behavioral observations can, by itself, tease out which preferences are operative.
103. See id. at 1823.
104. See id. at 1821, 1823. They see a role for psychology in uncovering new, perhaps less common sense, assumptions of this sort. See id. at 1827, 1830–31.
105. See id. at 1827–28.
always good evidence for a person's preferences because her actions might express her mistakes rather than her desires.106 The take-home message, again, is that we can't just read a person's utility off her behavior without consulting psychological evidence and assumptions.107

Despite its problems, Koszegi and Rabin think the standard economic approach to welfare is on the right track: "[w]hen doing so with sensible ancillary assumptions, inferring people's well-being based on the presumption that observed choices are rational is in our view the best scientific program for studying well-being yet formulated."108 In particular, they stand by the substantive conclusions of standard welfare economics:

Despite conceptual problems . . . in many cases it seems clear that both rationality and choice-set independence of preferences are good enough approximations that in fact familiar approaches are quite sufficient. . . . [R]evealed preference is too powerful a tool for studying well-being, and the ancillary assumptions needed to render the tool effective are often too minimal and reasonable, to fret much about the conclusions economists are reaching except in cases where there are specific reasons to doubt these assumptions.109

Despite their shortcomings, then, the connection between choices and preferences is good enough to support the normative conclusions of economic reasoning.

Even critics of the Pareto principle accept something like the foregoing mitigation line. Hausman and McPherson, for example, make the case that "[t]here are problems with endorsing all Pareto improvements (as the Pareto principle does) . . . ."110 Still, they hold that "[t]he Pareto principle has some real ethical appeal because satisfying preferences surely has something to do with promoting well-being."111 Sen, likewise, emphasizes "the unacceptability of the Pareto principle as a universal rule."112 Nonetheless, he holds that "there is something very central in the idea that preferences unanimously held

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106. See id. at 1828–29.
107. Investigating mistakes provides another potential role for psychology within the general economic framework.
108. Koszegi & Rabin, supra note 20, at 1821. While Koszegi and Rabin "make the case for supplementing and combining" the traditional approach with psychological research, they are primarily interested in patching conceptual cracks. Id. at 1821.
109. Id. at 1823.
110. HAUSMAN & MCPHERSON, supra note 1, at 137.
111. Id. at 138.
112. Sen (1976), supra note 18, at 235.
by members of a community cannot be rejected by that community. As Blau . . . puts it, "I can see no case for an outside observer denying a unanimous choice."\textsuperscript{113}

Standard welfare economics treats choices (or at least the instrumentally rational ones) as welfare maximizing.\textsuperscript{114} The mitigation response to the criticism of the Pareto principle, while it allows that choice and welfare can come apart, argues that the connection is still good enough to be useful. It is important to recognize, however, that the Pareto principle relies upon the connection between choice and welfare. Under the standard view, that connection involves two steps: the first equates choice with preference satisfaction and the second preference satisfaction with welfare. The mitigation response is primarily concerned with examining and ultimately defending the first step, but such moves shed little light on the validity of the second, which is crucial to the Pareto principle (and the focus of this essay).

Mitigationists such as Koszegi and Rabin are a perfect, recent example of this. While they reject "the debilitating tautology that everything people do maximizes their utility,"\textsuperscript{115} they still accept the even more problematic view that well-being is a matter of utility maximization. Koszegi and Rabin, for example, only argue for the claim that behavior, supplemented by psychological assumptions, allows us to characterize preferences. The view that "rationality and choice-set independence of preferences are good enough approximations" only supports the claim that we can read preferences off behavior, yet they conclude that looking at preferences "is too powerful a tool for studying well-being."\textsuperscript{116} They just take it for granted that there is a close connection between utility and welfare. Much the same point holds for Hausman and McPherson, as well as for Sen. While they recognize that they are concerned specifically with preferences on the one hand and welfare on the other, they simply appeal to their intuitions that there must be something that connects preference satisfaction and well-being.

Appeal to the popular views of the good canvassed above should be enough to cast at least some doubt on any intuition linking welfare and preference satisfaction. If the Second Noble Truth (or a Christian account of

\textsuperscript{113} Id. at 235–36. Sen rejects the Pareto principle in favor of "a conditional version . . . . If everyone in a community prefers \( x \) to \( y \) and wants that preference to count, then \( x \) must be socially preferred to \( y \) (conditional weak Pareto principle[)] . . . ." Id. at 236. Sen also discusses a conditional version of the strong Pareto principle. Id. at 243. Conditionalizing the Pareto principle in this way doesn't help with the objection we are pressing. Sen wants to salvage the intuition that no outside observers can question a unanimous choice; this is exactly the intuition we argue is unsupported.

\textsuperscript{114} Koszegi & Rabin, supra note 20, at 1821.

\textsuperscript{115} Id. at 1822.

\textsuperscript{116} Id. at 1823.
original sin or Kant's categorical imperative, etc.) were correct then the "ancillary assumptions" to which Koszegi and Rabin appeal, "minimal and reasonable" though they might be, wouldn't be enough to vouchsafe "the conclusions economists are reaching" about the welfare properties of Pareto improvements.\textsuperscript{117} The intuition that preference satisfaction has something to with welfare must be sensitive to the debate about the good. Mere appeal to the existence of Pareto improvements cannot answer any normative questions.

More importantly, any intuition that actual, situation-specific preferences (as opposed to broader value commitments) at least approximate the good must yield when we recall the way in which welfare and utility come apart. As we saw before, poor reasoning (in its many forms) will lead everyone to have desires that don't make sense given their more fundamental values. Whatever conception of the good someone might hold, she can (and, as a practical matter, will) want something inconsistent with that conception. In order to separate mistaken from value-congruent preferences, we need to be explicit about the value standard at issue and use it to evaluate preferences. This, however, is exactly what standard normative economics tries to avoid—the Pareto principle is supposed to allow us to determine when we have a welfare gain without any need to look at the value judgments that preferences are based upon. Once the value standards are required, there isn't much point in consulting preference satisfaction—we can look directly at whether behavior advances the relevant values. Again, taking a poll might provide correct answers to a math problem, but maybe not. The only way to tell is to either know the answer independently or to closely follow and evaluate the reasoning process of those polled. Once you have done or are doing the math, however, the existence of the poll isn't helping you find the answer. Likewise with the Pareto principle: the mere existence of a Pareto improvement doesn't tell us about welfare; we need to look at the appropriate values for that.\textsuperscript{118}

\textsuperscript{117} Id.

\textsuperscript{118} The contractarian case for UWG is undermined by the same point. Contractarianism assumes that people will agree to what they should. Even contractual views allow that people can misunderstand or misforecast value assessments. See Cudd, supra note 20, at 26; Sugden & Weale, supra note 18, at 119. The normative force of a social contract depends on avoiding such errors. Even contractarians, then, must distinguish between deals that people would actually make and deals they should make (by way of constraints such as the original position). See Sugden & Weale, supra note 18, at 111, 113. Absent such a distinction, a contract is, at best, a modus vivendi. Political sustainability is important, of course, but it is a different issue than morality. See Atkinson, supra note 90, at 197, 199.
IV. WHITHER CORPORATE GOVERNANCE?

The Pareto principle is false because the existence of a Pareto improvement does not imply a welfare gain for anyone. The problem isn’t merely that Pareto improvements do not guarantee well-being on many views of the good. Rather, no view of the good allows someone to draw conclusions about welfare (or any other facet of the good) from the existence of a Pareto improvement (or any other pattern of preference satisfaction). As a normative claim, the Pareto principle is worthless because it looks at the wrong thing.

There are some obvious practical benefits to unanimous consent, especially in the political realm.119 Politics is the art of the possible so it is important to identify a consensus-based starting point for normative assessment. We are willing to allow, then, that trying to achieve Pareto improvements might generally be a wise policy, despite the fact that the Pareto principle isn’t true. Still, getting agreement is, at most, a modus vivendi, not a stopping point. Economists are therefore mistaken when they assert that “economic research and teaching does now (via our various notions of efficiency and welfare) reach strong conclusions about well-being.”120 What, then, is the appropriate role for economics in the study of welfare?

Economists, as such, have no particular insight about what makes people better or worse off. Even without its own characterization of well-being, however, economic analysis can still help us understand features of the world that have been independently identified as relevant to well-being.121 Economics, for example, is the primary tool we have for studying the distribution of food, shelter, security, and comfort items in a given society. While the connection is not straightforward, the distribution of such goods is (quite plausibly) a crucial determinant of human welfare. Economics has an important role to play in the study of well-being but it is no part of that role to determine what counts as welfare.

Arguments based on economic efficiency, however, are often used to counter proposals for restructuring corporate law. Kent Greenfield, for example, has long championed a variety of progressive corporate reforms.122 He generally advocates moving away from the model of shareholder primacy by allowing firms to straightforwardly account for the effect of their decisions

119. It might even be that agreement on a course of action has some evidentiary value—there may be something to folk beliefs about the “wisdom of the crowd” and “crowdsourcing.”
120. Koszegi & Rabin, supra note 20, at 1831.
121. See Haas & McPherson, supra note 1, at 129–33.
on society at large. More specifically, he argues in favor of changing the composition of the board of directors to include representatives of other corporate stakeholders such as employees, customers, creditors, and the community. In Greenfield’s view, these reform proposals would shift the focus of corporations away from the aggregation of shareholder profit in favor of promoting other social values.

These proposals are often countered with simple appeals to their purported inefficiency. D. Gordon Smith, for example, recently argued against many of Greenfield’s proposals by noting that they might come at the expense of shareholder utility. Any move toward Greenfield’s goals that materially changed the content of corporate decisions would “sacrifice potential shareholder value in favor of value for non-shareholder constituencies” and thus “destroy much of the good that corporations have done.” While Smith allows that corporations might “enhance employee welfare, make the environment cleaner, or improve human rights throughout the world,” they should do so only when they can act “without impairing shareholder value.”

Importantly, Smith doesn’t counter these proposals on their own terms. Instead, he is content to point out, “[l]ike other would-be reformers, Professor Greenfield runs smack into Adam Smith’s invisible hand.” To be fair, Greenfield, like Blair and Stout discussed above, also structures his arguments largely on the basis of preference-based efficiency claims—he views his reform proposals to be superior because they take more direct account of the preferences of all stakeholders rather than just the shareholders. (Indeed, he is complimented for “cleverly” turning economic analysis against its practitioners.) Smith then counters those proposals with a claim that shareholders may not prefer them—any move away from status quo is viewed with suspicion because it could not be a Pareto improvement. These simple appeals to the descriptive efficiency (or inefficiency) of corporate law masquerade as normative argument and, in the end, mean that neither side fully engages with the real issues.

A quick survey of the scholarship turns up many similar arguments with respect to current and proposed changes in corporate law. The Sarbanes-
The Cult of Efficiency

Oxley Act and its provision of independent audit committees is criticized for failing to improve corporate financial performance.131 Proposed reforms that target excessive executive compensation are defended on the grounds that no corporate constituents, including shareholders, have anything to complain about because they all received the benefit of their real or "hypothetical" bargains.132 This species of argumentation really thrives against the background view of the corporation as a nexus of contracts. If the proposal were an improvement, then people would have already agreed to it; they haven't, therefore it's a bad proposal. Whether applied to the Sarbanes-Oxley Act, Say-on-Pay, or other broader corporate reforms of the sort advocated by Greenfield, the debates assume a Panglossian view of corporate affairs in which the mere existence of a particular feature of corporate governance is the ultimate argument for its continuation.

CONCLUSION

The primary upshot of this paper is methodological. Debate about corporate structure has been effectively short circuited by appeals to considerations of allocative efficiency. There is nothing wrong with treating the standard structures of corporate governance as a descriptive base-line. But the (purported) efficiency of such structures provides them with no normative presumption whatsoever. If someone were to give a compelling moral argument that corporate decision-makers should abide by certain rules or take into account certain interests that they currently don't, it adds nothing to the debate to merely point to inefficiencies that would be introduced. It is important to know the results of any changes in corporate governance, of course, and such results may well affect the argument that supports such changes. It is important to note, however, that the consequences of interfering with even voluntary transactions are not self-evaluating: we need to appeal to normative arguments before we can draw any conclusions. Even if corporations as currently structured are efficient in a descriptive sense, that is no barrier at all to any normative argument for altering corporate governance.

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‘Nothing But Wind’? The Past and Future of Comparative Corporate Governance

Donald C. Clarke

George Washington University Law School, dclarke@law.gwu.edu

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DONALD C. CLARKE*

“Nothing But Wind”?
The Past and Future of Comparative
Corporate Governance†

Corporate law scholarship has come a long way since Bayless Manning some four decades ago famously pronounced it dead. Not only has doctrinal scholarship continued its project of critique and rationalization, but empirical and economic approaches have injected new life into the field.

Recent years have seen the rise of comparative corporate governance (CCG) as an increasingly mainstream approach within the world of corporate governance studies. This is a function partly of an increasing international orientation on the part of legal scholars and partly of an increasingly empirical turn in corporate law scholarship generally. Different practices in other jurisdictions present at least the possibility of natural experiments that attempt to find causal relationships between particular features of a corporate governance regime and real-world outcomes. This body of research has become particularly relevant as we enter the second decade of the twenty-first century. The financial crisis has called into question many of our traditional ways of thinking about corporate governance and the relationship between business enterprises and the state. Are there other countries that do it better?

This Article discusses what is unique about CCG as an approach to corporate governance studies. It begins by examining the concepts of corporate governance and comparative corporate governance, making the point that comparative corporate governance has in general been focused on agency problems between shareholders and managers but need not be so. It then looks at methodological issues in comparative corporate governance, critiquing in particular economic Darwinist theories and the failure of theories of international competition in corporate governance to incorporate the notion of comparative advantage. Finally, it reviews major lessons learned from this body of work and

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suggests direction for future research. Among other things, it calls for more comparative research into alternative business entities dubbed “uncorporations” by Larry Ribstein and into corporate governance in increasingly important economies such as China and India.

I. INTRODUCTION

Corporate law scholarship has come a long way since Bayless Manning some four decades ago famously pronounced it dead, with “nothing left but our great empty corporate statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind.”\footnote{Bayless Manning, The Shareholder’s Appraisal Remedy: An Essay for Frank Coker, 72 YALE L.J. 223, 245 n.37 (1962).} Not only has doctrinal scholarship continued its project of critique and rationalization,\footnote{By “rationalization” I mean attempts to rid doctrine of irrationalities and inconsistencies; I do not mean providing apologetics for the status quo. A personal favorite in the critique-and-rationalization genre is Saikrishna Prakash, Our Dysfunctional Insider Trading Regime, 99 COLUM. L. REV. 1491 (1999).} but empirical and economic approaches have injected new life into the field.

Recent years have seen the rise of comparative corporate governance (CCG) as an increasingly mainstream approach within the world of corporate governance studies. In part, this stems from a recognition by legal scholars—traditionally somewhat insular in most countries, and perhaps even more so in the United States—that globalization calls for an increased understanding of how things are done in the rest of the world. And in part, it is a function of an increasingly empirical turn in corporate law scholarship generally. Different practices in other jurisdictions present at least the possibility of natural experiments that attempt to find causal relationships between particular features of a corporate governance regime and real-world outcomes.

What specifically is unique about CCG as an approach to corporate governance studies? What have we learned, and where should we go? These questions are particularly urgent as we enter the second decade of the twenty-first century. The financial crisis has called into question (if it has not yet, perhaps, definitively overturned) many of our traditional ways of thinking about corporate governance.
and the relationship between business enterprises and the state.  

But there is another economic trend that makes comparative corporate governance research more urgent than ever: the rise of what we might call “non-traditional” jurisdictions. As this Article will show, CCG research has dealt extensively and skillfully with Anglo-American jurisdictions, Europe, and Japan. But the last thirty years have seen a startling rise in the economic importance of other countries, particularly China and the rest of non-Japan Asia. From 1980 to 2006, for example, China’s share of world GDP (estimated on the basis of purchasing-power parity) rose from about three percent to about sixteen percent. The rest of non-Japan Asia went from about twelve percent to about eighteen percent. Students of business organization simply cannot ignore what is going on in those countries.

With these questions in mind, this Article reviews where we have come in the last several years and the prospects for the future. Part II examines and clarifies the concepts of corporate governance and comparative corporate governance in order to set the stage for the ensuing discussion. It makes the point that comparative corporate governance has in general—although not uncontroversially—been focused on agency problems between shareholders and managers. It need not, however, always be so.

Part III looks at the methodology of comparative corporate governance, focusing particularly on the problems of functionalism and empirical studies.

Part IV reviews briefly some of the major lessons learned from comparative corporate governance scholarship, while Part V lays out some future directions and challenges for research, focusing particularly on the vexed problem of convergence. Part VI offers a brief conclusion.

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4. This is the suggestion of Paul Krugman in a recent column; see Paul Krugman, An Irish Mirror, N.Y. TIMES, Mar. 7, 2010, available at http://tinyurl.com/\

II. WHAT IS COMPARATIVE CORPORATE GOVERNANCE?

A. The Concept of Corporate Governance

To understand the field of CCG, we must first clarify how the field understands the notion of corporate governance itself. Corporate governance can mean many things to many people, and the definition typically will depend on what the definer cares about. I canvass some definitions below in order to clarify what CCG typically excludes as well as includes.6

The simplest definition may be that of the (British) Committee on the Financial Aspects of Corporate Governance in the Cadbury Report, which defines corporate governance as “the system by which companies are directed and controlled.”7 Economist Margaret Blair also supplies a broad definition: “the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.”8

Institutional economists favor a narrower definition. Oliver Williamson, for example, sets out in his chapter on corporate governance to examine the relationship between the firm and what he calls its constituencies: labor, capital (equity and debt), suppliers, customers, the community, and management.9 This conception of corporate governance in essence tries to cover all who participate in some way in the process by which a firm’s product is produced and sold. It sees these parties as voluntarily interacting with the firm, and asks what the terms are on which they interact as well as why those terms look the way they do. “Governance” in the work of Williamson and others of the same school refers to the institutional structure parties set up to deal with the inevitable incompleteness of their contracting, and attempts to explain voluntary relationships in those terms.

Finally, some scholars use a quite narrow concept of corporate governance. This concept is concerned with issues of finance and agency cost and has a policy component: the prevention of the exploitation of those who supply the money by those who control it.10 It

6. This review of corporate governance definitions draws on my discussion in Donald C. Clarke, The Independent Director in Chinese Corporate Governance, 31 Del. J. Corp. L. 125, 143-44.
centers on the relationship between stockholders, the board of directors, and senior management, and in effect asks, with Shleifer and Vishny, “[H]ow can financiers be sure that, once they sink their funds [into a firm], they get anything but a worthless piece of paper back from the manager?11

The approaches of the Cadbury Report and of Blair are typically too broad for CCG. In its simplicity, the definition of the Cadbury Report does little more than repeat the term “corporate governance” using different words. At the same time, the Blair definition seems to encompass not only shareholder-management relations and other internal governance institutions, but also external constraints such as environmental and labor regulations.12 Such a definition might be useful for some purposes, but it is not generally used in CCG. Instead, CCG has typically focused on the issues implicated in the approaches of Shleifer and Vishny and of Williamson: (1) agency problems between investors and management—i.e., the narrow definition of corporate governance—and in particular how this is related to ownership patterns; and (2) shareholder versus stakeholder theories—i.e., questions of for whose benefit the corporation should be run.13

B. The Concept of CCG

Once we have decided what corporate governance is, it would seem to follow that comparative corporate governance involves asking what other jurisdictions do and seeing how they differ. But such inquiries do not take place in a realm of abstract purposelessness; they are invariably driven by some purpose of the inquirer. Thus, the question of “what is CCG?” can best be answered by asking “why do CCG?”


The question that has motivated many American corporate law scholars since Berle and Means, and certainly much recent scholarship, has been, at heart, the question of how we can make managers sufficiently accountable so that they will manage the corporation for the shareholders.


12. This is not completely clear. In restricting her definition to public corporations, Blair may mean only such restrictions as apply only to public corporations as such.

CCG began, and continues, as an approach to corporate governance studies that found inspiration for solutions to problems in one jurisdiction by looking at the practice of other jurisdictions. The policy orientation is explicit.¹⁴ It has developed into something much richer, however, and now encompasses studies that are aimed less at policy recommendations than at simply attempting to understand, through comparison of different regimes, why certain approaches to common problems work or do not work in different contexts.¹⁵

These studies have also taken various approaches to comparison. Some studies have been of single countries, in which the explicit comparative lesson, if any, comes tacked on at the end. Thus, we see studies of takeover law in England¹⁶ or derivative suits in Japan¹⁷ or fiduciary duties in China.¹⁸ Some studies explicitly take a few countries that are similar enough to make comparison worthwhile—for example, they are all advanced economies—but that have differences from which hopefully something can be learned.¹⁹ These studies examine particular national solutions in great detail.

Then there is the “LLSV” and LLSV-inspired literature,²⁰ which codes particular traits of national corporate governance regimes in a

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¹⁴. See, e.g., Comparative Corporate Governance: The State of the Art and Emerging Research v (Klaus Hopt et al. eds., 1998) (“[T]he ability to give welfare-enhancing recommendations is still poor and needs substantial improvement.”). A good example of this type of approach is John C. Coffee, Jr., A Theory of Corporate Scandals: Why the United States and Europe Differ, in Corporate Governance Post-Enron: Comparative and International Perspectives 3 (Joseph J. Norton, Jonathan Rickford & Jan Kleineman eds., 2006).

¹⁵. See, e.g., Comparative Corporate Governance, supra note 14, at v (“Comparative corporate governance research may bring forth new insights that research conducted only within one system may fail to produce.”). Two good examples of this type of approach—trying to explain what we see, without aiming for specific policy recommendations—are Mark J. Roe, Path Dependence, Political Options, and Governance Systems, in Comparative Corporate Governance: Essays and Materials 165, 165 (Klaus J. Hopt & Eddy Wymeersch eds., 1997), and Peter Gourevitch & James Shinn, Political Power and Corporate Control: The New Global Politics of Corporate Governance (2005).


²⁰. “LLSV literature” refers to a series of studies by the economists Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. Representative early works are Andrei Shleifer & Robert Vishny, A Survey of Corporate Governance, 52 J. Fin. 737 (1997); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Law and Finance, 106 J. Polit. Econ. 1113 (1998) (hereinafter Law and Finance); 2nd Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate
large number of countries and then attempts to correlate those traits with other features of a country’s economy, such as per capita GDP or capital market development.

In some cases, scholars have used law to explain economic and financial phenomena. For example, the LLSV literature asserts that patterns of dispersed shareholding can be explained by the rights shareholders are given under the law. The common law protects minority shareholders and therefore supports dispersed shareholding; civil law systems do not, and therefore blockholding emerges as the efficient solution to agency problems. And Mark Roe has had a major influence on the field by arguing, on the basis of the experience of different jurisdictions, that what supports dispersion is not laws on shareholder rights so much as it is populist-inspired legal restrictions on economic concentrations.21

At other times, scholars have used economics and finance to explain law. John Coffee, for example,22 argues that “[m]uch historical evidence suggests that legal developments have tended to follow, rather than precede, economic change[,]”23 and Stuart Banner surveys three centuries of international history to argue that waves of securities regulation typically follow securities market collapses (and are therefore not attributable to broader political factors such as populism à la Roe).24

The “why” of CCG can perhaps best be explained through its history. Although CCG came into its own in the 1990s, its modern reform-oriented version can be traced back to the 1960s and 1970s. Ever since Berle and Means published The Modern Corporation and Private Property,25 American corporate law scholarship has been focused on the separation of ownership from control, and on the ways of mitigating the problems created by that separation. But the problems stubbornly persisted, and it seemed impossible that directors could ever truly play a significant role in managing the corporation, given their limitations of time and information. The late 1960s and early 1970s then saw essentially the abandonment of the ideal of the managing board; the board was reconceptualized as a body that monitored but did not manage. As part of this shift in thinking,

23. Id. at 7.
American academics began to look in particular at the German system of a two-tier board.\textsuperscript{26} At the same time, CCG scholarship remained largely doctrinal, focusing on differences in rules.\textsuperscript{27} Ronald Gilson writes that prior to globalization, "[t]his area of scholarship had been largely the domain of taxonomists, intent on cataloguing the central characteristics of national corporate governance systems, and then classifying different systems based on the specified attributes."\textsuperscript{28}

Several events brought gradual changes to this picture. First, as early as 1976, Jensen and Meckling’s seminal article, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,\textsuperscript{29} turned the focus of corporate law scholarship in the United States to issues of agency cost and ownership structure. This focus naturally made American scholars interested in ownership structures outside the United States and in the implications of their differences. Second, Mark Roe’s work on the political roots of American corporate ownership patterns and their associated governance institutions\textsuperscript{30} suggested that corporate governance might be not just a matter of market-driven evolution toward an optimal set of arrangements, but instead the product of political choices.\textsuperscript{31} Other scholarship showed that the lifetime employment system in Japan,

\textsuperscript{26} See generally Rock, supra note 11, at 368-73.
\textsuperscript{27} See, e.g., André Tunc, A French Lawyer Looks at American Corporation Law and Securities Regulation, 130 U. PENN. L. REV. 757 (1982); ALFRED F. CONARD, CORPORATIONS IN PERSPECTIVE 75-93 (1976); see generally Pinto, supra note 13, at 477, 482.
\textsuperscript{28} Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, in CONVERGENCE AND PERSISTENCE IN Corporate Governance 128, 128 (Jeffrey N. Gordon & Mark J. Roe eds., 2004).
\textsuperscript{31} Professor Roe’s work is not unchallenged. John Coffee has argued that [t]he most convincing explanation for this sharp disparity [between the importance of equity markets in the U.S. and in France, Germany and Italy] is that only those legal systems that provide significant protections for minority investors can develop active equity markets . . . . But once this explanation is accepted, it amounts to a rejection of the “political theory” offered by Professor Roe and others.


Brian Cheffins has also challenged the Roe thesis, pointing out that Britain, despite its very different politics, has developed a capital market and ownership structure very similar to that of the United States. See Brian R. Cheffins, Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom, in CORPORATE GOVERNANCE REGIMES—CONVERGENCE AND DIVERSITY 147 (Joseph McCahery, Piet Moerland, Theo Raaijmakers & Luke Renneboog eds., 2001). The most extended and sophisticated approach to political explanations of corporate governance patterns of which I am aware is Gourevitch & Shinn, supra note 15.
explained variously as a venerable tradition or as an effort to encourage workers to invest in human capital, in fact grew out of a postwar political deal. What all this meant was that the institutions of any one country were not necessarily the most efficient ones for it, and thus research into alternatives could have real payoffs.

Finally, as globalization made issues of national competitiveness increasingly salient, scholars viewed governance systems as competing in much the same way that products do. CCG studies began to proliferate in the 1980s and 1990s. When Japan and Germany were riding high economically in the 1980s, there was great interest in the apparent strengths of German and Japanese models and what was thought to be their contribution to economic performance both at the corporate and at the national level. Some scholars produced studies of the monitoring benefits of the Japanese main bank system and keiretsu structure, while others argued that American equity markets forced executives to focus on quarterly results whereas “the bank centered capital markets of Germany and Japan allowed executives to manage in the long run.” In a word, Japan and Germany were

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33. See Gilson, supra note 28, at 130.

34. Id. at 129.


37. See Gilson, supra note 28, at 130.
going to eat our lunch unless we improved our corporate governance system.38

By later in the 1990s, however, the worm had turned, and the U.S. economy seemed to be outperforming the others. CCG then became, for both Americans and many non-Americans, a study of the superiority of the American system in raising capital and constraining agency costs.39 The focus changed from importing foreign practices to exporting American ones.40 But whoever was viewed as on top, the research agenda of CCG had pretty much crystallized by this time: in the words of two leading scholars in 1999, “In these globalizing times, corporate law’s leading question is whether there is a national corporate governance system (or component thereof) that possesses relative competitive advantage.”41 The second question that dominated the field was what the future would bring: if one model was indeed better than another, would national corporate governance regimes converge? Or would national differences remain?

There was by then no shortage of excellent and detailed studies,42 but the question of convergence seemed as unsettled as ever. Into this morass of doubt and uncertainty, Hansmann and Kraakman in 2001 tossed their bombshell, entitled “The End of History for Corporate Law”;43 the debate was over, U.S.-style corporate governance had won, convergence had already taken place at the ideological level, and formal convergence was “only a matter of time.”44 I shall return to this claim later.

Alongside the discussion of convergence, carried on largely by legal scholars, was a parallel research agenda carried on largely by economists that sought to draw causal links between features of a country’s legal system—in particular, its rules about corporate governance—and various economic indicators. This body of research was launched in the late 1990s by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (LLSV) with several arti-

41. Id.
42. See, for example, the mammoth COMPARATIVE CORPORATE GOVERNANCE, supra note 14. For an extensive review, see Cioffi, supra note 13.
44. Id. at 439.
articles on law, finance, and corporate governance, and the authors have continued, both together and with other collaborators, to produce research in this vein in subsequent years. While the methodology of this research has been criticized, it is sufficient for present purposes to note that its conclusion—that law mattered—added new urgency to the quest for optimal corporate governance rules. In addition, the work of financial economists such as LLSV has moved CCG out of the realm of traditional corporate law. Not only are economists getting into the game, but business school professors—which could only be expected—political scientists, and sociologists are doing so as well.

III. Methodologies of Comparative Corporate Governance

A. Functionalism and its Problems

The overall methodology of CCG has traditionally been, and remains, functionalism. In other words, the scholar identifies a need or a function or a problem that is shared by several jurisdictions, and then asks how they address it. The solutions will by definition be functionally equivalent and therefore comparable. This approach is widely used in comparative law generally. An often-cited example in the CCG field is Ronald Gilson’s “Globalizing Corporate Governance: Convergence of Form or Function.” In this paper, Professor Gilson explicitly takes a function-centered approach to CCG in examining various problems, stating, for example, that “[a]ny successful system must find a way to replace poorly performing senior managers,” and then showing that different systems manage to do it with similar levels of efficiency despite formally different structures. As noted above, CCG scholarship has traditionally taken the cross-na-
tional problem to be that of minimizing agency costs in the shareholder-management relationship.

Although this approach has been praised as “value-neutral,”53 the injection of values into a study is in fact unavoidable, and can only be managed, not eliminated. First, values enter the picture because there is no objective way of knowing what function or need a particular practice serves. What is a problem in one system may not be a problem (or perceived as one) in another. The very act of deciding what is a problem involves a value judgment. Thus, for example, the separation of ownership and control is perceived as a central problem in American corporate law and is therefore assumed often to be a central problem in other jurisdictions.54 But it has been embraced as a solution in much of Chinese corporate governance discourse.55 While one could argue (as I have)56 that this discourse misconceives the nature of the problem that separating ownership from control is supposed to solve, the fact remains that a search for Chinese solutions to the “problem” of this separation is going to yield odd results.

This leads to the second problem: that if the function is exogenously determined, we can always, if we look hard enough, find something that we judge attempts to accomplish it. Consider this passage from Max Gluckman’s *The Judicial Process Among the Barotse*:

[I]n contract cases the court begins by defining the social positions of the litigants: buyer and seller, lender and borrower, employer and servant, cattle-owner and herder, owner and share-cropper in fishing, partners. These positions are linked by agreement (*tumelano*), in sale (*muleko*) or barter (*musintana*), loan (*kukalimela*), employment (*kusebezisa*), herding (*kufisa*), share-fishing (*munonelo*), or partnership (*kopanyo*).57

It may well be that the Lozi terms in question are the closest one can get to the English term preceding it. And it is of course possible that Lozi society happened to come up with a legal system that also uses abstract definitions such as “buyer” and “seller,” “lender” and “borrower,” and so on, and has business organizations like partnerships as we know them. But one cannot escape the suspicion that

53. See Mantysaari, supra note 49, at 11.
54. See, e.g., Gilson & Roe, supra note 36, at 871, 874 (“To date, comparative analyses of the Japanese corporate governance system have assumed that the central purpose of the Japanese system, like that of the American system, is solving the Berle-Means monitoring problem.”).
56. See id.
Gluckman began with the concept from English or Roman-Dutch law, proceeded to look for its equivalent, and inevitably (because the methodology required it) found one.  

A third problem with functionalism crops up when starting not with a posited function, but instead coming from the other direction: starting with an institution and attempting to attribute to it a function. In Teemu Ruskola’s colorful example,

Explaining in a functionalist framework why the medieval French chose to try rats, for example, would require considerable ingenuity. How would one even begin to frame the inquiry? (“How did the French deal with the problem of criminal rodents in the Middle Ages?” Or, “How did medieval French law address cross-species disputes?”)  

Thus, we might see a foreign practice as a response to the “need” to limit controlling-shareholder exploitation of non-controlling shareholders, whereas in fact it serves some other, quite different social purpose. This risk is admittedly small when we are looking at foreign jurisdictions similar to our own, and where there is considerable cross-communication among scholars, so that we have a good sense of how people in the jurisdiction in question view the practice. But once we move to more unfamiliar and exotic jurisdictions without much of a shared legal tradition, and in particular if we do not go below the surface but simply code the rules on the books, the danger of missing something important is very high.

Finally, functionalism is problematic because it requires one in effect to take for granted the function that is served in the analyst’s home jurisdiction. For example, much of the discussion in CCG is over whether there is a single optimal form of corporate governance, and if so, what it is. But although this discussion has resulted in many different views, even to have it requires agreement on what corporate governance is supposed to be optimizing. Although many would say it is or should be about maximizing shareholder returns, there is a sizable dissent from those associated with stakeholder theory and the progressive corporate governance school.

None of this is to condemn functionalism out of hand or to deny its usefulness in some circumstances. Many corporate governance re-

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60. Roberto Romano, for example, posits that institutional blockholding in Germany and Japan exists not to minimize agency costs in that particular institutional environment, but to prevent hostile takeovers or to allow the blockholders “to safeguard or favor their non-shareholder positions at the public shareholders’ expense.” See Roberta Romano, A Cautionary Note on Drawing Lessons from Comparative Corporate Law, 102 YALE L.J. 2021, 2033 (1993).
gimes do indeed face common problems. For example, to whom do assets used by the corporation belong, and to whose creditors shall they be made available? Who can act for the corporation, and how shall that actor's performance be monitored and controlled? CCG studies have gotten a great deal of mileage out of the comparative approach by showing how similar results can sometimes be achieved in spite of different formal legal norms. Functionalism can also be useful in naturalizing the exotic, as it were; in showing that what seems at first glance to be utterly strange can in fact be reduced to familiar terms. As CCG extends its reach beyond the familiar jurisdictions of the industrialized world to transition and developing economies, this approach may still prove valuable. The key is to be alert to, and avoid, functionalism's tendency to reduce to familiar terms that which truly is exotic, thereby hiding precisely what is different and interesting about it.

B. Cross-Sectional Studies Versus Longitudinal Studies

A marked feature of CCG in recent years has been its focus on cross-sectional studies. These studies can examine the relative efficiency of given structures at given times and yield policy recommendations, but do not tell us how structures change over time. One notable exception is an admirable 2002 study by Katharina Pistor and her colleagues of the evolution of corporate law in several jurisdictions since about the late eighteenth century. Another exception is a 2001 article by Mark West showing how Japanese corporate law began after World War II looking like Illinois corporate law, and then gradually diverged over time. West then uses this phenomenon to develop a theory about the differences between Japanese and U.S. corporate law understood as systems; it is their larger unchanging features that explain the way subsidiary features change over time.

C. Empirical Studies using Standardized Data

The well-known LLSV literature and its progeny are empirical studies using standardized data. Particular areas of importance are

61. See, e.g., Gilson, supra note 28.
65. The relevant literature is discussed in La Porta et al., Economic Consequences, supra note 20, passim.
identifying, the relevant rules are found and coded, and then attempts are made to make correlations.

Although one must admire the energy and ambition behind these coding efforts, this genre of literature has been the subject of extensive criticism. First, it is said to focus too much on law on the books, with inadequate attention to whether the law is actually enforced, and that when it does pay attention to enforcement issues, it again looks at law on the books. Second, the literature’s descriptive account of the law is sometimes simply wrong or inconsistent.

Related to the second critique is a third: that the indicia the literature focuses on do not in fact measure something useful. Some of the shareholder rights measured in the literature supply only partial protection to shareholders and are easily circumvented. In other cases, bad or good rules can be varied by contractual arrangements. In still other cases, such as shareholders’ pre-emptive purchase rights for new issues, it is not clear that shareholders—particularly minority shareholders, who are the main objects of this literature’s concern—are better off in a regime that mandates such rights and makes it impossible for shareholders to decide that a different rule might be of greater collective benefit.

Cumulative voting, prized by the literature as a measure of small shareholder protection, is another example. It has been criticized as in fact allowing greater power to directors who are either shareholders themselves or hold the proxies of smaller shareholders. More obviously, cumulative voting cannot...
help the typical public shareholder in a listed company, who holds far less than the minimum proportion—one divided by the total number of directors—required to elect a single director. In a company with a board of as many as twenty directors, the only kind of “small shareholder” who benefits from cumulative voting will be one who already holds at least five percent.

Finally, it has been argued that the correlations this literature finds are spurious and the product of data mining.  

On the other hand, some of the LLSV literature has shed valuable light on comparative questions. It was the LLSV literature that showed how rare regimes of dispersed ownership actually are around the world, suggesting therefore that rules designed for such a regime, where the main agency problem is the vertical one between shareholders and management, are of limited transplantability to countries where the main agency problem is the horizontal one between controlling shareholders and non-controlling shareholders. It also suggested, although not irrefutably, that existing ownership structures are an equilibrium response to domestic legal environments. Controlling shareholders in blockholder-dominated systems do not lobby for more protection for minority shareholders, even though that might increase overall firm value, probably because they would lose more than they would gain by it.

More generally, the problem pointed out over a decade ago by Jonathan Macey remains:

[T]here are no generally accepted criteria for the appropriate means to measure alternative systems of corporate governance. That is to say, there are no formalized, generally accepted criteria for determining whether a particular system of corporate governance is working. Once such criteria are developed, it should be possible to begin serious comparative empirical work in corporate governance.

Macey proposes a set of criteria of his own. First, how successful is the system in preventing managers from diverting firm resources to private use? To answer this question, one could look at the premium

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74. See La Porta et al., Corporate Ownership, supra note 20.


on voting over non-voting stock, or on control-block stock over non-control-block stock.77

Second, how willing are entrepreneurs to sell stock to the public? In a well functioning system, entrepreneurs can credibly promise not to expropriate investors, and therefore receive a high price for the stock. In a poorly functioning system, their promise is worth much less and so they receive much less from investors, making even honest entrepreneurs less willing to sell.78

Third, are there well functioning internal and external markets for corporate control? If so, inefficient management can be replaced by action of the board or by a hostile takeover.

While these criteria are good ones for particular purposes, they are unlikely to solve the problem of general acceptance pointed out by Professor Macey because they do not make explicit the goal that a “working” corporate governance system ought to achieve. Is it control of agency costs as between shareholders and management? Maximization of stock price? Maximization of contribution to gross national product? None of these goals will command universal agreement. Yet without answering this question, it is impossible to know how, for example, to weight the scores on the various suggested criteria for the purpose of comparing different regimes even if we could come up with such scores.

IV. LESSONS FROM COMPARATIVE CORPORATE GOVERNANCE

Despite the suspicion that it is somewhat dull work,79 taxonomy in CCG has been quite illuminating. Scholars have distinguished between insider- and outsider-dominated systems, with the latter relying more heavily on disclosure and markets than the former,80 and Hansmann and Kraakman classify corporate governance systems by their orientation to shareholders, managers, labor, or the state.81 Gourevitch and Shinn go further to produce a typology of six political coalitions resulting from different outcomes of alliance and conflict between owners, managers, and workers.82

77. See id. at 910. On the latter measure, it seems, the United States scored well: 5.4% compared with Italy’s 82%. See id.

78. This is, of course, the lemons problem famously analyzed in George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 Q. J. ECON. 488 (1970).

79. See Gilson, supra note 28, at 128 (“The result [of the taxonomists’ work] was an interesting, if somewhat dry, enterprise.”).


81. See Hansmann & Kraakman, supra note 43.

82. See Gourevitch & Shinn, supra note 15, at 21, Table 2.3.
CCG scholarship also led to the discovery that national systems varied dramatically along dimensions of ownership—some countries have large groups of related corporations (for example, chaebol in South Korea, holding companies in Europe, keiretsu in Japan\textsuperscript{83}); others show patterns of family control (for example, Canada, Italy, and Hong Kong); and others show relatively dispersed shareholding (for example, the United States and the United Kingdom).\textsuperscript{84} A great deal of CCG scholarship has been about trying to explain cross-country variations in patterns of corporate ownership. Different studies have reached different conclusions, not all of them mutually reconcilable. But it is a sign of the vigor of the field that so many different theories have been raised and discussed, and it is hardly a sign of failure that no consensus on a definitive conclusion has yet been reached.

The simplest hypothesis of the CCG literature is that economics, and only economics, matters. Corporate governance is a technology of business organization, just like lean production or indeed the assembly line itself. Countries faced with similar economic pressures will, over time, adopt similar corporate governance institutions. Evolutionary processes will ensure the elimination of unsuccessful competitors.\textsuperscript{85}

CCG research has forced this hypothesis into some major qualifications. Significant differences do persist that are hard to explain as the result of different competitive pressures.\textsuperscript{86} The response of the “economics matters” school has essentially been to say that economics matters within the constraints imposed by politics,\textsuperscript{87} which has something of a tautological flavor, or to maintain that economics still matters in the long run; that even though short- or mid-term differences may persist, long-term trends are decided by competitive economic pressures.

\begin{itemize}
\item \textsuperscript{83} Mark Ramseyer and Yoshiro Miwa challenge what they call the “myth” of the keiretsu; see the discussion at supra note 36.
\item \textsuperscript{84} See Gilson, supra note 28, at 128-29.
\item \textsuperscript{85} This economic Darwinist explanation is discussed more fully and critiqued in Part V.B below.
\item \textsuperscript{86} Doremus et al., for example, write:
\begin{quote}
[S]triking differences in firm behavior persist. These differences correlate most obviously with corporate nationality, not with sectoral characteristics or investment maturity . . . . Those differences . . . are systematic. Across firms, sectors, and in the aggregate, only one set of behavioral variations shines through: national ones.
\end{quote}
\item \textsuperscript{87} See, e.g., Frank Easterbrook, \textit{International Corporate Differences: Markets or Law?}, 9 J. APPLIED CORP. FIN. 23 (1997). But see Romano, supra note 60, at 2037 (“[P]rivate parties are persistent in devising institutions that circumvent, or minimize the effect of, political constraints on economic activity.”).
\end{itemize}
A second hypothesis is that law matters. This is essentially the message of the LLSV literature, which finds a correlation between formal law on the one hand and systems of finance and corporate governance, including ownership patterns, on the other. Whether the link is indeed one of cause and effect, and whether the link is more than spurious, can be (and has been) debated. But in any case, the hypothesis is out there, and it has not been decisively refuted.

A third hypothesis is that history and politics matter. This is, of course, the position of Mark Roe, who argues, “The economic model cannot alone explain foreign structures and their differences with the American structures; it needs a political theory of American corporate finance to provide an adequate explanation.” This hypothesis incorporates path dependency: different ownership patterns prevail because of previous choices in corporate structures and corporate law itself. Both result in regimes that are costly to change even though if we were starting from scratch we might not choose them.

While the Roe hypothesis is far from unchallenged, it has inspired a number of inquiries into the details of various national corporate governance regimes, and has proven a useful lens through which to view national differences. It is hard to find a work of CCG these days that does not cite Roe’s work on path dependency and the importance of history and politics, even if it does not always completely agree with it.

A fourth hypothesis is that culture matters. A traditional concern of comparative law scholarship generally has been that of the transplantability of laws and legal institutions. Will the transplant take? Why or why not? Are there things that need to be considered beyond market pressures and interest-group politics? The “culture matters” school answers “Yes,” and the argument has been applied in the corporate governance context. The problem with culture as an independent variable is that it is very susceptible to vague cliché-mongering, and often used by vested interests as a reason to oppose change. Amir Licht is probably the scholar most prominently associated with an effort to be more rigorous about looking at the relationship between culture and corporate law.

Finally, another effort to get at deep-structure issues can be called the “property rights matter” approach essayed by Curtis

88. The LLSV literature and critiques of it are discussed more fully in Part III.C above.
90. See generally Bebchuk & Roe, supra note 75.
91. See the discussion at supra note 31.
Milhaupt in his 1998 article, “Property Rights in Firms.” The hypothesis here is that we need to understand the claims on corporate assets and behavior that can be made by state as well as private actors, and that the security and predictability of property rights in a polity will affect the ownership structure of firms. In particular, the claim is that dispersed ownership is possible only in countries where private property rights are highly secure, and that concentrated ownership is a response to insecure property rights.

V. Future Directions and Challenges

A. Comparative Corporate Ecology

One criticism leveled at the LLSV literature is that it mistakes the rules on the books for actual practice. This is so in two ways. First, it neglects enforcement issues. But perhaps more importantly, it neglects the ways in which actors can often negotiate around the rules if they wish, to the extent that Bernard Black has famously called corporate law “trivial.” A contractarian theory of corporate law would hold that the rules we see applying to participants in the corporate enterprise are all rules that they have in some sense chosen. The LLSV literature in effect rejects by implication this theory of corporate law without ever directly engaging it or even acknowledging its existence.

More broadly, CCG would benefit from a stronger focus on the institutional environment for corporate governance. This means comparing not just rules, no matter how well selected, but also the various institutions that exist to make the rules meaningful, as well as non-legal institutions that may work to accomplish the purposes—for example, the reduction of agency costs—attributed to corporate governance rules. A decade ago, for example, John Cioffi asserted that

... even under the liberal legal tradition and pluralist political conditions in the United States, fiduciary duties cannot fulfill their governing function unless one assumes the existence of powerful, pervasive, and effective extra-legal social mechanisms of norm internalization. Whatever the moral force and effect of fiduciary duty law, the hypertrophy of the business judgment rule reveals the impracticability of structuring corporate governance through formal rights and

93. See Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 NW. U. L. Rev. 542 (1990). Black does not actually assert that all corporate law is trivial in the sense that unwanted rules can be avoided at low cost. He argues that where such rules cannot be avoided, political pressures will be brought to bear to change them.

94. I have tried to do this myself in Donald C. Clarke, Law Without Order in Chinese Corporate Governance Institutions, 30 NW. J. Int’L L. & Bus. 131 (2010).
judicial enforcement . . . . Economically functional corporate governance regimes thus require alternative or additional legal mechanisms of governance such as disclosure regulations, proxy rules, board structure and operation, and board and/or works council codetermination. Hence, corporate governance regimes and their reform reflect a politics of institutional mechanisms.95

The last ten years have seen numerous studies of the “alternative or additional legal mechanisms” noted by Cioffi, plus others not mentioned. A few scholars have produced comparative studies of shareholder derivative actions, for example.96 And the CCG community is certainly aware of the importance of institutional context in general. But further comparative research on many specific institutions is needed; surely interesting insights could be gained by studying the role in other countries of the financial press or of gatekeepers such as lawyers and accountants.97

B. The Issue of Convergence

A key question occupying CCG almost from the beginning has been that of the prospects for convergence.98 Most of the arguments on convergence—whether it is going to happen, and what pressures exist either for or against it—were already out there in the literature ten years ago.99 Yet there was no consensus then100 and there is none now.

95. Cioffi, supra note 13, at 523-24 (internal footnotes omitted) (emphasis in original).
97. See Coffee, supra note 31 (studying gatekeepers in other countries).
98. In these globalizing times, corporate law’s leading question is whether there is a national corporate governance system (or component thereof) that possesses relative competitive advantage . . . . If only the fittest practices can survive in the global market, it also becomes plausible to project that national governance systems will converge upon them and systemic differences will disappear.
99. See, e.g., Bebchuk & Roe, supra note 75; Bratton & McCahery, supra note 40; Gilson, supra note 28; Coffee, supra note 31.
100. See Bratton & McCahery, supra note 40, at 216 (“[A]s descriptions have become thicker and more cogent, answers to the bottom-line questions respecting
The definition of insanity is said to be doing the same thing over and over and expecting different results. If so many scholars after so many years still cannot get any traction on the problem, perhaps this is a clue that we are asking the wrong question.

The issue of convergence can be divided into three main sub-issues. First, why might it happen? Second, is it happening? Third, is it a good thing?

The CCG literature has proposed several reasons why convergence might happen. Foremost among these explanations is the economic Darwinist one: convergence will occur because one system must necessarily be more efficient than the others, and that system will prevail in economic competition between corporations. A typical statement of this view is as follows:

In the long run, product market competition resulting from the increased openness of national economies to foreign trade may demonstrate which of the two local [corporate governance] optima is also optimal for the world as a whole. While there may be no unique answer, it may turn out that one or the other is better suited for particular industries.

This view sees corporate governance as an organizational technology, and firms must adopt the best available technology to survive. With the increased flow of information, lack of knowledge about this technology is no longer an obstacle to its diffusion. Countries that fail to adopt efficient rules will suffer; their corporations competitive advantage have become more elusive and convergence predictions have become more qualified.

101. The expression is often attributed to Einstein or Franklin, but I have found no specific citation.


103. See Nestor & Thompson, supra note 80, at 35. An interesting field of research within this approach is the degree to which there is a necessary correlation between production technology and organizational technology. Ronald Gilson writes:

[I]t was thought that Japanese lean production, supported both by employees rendered cooperative and inventive by lifetime employment, and by close, long-term ties to suppliers, could not be matched without dramatic changes in US governance institutions. In fact, American manufacturers adopted lean production, but adapted lean production to fit their governance institutions, rather than adapting their institutions to lean production.

Gilson, supra note 28, at 131-32. For more on the relationship between governance and production systems in the United States and Japan, see Charles Sabel, Ungoverned Production: An American View of the Novel Universalism of Japanese Production Methods and Their Awkward Fit with Current Forms of Corporate Governance, in Convergence and Persistence in Corporate Governance, supra note 28, at 310.
will be worth less, and will have a harder time raising capital. Business will suffer, or will move elsewhere.104

To be complete, this explanation must be supplemented by another one setting forth the mechanism by which competitive adaptation takes place. The literature offers a number of suggestions: technological determinism, in which similar problems dictate similar solutions; emulation, where policymakers consciously imitate the practices of other countries; elite networking, where a cosmopolitan group of experts forms a consensus and then proselytizes it back in the members’ home countries; harmonization, where policymakers recognize interdependence and the need to avoid unnecessary incompatibilities; and penetration, where states face serious externally imposed costs of some kind for not adopting converging structures.105 For example, investors might plausibly threaten to leave (or not to come) if there is not reform. An interesting development in recent years has been the explicit promotion of a corporate governance agenda by international financial institutions such as the World Bank, the International Monetary Fund, and the Asian Development Bank.106

Whether political factors lead to convergence or divergence seems to be indeterminate. Scholars such as Mark Roe have emphasized the importance of social-democratic politics in the making of national corporate governance regimes.107 If he is right, then corporate governance will converge at about the same time politics converges. Other scholars see politics as a force for convergence. Mary O’Sullivan argues, for example, that while social democratic values may drive political decisions, it does not follow that they will drive corporate governance regimes. Quite the opposite may occur (and, she argues, did occur in France in the 1990s108): if social democratic values mean that society assumes the cost of redundancies, then it may be easier for corporations to make decisions that maximize profits and do not take labor and other “stakeholder” interests into account.109

Indeed, it is not even undisputed that economic factors will lead to convergence, as argued by the Darwinian view. The “varieties of capitalism” perspective holds that

104. This story is presented in Bebchuk & Roe, supra note 75, at 134-38, although it is not clear that they subscribe to it.
106. See Rosser, supra note 66, at 320.
107. See Roe, supra note 30.
108. See O’Sullivan, supra note 47, at 53.
109. See id. at 63. On the other hand, the state’s reluctance to bear the cost of generous redundancy benefits may lead to regulatory regimes that make it difficult for employers to fire workers. For political sources of convergence generally, see id. at 30.
an understanding of the foundations of economic performance suggests the persistence of diversity in systems of corporate governance. [This perspective] emphasize[s] the importance of institutional diversity for shaping enterprise behaviour and economic performance. [It] reject[s] the assumption that there is one best way to organize an economy and, in particular, that the free flow of economic resources through “perfect” capital, labour and product markets will lead to optimal economic outcomes.110

Moreover, the argument that firms must adopt international norms in order to attract investment is empirically questionable. The standard view is expressed by Nestor and Thompson, who state that in an era of globalized capital markets, firms know that “in order to tap this large pool of global financial resources, they need to meet certain governance conditions.”111

Institutional investors also insist that companies respect international norms of governance, particularly concerning the duties of management and controlling shareholders to respect the demands of minority investors concerning transparency and the procedures for exercising corporate control, especially at the shareholders meeting.112

This argument is not implausible on its face, and may well be true at least at the margin and when all other things are equal. But all other things are never equal, and the question is whether corporate governance survives as a decisive factor when other factors have been taken into account. Particularly in emerging markets with poor and unreliable disclosure, investment decisions are as often driven by predictions about broad economic trends or government policies as they are driven by company-specific matters such as governance. Randall Morck found a high degree of synchronicity in stock prices in emerging market countries, suggesting that investors in those markets pay more attention to systemic risk factors than to corporation-

111. Nestor & Thompson, supra note 80, at 20.
112. Id. at 34.
specific information. The foreign business community has been telling China for years that it must improve its corporate governance regime or face a loss of investment, but the threat has proved empty. And foreign investment continues in Russia, despite corporate governance practices described by Bernard Black and his co-authors with terms such as “kleptocracy,” “looting,” and “plunder.” In short, investment in many emerging markets seems to be driven by a desire simply to be there, with little attention paid to the quality of the company in which the investment is made.

But even if economic pressures do drive firms toward a single model, it does not follow that Darwinian selection will actually result in convergence. First, for this result to obtain, selection pressures brought about by corporate governance differences would have to operate quickly and massively. To say that selection pressures push firms toward a particular destination is a different thing from saying that they will actually arrive there, and to show that some structure is efficient in the long run is not to show that at any given moment no inefficient structures can be observed.


114. See Bernard Black et al., Russian Privatization and Corporate Governance: What Went Wrong?, 52 Stan. L. Rev. 1731, passim (2000). It is of course very plausible to suppose that foreign investment in Russia would be higher if it had better corporate governance. The point is that it would also be higher if many other things were true—for example, if oil prices were higher or if taxes were lower—and it may be that investors are willing to overlook a lot of poor corporate governance if an investment has other attractive features.

115. An excellent if ultimately anecdotal account of this phenomenon is Tim Clissold, Mr. China (2005), which tells the tale of how two investment managers lost half a billion dollars in China. A recurring theme is the pressure they faced from investors in their China fund to invest in something—anything—even when no good prospects were available.

116. Miwa and Ramseyer, for example, while sometimes acknowledging that competitive pressures “drive firms toward” a firm-specific optimum number of outside directors, elsewhere go much further and assert in effect that all firms are always already there. See Yoshio Miwa & J. Mark Ramseyer, Who Appoints Them, What Do They Do?: Evidence on Outside Directors from Japan 6 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 374, 2002), available at http://papers.ssrn.com/abstract_id=326460 (analogizing a sub-optimal number of outside directors to $20 bills lying on the sidewalk in order to conclude that all firms in their survey must already have the optimal number). This vastly overestimates the flexibility of human institutions. See also Rational Choice 26 (Jon Elster ed., 1986) (questioning the applicability of the biological analogy to economic activity on the grounds that the economic environment changes rapidly relative to the speed with which inefficient firms are eliminated from competition, and that therefore at any given time we are likely to observe efficient and inefficient firms coexisting); Mark Granovetter, Economic Action and Social Structure: The Problem of Embeddedness, 91 Am. J. Sociology 481, 503 (1985) (“The operation of alleged selection pressures is
Even if one believes in the effect of selection pressures, they will not push toward convergence unless the political, economic, and social environments for all competing firms are identical, such that the same set of rules turns out to be optimal for all. While the economic Darwinist view quoted above is intuitively appealing at first glance, it ultimately fails for two reasons. First, corporate governance structure is only one cost of production. There are many other reasons for differences between countries in production costs, and those reasons might easily swamp any effect from corporate governance. Second, and more important, the argument does not take into account the concept of comparative advantage and its role in international trade. In a two-product world of wine and wheat, if it is relatively cheaper in terms of wine for Ruritania to produce wheat with Corporate Governance Regime X than for Freedonia to produce it with Corporate Governance Regime Y, then Ruritania will end up supplying wheat to the world even though Country N might be able to produce it at lower absolute cost and even if the only difference in production costs is the corporate governance regime. Thus, the more efficient corporate governance regime, even if we define it on an industry-by-industry basis, will not necessarily prevail unless all other differences between countries have been removed.

Finally, if the story of selection pressures were true, then not only would we see convergence in corporate governance, but we would long ago have seen convergence in political and economic systems. All societies would look the same now. But they do not, and therefore the optimal set of corporate governance rules in each society is likely to be different even if you believe that selection pressures push companies toward optimality. Since corporations have not as an empirical matter all migrated out of all countries except one (the one that has the best rules), it must not be true that selection pressures work the way the story says they do. In short, while it is plausible to believe that selection pressures can push firms in a certain direction, it is not clear that that is the same direction for all firms, and even if it were the same direction, it is not clear that firms ever actually get there.

... neither an object of study nor even a falsifiable proposition but rather an article of faith.

117. See text accompanying supra note 102.

118. The demonstration of this result must be left to the economics textbooks. See, for example, Paul R. Krugman & Maurice Obstfeld, International Economics: Theory and Policy 11-37 (3d ed. 1994). Needless to say, the result depends on various simplifying assumptions. But the basic insight remains valid. An experienced mechanic might be able to do six oil changes in an hour, as opposed to his apprentice, who can do only three. But the mechanic will still leave oil changes to the apprentice and focus on higher-value transmission repair work, since his income from using his time in that way more than makes up for the lost income stemming from less efficient oil change operations.
Are we actually seeing convergence? Despite Hansmann and Kraakman's provocative bombshell, there is no consensus that we are. In the advanced industrial countries, there has been little movement toward convergence. German-style co-determination, for example, has not proven attractive to other countries, but the Germans for their part show little inclination to reject it. In what for CCG studies has traditionally been the key realm of shareholder rights, an extensive recent study concludes that it is "a mixed picture." There has been some convergence in management compensation practices, but no noticeable convergence in the area of defenses against hostile takeovers.

At the same time, we should not overlook some important specific instances of convergence. Over the last several years, Japanese corporate law has undergone "massive" revisions in what could be called an American direction, culminating in the consolidated Company Law of 2005. Most observers, however, maintain that despite revisions to the formal law, the practice of corporate governance in Japan is changing only slowly.

The same might be said about China. Given that the People's Republic of China did not even have a general corporate statute for the first four-plus decades of its existence, the very adoption of such a statute in 1993 could be viewed as a formidable example of convergence. More to the point, the 2005 revisions of China's company and securities laws were unquestionably in a direction that brought them closer to, and not further from, the mainstream. Yet the reality of

120. See id. at 358-59 and sources cited therein.
121. Nottage, Wolff & Anderson, supra note 36, at 1, 2. A table showing the reforms is appended to the article; see id. at 11.
corporate governance practices in China remains very different from what appears in the statute books, and indeed is so opaque that it is difficult to measure reliably where it is, let alone to know in what direction it is moving.  

Finally, it is worth considering the question of whether convergence would be desirable even if we had it. Here the argument for cross-national convergence or uniformity seems less compelling than in other areas of the law. In transnational bankruptcy cases, for example, there is value in a system that ensures uniform principles of distribution regardless of where the debtor's property happens to be or who first brings the case to court in which country. Consistent rules of contract on matters such as offer and acceptance make business transactions more predictable and forum-shopping less rewarding. But while there is general agreement that forum-shopping in those types of cases is a bad thing, there is much less agreement that the corporate law equivalent of forum-shopping—that is, incorporating in the jurisdiction that offers the best form of business entity for one's particular needs—should be discouraged. It has long been allowed in the United States, and is increasingly allowed in Europe following the landmark Centros decision. Clearly, there is substantial political as well as intellectual force behind the idea that choice is a good thing. It has even been argued that diversity in corporate governance regimes is per se a good thing, in the same way that biological diversity is a good thing: it preserves alternative ways of organizing that may prove superior to current ways if the relevant environment changes.

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125. See generally Clarke, supra note 94.


127. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. 11459. In that case, two Danish citizens and residents with no connections to the United Kingdom established Centros Ltd. under English law. The company then attempted to register a branch in Denmark in order to do business there. (It was assumed for the sake of the decision that the shareholders followed this procedure to avoid Danish minimum capitalization requirements.) The Danish government refused registration, but the refusal was overturned by the European Court of Justice. For a sample of commentary on the case, see Jankolovits, supra note 126; Wolf-Georg Ringe, Sparking Regulatory Competition in European Company Law—The Impact of the Centros Line of Case-Law and its Concept of “Abuse of Law,” in PROHIBITION OF ABUSE LAW—A NEW GENERAL PRINCIPLE OF EU LAW (R. de la Feria & S. Vogenauer eds., forthcoming 2010).

128. See Brett H. McDonnell, Convergence in Corporate Governance—Possible, But Not Desirable, 47 VILL. L. REV. 341, 382-83 (2002). The metaphor is a little strained; a
The whole discussion of convergence in corporate law is, in fact, oddly different from discussions of convergence in other fields of law, because convergence in corporate law does not necessarily mean uniformity. For corporate governance models do not vary only on the substantive rules they apply to business organizations. They vary also on the degree to which they offer and respect choices about which form of organization to use. Thus, if Model A offers one form and forbids the adoption of others, worldwide convergence to Model A might mean the elimination of choice. But convergence to Model B might mean the preservation of choice, if Model B is (for example) Delaware, which allows choice between a wide variety of organizational forms, one of which—the Delaware business trust—itself has virtually no mandatory rules.

Given, then, that the very meaning of convergence is so uncertain, as well as the failure over so many years to come to any consensus as to whether it is occurring, perhaps it is time to abandon the crystal-ball approach to CCG studies. After all, what purpose is really served by trying to figure out if convergence is inevitable or not? There is value in determining which features of which system do what well and do what badly. If policy advocacy has any real-world effect, then one should advocate what seems to work well, regardless of what direction the rest of the world is going in.

The debate about convergence seems really to be a debate about the conclusion to a number of debatable premises, and it would be better to debate the premises directly. In other words, the point is not whether it will rain tomorrow. The point is whether cloud-seeding today is an effective way to make it rain. The issues therefore become: (1) is there really a single best corporate governance system that is determined solely by economics, and (2) what is the process by which a country might come to adopt that system? Will it be the inevitable outcome of competitive processes, or might it not happen at all without proper policy advocacy, with the result that a country could become a laggard? These are the questions that matter from an academic and policy standpoint.

biological species, once gone, is gone for good, at least until Jurassic Park-like technology is invented. A species of organization, by contrast, can exist in the minds of human beings even if there are no examples of it on earth, and thus can be resurrected any time someone thinks it might be useful.

130. See Tamar Frankel, The Delaware Business Trust Act Failure as the New Corporate Law, 23 Cardozo L. Rev. 325, 326 (2002) (the Delaware Business Trust Act "contains highly permissive provisions, allowing promoters of business trust a staggering degree of freedom to design their relationships with beneficiaries-investors.")
C. Breadth of Focus

1. Focus on the Public Corporation

CCG studies have tended to focus on publicly listed corporations. There are probably several reasons for this: they are the type of corporation that law professors tend to know best, and disclosure laws around the world mean that they produce the most numbers for economists to crunch. Furthermore, such companies feature almost by definition the involvement of small, passive shareholders, and thus present public policy questions arguably not present in business entities involving a small number of people who bargain with each other. Finally, if large public corporations dominate the economy, then the value of studying them is self-evident.

Although the focus on public corporations is for all these reasons understandable, it means that a great deal of interesting territory has been left largely unexplored. American corporate law scholarship and teaching has long been moving from a “corporations” approach to a “business organizations” approach, and scholars such as Henry Hansmann and Larry Ribstein have written extensively about alternative business structures. It is time for CCG to do the same. Non-public-corporation business organizations (NPCBOs) play a major role not just in advanced industrialized economies, but even more in the transition and emerging market economies that have become increasingly important. They are major sources of employment, and are an essential stage in the life cycle of the large, successful public corporation. To focus on public corporations without understanding how NPCBOs operate, then, is to overlook a major part of

132. In the United States, for example, small businesses (not the same thing as NPCBOs, but close enough for present purposes) have generated sixty to eighty percent of net new employment since the mid-1990s. See Small Business Administration, The Small Business Economy 2009, at 9 (2009).
the global economic landscape. Therefore, if the CCG approach has any value at all, attention to NPCBOs would benefit scholars and policymakers from all types of jurisdictions: common law and civil law, advanced economies and developing economies.

What insights might such an approach yield? If we accept a basic premise of CCG scholarship—that national differences in the governance of public corporations matter for national economic performance—then we must also accept the premise that national differences in the governance of NPCBOs also matter (assuming NPCBOs matter at all in the economy). This in turn suggests the possibility that to the extent the current perceived superiority of American over Japanese capitalism can be attributed to differences in corporate governance, we should study the differences not in the governance of large, public corporations—after all, General Motors did not outperform Toyota—but rather in the way innovative start-ups such as Apple and Google could be governed and funded through venture capital.134

2. Focus on the Boundaried Firm

As noted earlier in the Article, the focus of CCG studies, particularly in the United States, has tended to be on the relatively narrow set of issues involving the relationship between shareholders and managers—in other words, on corporate law and securities law. Some voices have urged greater attention to labor issues.135 But the desirability of broadening CCG’s focus goes beyond the familiar shareholder vs. stakeholder conceptions of the corporation. Those competing conceptions still have one important thing in common: a vision of the corporation as a well-defined entity, with insiders and outsiders, employees and non-employees, shareholders and creditors.

But CCG, at least as practiced by legal scholars, needs to come to grips with patterns of industrial organization in which the boundaries of the firm are by no means clear. As William Klein pointed out almost three decades ago, although “[t]he notion that activity is organized either within firms or across markets does seem useful” for some purposes,

[t]he types of organization people use to accomplish their economic goals, however, vary greatly; one can draw a clear line between firms and nonfirms only by adopting simplistic and unhelpful definitions. More realistically, one should envision a spectrum with varying degrees of “firmishness” and treat the firm not as an entity, but as an abstraction that

134. I am grateful to Barry Naughton for suggesting this point.
135. See, e.g., Cioffi, supra note 13, at 524.
facilitates the examination of complex relationships among different actors.\textsuperscript{136}

In his 1983 article “The Contractual Nature of the Firm,” Stephen Cheung argued that the notion of a firm with boundaries made no sense and that, from an economist’s standpoint, “it is futile to press the issue of what is or is not a firm.”\textsuperscript{137} And Ronald Coase himself, in his seminal article “The Nature of the Firm,” admitted that “it is not possible to draw a hard fast line which determines whether there is a firm or not.”\textsuperscript{138}

The essential insight of all three authors is that the complexity of explicit and implicit contractual relationships among all those involved in production often makes it impossible, and indeed pointless, to say who is inside the firm and who is outside.\textsuperscript{139} In real life, of course, it has long been true that a great deal of production takes place within the traditional hierarchical firm analyzed in Alfred Chandler’s classic work, \textit{The Visible Hand: The Managerial Revolution in American Business}.\textsuperscript{140} But that has not been true everywhere\textsuperscript{141} or in all industries,\textsuperscript{142} and it may well be less true in the future as developments in communications and transportation technology make the economic environment more hospitable to what has been called the “virtual firm” or the “networked company.”\textsuperscript{143}

So far, however, these insights into the complexities of contracting have not been extensively explored in the CCG literature. What might such an exploration show—that is, what insights might

\begin{itemize}
  \item \textsuperscript{137} Stephen N.S. Cheung, \textit{The Contractual Nature of the Firm}, 26 \textit{J. L. \& Econ.} 1, 18 (1983).
  \item \textsuperscript{138} Ronald H. Coase, \textit{The Nature of the Firm}, 4 \textit{Economica} 386, 391 (1937).
  \item \textsuperscript{139} This is not to deny that sometimes the law requires us to make precisely those distinctions. Consider the number of politicians and would-be government officials who have had “nanny tax” issues precisely because they treated their nannies as independent contractors (outside the firm, so to speak) when they should have treated them as employees (inside the firm) and paid social security taxes.
  \item \textsuperscript{140} Alfred D. Chandler, Jr., \textit{The Visible Hand: The Managerial Revolution in American Business} (1977).
  \item \textsuperscript{142} Consider, for example, mutual funds, which outsource virtually all their activities, see \textsc{Schools Brief: Moneyed Men in Institutions}, \textit{Economist}, Nov. 6, 1999, at 83, 83; the technology industry in Silicon Valley, see AnnaLee Saxenian, \textit{Regional Advantage: Culture and Competition in Silicon Valley and Route 128} (1994); and the construction industry, see William A. Klein & Mitu Gulati, \textit{Economic Organization in the Construction Industry: A Case Study of Collaborative Production Under High Uncertainty}, 1 \textsc{Berkeley Bus. L.J.} 137 (2004).
  \item \textsuperscript{143} See Remo Häcki & Julian Light, \textit{The Future of the Networked Company}, 3 \textsc{McKinsey Q.} 26 (2001); Anne E. Conaway Stilson, \textit{The Agile Virtual Corporation}, 22 \textsc{Del. J. Corp. L.} 497 (1997).
\end{itemize}
be gained by approaching comparative corporate governance from a “firmishness” perspective? Such a perspective means abandoning the focus on the large integrated firm and opening up our field of vision to networks of many small firms connected by formal or informal contractual relations in a production chain; it means abandoning the effort to figure out if those relationships should be labeled hierarchical ones of ownership or horizontal ones of contract. In such a network, the concept of “corporate governance” would have to be broadened to mean institutions intended to prevent, at reasonable cost, excessively opportunistic behavior by network members.  

As discussed earlier, a core concept of corporate governance in its traditional sense is the idea that all participants in the corporate enterprise have an interest in assuring minority investors that their powerlessness will not be unduly exploited; this is the only way they can be induced to invest in the first place. Similarly, network members need some assurance that other members will not take advantage of their transaction-specific investments to hold them up. Comparative corporate governance from a “firmishness” perspective would look at the various arrangements in different societies that appear to prevent the kind of excessive opportunism that would cause production networks to collapse.

One reward might be a better understanding of the trade-offs between contractual governance arrangements and hierarchical ownership arrangements, and perhaps even insights into arrangements that are completely outside this duality. For example, vertical integration is often thought of as the solution to excessive contracting costs—costs that include not only negotiation, but also enforcement. In societies where contracts cannot be reliably enforced, we would expect to see a higher degree of vertical integration. But do we? China poses the example of highly specialized production chains involving complex networks of firms not tied together through vertical integration, and yet its courts are generally considered unreliable as contract enforcers. What institutions are performing the governance function, and what do we find in other countries that appear to exhibit the same combination of weak contract enforcement and low levels of vertical integration?

3. Moving Beyond the Traditional Jurisdictions

As the previous point suggests, CCG would benefit by moving to newer and more exotic—but still very important—jurisdictions and

144. I specify “excessively” because network members cannot be expected to be fiduciaries for each other; a certain amount of selfish behavior must be expected and allowed.
145. The concept of asset specificity and the vulnerability this entails is discussed extensively in Williamson, supra note 9.
truly taking account of foreignness. This means countries like India and China. The challenge is that they are going to look in some respects very familiar, with familiar forms. But in other respects they are quite different, especially China, since at least India shares a common legal tradition with the United States (and, more directly, England). Even that, however, can be misleading. How well can India fit into theories of legal governance designed for the United States or Europe when simple cases can drag on for decades? 146 Both of these countries are going to challenge legal scholars to think about how corporate governance can work when it cannot rely on a reasonably efficient court system. Can gatekeepers and reputation effects do all the work? And if so, does this suggest that a sound court system, even in countries where it exists, is not as important as we might have thought?

4. Contingency of Problem Issues

One of the original insights from CCG was that others are not necessarily concerned with the same problems that we are. This in turn is a lesson about the contingency of our own concerns; maybe there are problems we should be worrying about other than shareholder-management agency costs. Back in 1996, Edward Rock wrote about the comparative scholarship of Richard Buxbaum, for whom the interesting question was not how we can make managers sufficiently accountable to shareholders, but rather “why society permits the establishment and persistence of massive private concentrations of economic and political power over which the political process exercises relatively little control.” 147 Comparative scholarship can thus show us that what we think is fundamental may not be so fundamental, and that we may be taking for granted issues that outsiders find of intense interest.

CCG has not really taken up this challenge. By and large it is still interested in the basic issue of convergence or divergence, and the fundamental issue is that of reducing agency costs. The virtues and vices of dispersed ownership versus blockholding are typically discussed in terms of their monitoring capacities, not in terms of, say, their contribution to social cohesion.

Of course, it can be objected that this is outside the realm of corporate governance studies, properly understood. But what does and does not count as corporate law is also a contestable proposition. If one defines corporate law as the law governing the relationship be-

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146. See Jeremy Page, Delhi Judges Face 466 Years’ Hard Labour, THE TIMES, Feb. 17, 2009, available at http://tinyurl.com/e9qsp (even working at its current rate of less than five minutes per case and assuming the rate of new filings does not increase, it will take the Delhi High Court 466 years to clear its current backlog of cases).

147. Rock, supra note 11, at 389.
between shareholders and managers, then almost by definition it is going to be about the agency costs of this relationship, and one can persuasively claim that corporate law neither does nor should deal with the claims of employees, customers, etc.

But if corporate law is defined more broadly as a kind of business law, then it is clear that we do have a lot of law dealing with these claims, and in different ways. Let me be clear: I am not advocating here a stakeholder theory of corporate governance as a normative matter. I want only to make the point that a focus on agency costs is not self-evidently the only way to go in comparative work. Simple and even self-evident though this point may be, it does suggest a new area of research in CCG: the comparative meta-study, as it were, of the key issues in corporate governance as they are perceived in different societies. Current research is focused largely on understanding the different ways in which legal systems solve similar problems. But there is much to be gained from understanding the different ways in which societies understand the problems they face. Not only can this alert us to the potential importance of problems we may have overlooked or deemed trivial, but it can also help us understand why transplants go wrong; the adopting jurisdiction may not have understood the problem the transplanted institution was designed to address in the home jurisdiction.

VI. Conclusion

Despite the somewhat undertheorized nature of the comparative project generally, CCG has proven a successful approach to corporate governance scholarship, if success is measured by the ability to generate interesting insights that provoke further scholarship and seem likely to continue to do so. This Article’s call to enlarge the scope of CCG scholarship is not a lamentation of its failures but an appreciation of its accomplishments.

One of CCG’s important successes is really an achievement of corporate law scholarship generally, and that is to bring comparative law—an interest in what people in other countries do—into the mainstream of a branch of American legal scholarship. Corporate law scholars who do not do CCG are still likely to be familiar with much of what this Article has discussed, and to have read at least some of the literature. Much of this popularization of CCG has occurred in


149. See, for example, the discussion of how Chinese corporate governance discourse looks at the separation of ownership and control, text accompanying supra notes 54-56; see generally Ralf Michaels, The Functional Method of Comparative Law, in THE OXFORD HANDBOOK OF COMPARATIVE LAW 339 (Mathias Reimann & Reinhard Zimmermann eds., 2006).
the last decade or so. One does not see a pervasive sense of American exceptionalism in the field of corporate law; even those who think we do it better than foreigners have some sense of how foreigners actually do it, and there have been periods in which the mainstream view was that foreigners do it better than we do. Regardless, therefore, of how the debates on convergence or other issues come out, corporate law scholars can give themselves a pat on the back for that.
March 8, 2013

Important Questions About Activist Hedge Funds

In what can only be considered a form of extortion, activist hedge funds are preying on American corporations to create short-term increases in the market price of their stock at the expense of long-term value. Prominent academics are serving the narrow interests of activist hedge funds by arguing that the activists perform an important service by uncovering “under-valued” or “under-managed” corporations and marshaling the voting power of institutional investors to force sale, liquidation or restructuring transactions to gain a pop in the price of their stock. The activist hedge fund leads the attack, and most institutional investors make little or no effort to determine long-term value (and how much of it is being destroyed). Nor do the activist hedge funds and institutional investors (much less, their academic cheerleaders) make any effort to take into account the consequences to employees and communities of the corporations that are attacked. Nor do they pay any attention to the impact of the short-termism that their raids impose and enforce on all corporations, and the concomitant adverse impact on capital investment, research and development, innovation and the economy and society as a whole.

The consequences of radical stockholder-centric governance and short-termism prompt a series of questions that cry out for re-examination of basic premises by the academics who exalt simplistic principal/agent theories and neo-classical economic models on only select principal/agent relationships while ignoring not only all social cost and all of behavioral economics but even the application of these same agency theories to other key actors in the current financial landscape. So too do they cry out for re-examination of the regulations that facilitate corporate raiding and short-termism and the failure to put in place a system that would allow management to achieve the optimal long-term value of public corporations, for the benefit of long-term investors and the whole American economy. The boot-strap, bust-up, junk-bond takeovers of the 70’s and early 80’s proceeded unchecked and laid waste to the future of many great companies, all cheered on by the academics and aided by do-nothing regulators. The new incarnation of sacrificing the future for a quick buck is at least as dangerous. It requires new thinking to address the new threat.

Among the questions that must be addressed are:

1. **Purpose of the American Business Corporation.** Is the fundamental purpose of the American business corporation, and the proper goal of sound corporate governance, optimal long-term value creation? Or is the purpose to maximize short-term stockholder value at any time any particular stockholder—with its own goals and agenda, which are unlikely to be congruent with the interests of other stockholders—happens to demand it?

2. **How Are “Excess” Returns Actually Obtained?** Activist hedge funds are reportedly outperforming many other asset classes as their raids seem to “unlock” value through pressured transactions. Is this value actually created, or merely appropriated from fellow stockholders with longer-term investment horizons, and from other stakeholders such as employees, including by sacrificing capital spending and investment in long-term research and development?

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3. **Are There Really Best Practices?** Is there sufficient (or any genuine) evidence that “best practices” corporate governance of the type promoted by the academics and advisory services results in enhanced long-term performance of the corporation — especially given the fact that American corporations have historically enjoyed the best long-run performance in the world? Is “best practices” corporate governance a major factor in short-termism?

4. **Structural Conflict.** Is there a structural conflict in a system in which stockholders exercising power over a corporation owe no legal duty to anyone and are an ever-changing group that is free to enter a stock in size without advance disclosure and exit at any time of their choosing, act in concert, or even mask their interests using derivatives and engage in empty voting? And in which the decision-makers at these stockholder bodies are themselves agents, compensated, in many cases, on the basis of the short-term performance of the investment portfolios they supervise on behalf of savers and investors?

5. **The “Principal/Agent” Premise.** Is the essential premise of the stockholder-centric proponents – the principal-owner/agent view of the corporate firm – accurate or reasonable, given that the legal system gives legal immunity to the “owners” (stockholders) and imposes fiduciary duties and liabilities on the “agents” (directors)?

6. **The Missing Principal.** Is the principal/agent structure of institutional investors imposing an unacceptable cost on corporations when the underlying beneficial holders of the managed portfolios—retirees, long-term investors and savers – play little if any role in checking the power of those running the investment intermediaries? Regulation, litigation, and public scrutiny perform powerful roles in addressing agency costs that may exist at the corporate board and management level. But given the massive intermediated ownership of public corporations today by a variety of different types of institutional investors with varied compensation and governance arrangements of their own, do we fully understand the agency costs of these investment intermediaries, who is bearing those costs and whether they are being sufficiently monitored and mitigated? And why has the academy not fixed its gaze on these powerful actors, including advisors such as ISS and Glass Lewis?

7. **Trust the Directors.** Is the assumption by academics that directors on corporate boards cannot be trusted based on any actual evidence, on observed anecdotal information, or just the skepticism of a group that has never (or rarely) been in the boardroom or been charged with overseeing a for-profit enterprise? And does the constant assumption and allegation of untrustworthiness in fact create both a disincentive to serve and a disinclination to act, all to the detriment of the corporate enterprise and its beneficiaries?

8. **Directors’ and CEOs’ Time.** Is it desirable that directors and CEOs spend a third of their time on governance? Has the governance-rather-than-performance-centric debate resulted in a new breed of lawyer-type-CEOs and box-checking “monitoring” boards rather than sophisticated and experienced “advising” boards?

9. **Escaping Governance.** What part of the private equity activity wave is fairly attributable to increased costs imposed by corporate governance in the public markets that makes management for long-term value appreciation difficult or impossible in those public markets? Is that good or bad?
10. Why Do Venture Capitalists and Entrepreneurs NOT Choose the Academics’ Governance Model? Why do highly successful technology corporations go public with capital structures that preserve management control? To avoid the pressure for short-term performance? To avoid shareholder pressure on management? Do these companies underperform or are they our most innovative companies?

11. Economic and Business Theory. Is there any evidence that the ideas and suggestions of short-term money managers, who oversee diverse portfolios, promote long-term (or even medium-term) value creation? What happens to investment, strategic thinking and risk management in a world in which the ideas have time horizons measured in months or quarters? How do the advocates of stockholder-centric governance take account of the fact that stockholders do not have information and expertise about the corporation on a par with its directors and officers? Similarly are long-term stockholder interests and wealth creation served by intermediaries in the proxy advisory services, operating without regulation or fiduciary duty, either to the corporation or its stockholders or to investors and beneficiaries? And what to make of the elephant-in-the-room fact that activist hedge funds don’t have to eat what they cook?

12. Political Theory. At bottom, doesn’t the stockholder-centric theory hark back to the crudest 19th century aspects of laissez-faire capitalism—pressing for the legal system to recognize a single social good (maximizing rentiers’ portfolio returns) while ignoring or slighting the interests of employees, communities and societal welfare? Is stockholder-centric governance as currently promoted and practiced by the academic and governance communities, and the short-termism it imposes, responsible for a very significant part of American unemployment and a failure to achieve a GDP growth rate sufficient to pay for reasonable entitlements without a significant increase in taxes?

Martin Lipton
Theodore N. Mirvis
Adam O. Emmerich
David C. Karp
Mark Gordon
Sabastian V. Niles
The Economic Consequences of Legal Origins

RAFAEL LA PORTA, FLORENCIO LOPEZ-DE-SILANES, AND ANDREI SHLEIFER*

In the last decade, economists have produced a considerable body of research suggesting that the historical origin of a country’s laws is highly correlated with a broad range of its legal rules and regulations, as well as with economic outcomes. We summarize this evidence and attempt a unified interpretation. We also address several objections to the empirical claim that legal origins matter. Finally, we assess the implications of this research for economic reform.

1. Introduction

About a decade ago, the three of us, together with Robert Vishny, published a pair of articles dealing with legal protection of investors and its consequences (La Porta et al. or LLSV, 1997, 1998). These articles generated a fair amount of follow-up research and a good deal of controversy. This paper is our attempt to summarize the main findings and, more importantly, to interpret them in a unified way.

LLSV started from a proposition, standard in corporate law (e.g., Robert Clark 1986) and emphasized by Shleifer and Vishny (1997), that legal protection of outside investors limits the extent of expropriation of such investors by corporate insiders, and thereby promotes financial development.¹ From there, LLSV made two contributions. First, they showed that legal rules governing investor protection can be measured and coded for many countries using national commercial (primarily corporate and bankruptcy) laws. LLSV coded such rules for both the protection of outside shareholders, and the protection of outside senior creditors, for forty-nine countries. The coding showed that some countries offer much stronger legal protection of outside investors’ interests than others.

Second, LLSV documented empirically that legal rules protecting investors vary systematically among legal traditions or origins.

¹ This argument followed naturally from the contractual view of the firm (Michael C. Jensen and William H. Meckling 1976, Sanford J. Grossman and Oliver D. Hart 1988, Hart 1995), which sees the protection of the property rights of the financiers as essential to assure the flow of capital to firms. Financial economists have often argued, in contrast, that financial markets are sustained by “market forces” such as competition and reputation (Hayne E. Leland and David H. Pyle 1977, Eugene F. Fama 1980). Comparative research emphasized the role of banks (Franklin Allen and Douglas Gale 2000).

* La Porta: Tuck School Of Business At Dartmouth. Lopez-de-Silanes: EDHEC Graduate School of Management. Shleifer: Harvard University. We are grateful to Daniel Berkowitz, Olivier Blanchard, Simeon Djankov, Nicola Gennaioli, Roger Gordon, Oliver Hart, Paul Mahoney, Elias Papaioannou, Katharina Pistor, Mark Roe, René Stulz, students in Ec 2470, four reviewers, and especially Louis Kaplow for extremely helpful comments.
with the laws of common law countries (originating in English law) being more protective of outside investors than the laws of civil law (originating in Roman law) and particularly French civil law countries. LLSV further argued that legal traditions were typically introduced into various countries through conquest and colonization and, as such, were largely exogenous. LLSV then used legal origins of commercial laws as an instrument for legal rules in a two-stage procedure, where the second stage explained financial development. The evidence showed that legal investor protection is a strong predictor of financial development.

Subsequent research showed that the influence of legal origins on laws and regulations is not restricted to finance. In several studies conducted jointly with Simeon Djankov and others, we found that such outcomes as government ownership of banks (La Porta et al. 2002), the burden of entry regulations (Djankov et al. 2002), regulation of labor markets (Juan C. Botero et al. 2004), incidence of military conscription (Casey B. Mulligan and Shleifer 2005a, 2005b), and government ownership of the media (Djankov et al. 2003a) vary across legal families. In all these spheres, civil law is associated with a heavier hand of government ownership and regulation than common law. Many of these indicators of government ownership and regulation are associated with adverse impacts on markets, such as greater corruption, larger unofficial economy, and higher unemployment.

In still other studies, we have found that common law is associated with lower formalism of judicial procedures (Djankov et al. 2003b) and greater judicial independence (La Porta et al. 2004) than civil law. These indicators are in turn associated with better contract enforcement and greater security of property rights.

Assuming that this evidence is correct, it raises an enormous challenge of interpretation. What is the meaning of legal origin? Why is its influence so pervasive? How can the superior performance of common law in many areas be reconciled with the high costs of litigation, and well-known judicial arbitrariness, in common law countries?

In this paper, we adopt a broad conception of legal origin as a style of social control of economic life (and maybe of other aspects of life as well). In strong form (later to be supplemented by a variety of caveats), we argue that common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations. In words of one legal scholar, civil law is “policy implementing,” while common law is “dispute resolving” (Mirjan R. Damaška 1986). In words of another, French civil law embraces “socially-conditioned private contracting,” in contrast to common law’s support for “unconditioned private contracting” (Katharina Pistor 2006). We develop an interpretation of the evidence, which we call the Legal Origins Theory, based on these fundamental differences.

Legal Origin Theory traces the different strategies of common and civil law to different ideas about law and its purpose that England and France developed centuries ago. These broad ideas and strategies were incorporated into specific legal rules, but also into the organization of the legal system, as well as the human capital and beliefs of its participants. When common and civil law were transplanted into much of the world through conquest and colonization, the rules, but also human capital and legal ideologies, were transplanted as well. Despite much local legal evolution, the fundamental strategies and assumptions of each legal system survived and have continued to exert substantial influence on economic outcomes. As the leading comparative legal scholars Konrad Zweigert and Hein Kötz (1998) note, “the style of a legal system may be marked by an ideology, that is, a religious or political conception of how economic or social life should be organized” (p. 72). In this paper,
we show how these styles of different legal systems have developed, survived over the years, and continued to have substantial economic consequences. In our conception, legal origins are central to understanding the varieties of capitalism.

The paper is organized as follows. In section 2, we describe the principal legal traditions. In section 3, we document the strong and pervasive effects of legal origins on diverse areas of law and regulation, which in turn influence a variety of economic outcomes. In section 4, we outline the Legal Origins Theory, and interpret the findings from that perspective. In sections 5–7, we deal with three lines of criticism of our research, all organized around the idea that legal origin is a proxy for something else. The three alternatives we consider are culture, politics, and history. Our strong conclusion is that, while all these factors influence laws, regulations, and economic outcomes, it is almost certainly false that legal origin is merely a proxy for any of them. Section 8 briefly considers the implications of our work for economic reform and describes some of the reforms that had taken place. Many developing countries today find themselves heavily overregulated in crucial spheres of economic life, in part because of their legal origin heritage. Legal Origin Theory, and the associated measurement of legal and regulatory institutions, provides some guidance to reforms. Section 9 concludes the paper.

We note that this paper is not a survey and, therefore, only introduces particular papers in so far as they enter the discussion of the meaning and the consequences of legal origins. The last decade has witnessed an explosion of research on corporate governance that uses the investor protection framework. This research has successfully replaced the traditional Berle–Means conception of a public corporation with a much more realistic for most of the world model of family-run firms, pyramidal and group structures, and tremendous conflicts between outside investors and controlling shareholders. This research, however, is not covered in our paper.

2. Background on Legal Origins

In their remarkable three-hundred-page survey of human history, The Human Web, John Robert McNeill and William H. McNeill (2003) show how the transmission of information across space shapes human societies. Information is transmitted through trade, conquest, colonization, missionary work, migration, and so on. The bits of information transmitted through these channels include technology, language, religion, sports, but also law and legal systems. Some of these bits of information are transplanted voluntarily, as when people adopt technologies they need. This makes it difficult to study the consequences of adoption because we do not know whether to attribute these consequences to what is adopted or to the conditions that invited the adoption. In other instances, the transplantation of information is involuntary, as in the cases of forced religious conversion, conquest, or colonization. These conditions, unfavorable as they are, make it easier to identify the consequences of specific information being transplanted.

Legal origins or traditions present a key example of such often involuntary transmission of different bundles of information across human populations. Legal scholars believe that some national legal systems are sufficiently similar in some critical respects to others to permit classification of national legal systems into major families of law (Rene David and John Brierley 1985, Thomas Reynolds and Arturo Flores 1989, Mary Ann Glendon, Michael Wallace Gordon, and Christopher Osakwe 1982, 1994, Zweigert and Kötz 1998). "The following factors seem to us to be those which are crucial for the style of a legal system or a legal family: (1) its historical background and development, (2) its predominant and characteristic mode of thought in legal matters, (3) especially distinctive institutions, (4) the kind of legal
sources it acknowledges and the way it handles them, and (5) its ideology” (Zweigert and Kötz 1998, p. 68).

Most writers identify two main secular legal traditions: common law and civil law, and several subtraditions—French, German, socialist, and Scandinavian—within civil law. Occasionally, countries adopt some laws from one legal tradition and other laws from another, and researchers need to keep track of such hybrids, but generally a particular tradition dominates in each country.

The key feature of legal traditions is that they have been transplanted, typically though not always through conquest or colonization, from relatively few mother countries to most of the rest of the world (Alan Watson 1974). Such transplantation covers specific laws and codes and the more general styles or ideologies of the legal system, as well as individuals with mother-country training, human capital, and legal outlook.

Of course, following the transplantation of some basic legal infrastructure, such as the legal codes, legal principles and ideologies, and elements of the organization of the judiciary, the national laws of various countries changed, evolved, and adapted to local circumstances. Cultural, political, and economic conditions of every society came to be reflected in their national laws, so that legal and regulatory systems of no two countries are literally identical. This adaptation and individualization, however, was incomplete. Enough of the basic transplanted elements have remained and persisted (Paul A. David 1985) to allow the classification into legal traditions. As a consequence, legal transplantation represents the kind of involuntary information transmission that the McNeills have emphasized, which enables us to study the consequences of legal origins.

Before discussing the legal traditions of market economies, we briefly comment on socialist law. The socialist legal tradition originates in the Soviet Union, and was spread by the Soviet armies first to the former Soviet republics and later to Eastern Europe.² It was also imitated by some socialist states, such as Mongolia and China. After the fall of the Berlin Wall, the countries of the former Soviet Union and Eastern Europe reverted to their pre–Russian Revolution or pre–World War II legal systems, which were French or German civil law. In our work based on data from the 1990s, we have often classified transition economies as having the socialist legal system. However, today, academics and officials from these countries object to such classification, so, in the present paper, we classify them according to the main influence on their new commercial laws. Several countries, such as Cuba, still maintain the socialist legal system, and await liberation and recategorization. These countries typically lack other data, so no socialist legal origin countries appear in the analysis in the present paper.

Figure 1 shows the distribution of legal origins of commercial laws throughout the world. The common-law legal tradition includes the law of England and its former colonies. The common law is formed by appellate judges who establish precedents by solving specific legal disputes. Dispute resolution tends to be adversarial rather than inquisitorial. Judicial independence from both the executive and legislature are central. “English common law developed because landed aristocrats and merchants wanted a system of law that would provide strong protections for property and contract rights, and limit the crown’s ability to interfere in markets” (Paul G. Mahoney 2001, p. 504). Common law has spread to the British colonies, including the United States, Canada, Australia, India, South Africa, and many other countries. Of the maximal sample of 150 countries used in our studies, there are forty-two common law countries.

² The socialist legal tradition illustrates the significance of ideologies for legal styles. “...the socialist concept of law can be directly traced to the movement of legal positivism. The movement... sees law as an expression of the will of the legislators, supreme interpreters of justice” (David and Brierley 1985, p. 69).
The civil law tradition is the oldest, the most influential, and the most widely distributed around the world, especially after so many transition economies have returned to it. It originates in Roman law, uses statutes and comprehensive codes as a primary means of ordering legal material, and relies heavily on legal scholars to ascertain and formulate rules (John Henry Merryman 1969). Dispute resolution tends to be inquisitorial rather than adversarial. Roman law was rediscovered in the Middle Ages in Italy, adopted by the Catholic Church for its purposes, and from there formed the basis of secular laws in many European countries.

Although the origins of civil law are ancient, the French civil law tradition is usually identified with the French Revolution and Napoleon’s codes, which were written in the early nineteenth century. In contrast to common law, “French civil law developed as it did because the revolutionary generation, and Napoleon after it, wished to use state power to alter property rights and attempted to insure that judges did not interfere. Thus, quite apart from the substance of legal rules, there is a sharp difference between the ideologies underlying common and civil law, with the latter notably more comfortable with the centralized and activist government” (Mahoney 2001, p. 505).

Napoleon’s armies introduced his codes into Belgium, the Netherlands, Italy, and parts of Germany. In the colonial era, France extended her legal influence to the Near East and Northern and Sub-Saharan Africa, Indochina, Oceania, and French Caribbean Islands. Napoleonic influence was also significant in Luxembourg, Portugal, Spain, and some Swiss cantons. When the Spanish and Portuguese empires in Latin America dissolved in the nineteenth century, it was
mainly the French civil law that the lawmakers of the new nations looked to for inspiration. In the nineteenth century, the French civil code was also adopted, with many modifications, by the Russian Empire, and through Russia by the neighboring regions it influenced and occupied. These countries adopted the socialist law after the Russian Revolution, but typically reverted to the French civil law after the fall of the Berlin Wall. There are eighty-four French legal origin countries in the sample.

The German legal tradition also has its basis in Roman law, but the German Commercial Code was written in 1897, after Bismarck's unification of Germany. It shares many procedural characteristics with the French system but accommodates greater judicial law making. The German legal tradition influenced Austria, the former Czechoslovakia, Greece, Hungary, Italy, Switzerland, Yugoslavia, Japan, Korea, and a few countries of the former Soviet Union. Taiwan's laws came from China, which relied heavily on German laws during modernization. There are nineteen German legal origin countries in the sample.

The Scandinavian family is usually viewed as part of the civil law tradition, although its law is less derivative of Roman law than the French and German families (Zweigert and Kötz 1998). Most writers describe the Scandinavian laws as distinct from others, and we have kept them as a separate family (with five members) in our research.

Before turning to the presentation of results, five points about this classification are in order. First, although the majority of legal transplantation is the product of conquest and colonization, there are important exceptions. Japan adopted the German legal system voluntarily. Latin American former Spanish and Portuguese colonies ended up with codifications heavily influenced by the French legal tradition after gaining independence. Beyond the fact that Napoleon had invaded the Iberian Peninsula, the reasons were partly the new military leaders' admiration for Bonaparte, partly language, and partly Napoleonic influence on the Spanish and Portuguese codes. In this instance, the exogeneity assumption from the viewpoint of studying economic outcomes is still appropriate. The nineteenth century influence of the French civil law in Russia and Turkey was largely voluntary, as both countries sought to modernize. But the French and German civil law traditions in the rest of the countries in Eastern Europe, the Middle East, and Central Asia are the result of the conquests by the Russian, Austro–Hungarian, Ottoman, and German empires. The return by these countries to their pre-Soviet legal traditions during the transition from socialism is voluntary but shaped largely by history.

Second, because Scandinavian countries did not have any colonies, and Germany's colonial influence was short-lived and abruptly erased by World War I, there are relatively few countries in these two traditions. As a consequence, while we occasionally speak of the comparison between common and civil law, most of the discussion compares common law to the French civil law. This is largely because each tradition includes a large number of countries, but also because they represent the two most distinct approaches to law and regulation.

Third, although we often speak of common law and French civil law in terms of pure types, in reality there has been a great deal of mutual influence and in some areas convergence. There is a good deal of legislation in common law countries, and a good deal of judicial interpretation in civil law countries. But the fact that the actual laws of real countries are not pure types does not mean that there are no systematic differences.

Fourth, some have noted the growing importance of legislation in common law countries as proof that judicial law making no longer matters. This is incorrect for a number of reasons. Statutes in common law countries often follow and reflect judicial rulings, so jurisprudence remains the basis of statutory law. Even when legislation in
common law countries runs ahead of judicial law making, it often must coexist with, and therefore reflects, preexisting common law rules. Indeed, statutes in common law countries are often highly imprecise, with an expectation that courts will spell out the rules as they begin to be applied. Finally, and most crucially, because legal origins shape fundamental approaches to social control of business, even legislation in common law countries expresses the common law way of doing things. For all these reasons, the universal growth of legislation in no way implies the irrelevance of legal origins.

Fifth, with the reclassification of transition economies from socialist into the French and German civil law families, one might worry that the differences among legal origins described below are driven by the transition economies. They are not. None of our substantive results change if we exclude the transition economies.

With these points in mind, we can turn to the evidence.

3. Basic Facts

3.1 The Evidence in Brief

Figure 2 organizes some of our own and related research on the economic consequences of legal origins. It shows the links from legal origins to particular legal rules, and then to economic outcomes. Figure 2 immediately suggests several concerns for empirical work. First, in our framework, legal origins influence many spheres of law making and regulation, which makes it dangerous to use them as instruments. Second, we have drawn a rather clean picture pointing from particular legal rules to outcomes. In reality, a variety of legal rules (e.g., those governing both investor protection and legal procedure) can influence the protection of outside investors and hence financial markets. This, again, makes empirical work less clean.

Before turning to the evidence, we make four comments about the data. First, all the data used in this paper, and a good deal more, are available at http://www.economics.harvard.edu/faculty/shleifer/data.html. We do not discuss the data in detail, but the descriptions are available in the original papers presenting the data.

Second, the basic evidence we present takes the form of cross-country studies. An important feature of these studies is that all countries receive the same weight. There is no special treatment of mother countries, of rich countries, etc. This design may obscure the differences, discussed below, within legal origins, such as the greater dynamism of law in mother countries than in former colonies.

Third, the sources of data on legal rules and institutions vary significantly across studies. Some rules, such as many indicators of investor protection and of various government regulations, come from national laws. Those tend to be “laws on the books.” Other indicators are mixtures of national laws and actual experiences, and tend to combine substantive and procedural rules. These variables are often constructed through collaborative efforts with law firms around the world and yield summary indicators of legal rules and their enforcement. For example, the study of legal formalism (Djankov et al. 2003b) reflects the lawyers’ characterization of procedural rules that would typically apply to a specific legal dispute; the study of the efficiency of debt enforcement (Djankov et al. 2006) incorporates estimates of time, cost, and resolution of a standardized insolvency case. The data used in each study have their advantages and problems. An important fact, however, is the consistency of results across both data collection procedures and spheres of activity that we document below.

Fourth, over the years, various writers have criticized both the conceptual foundations of LLSV variables such as shareholder rights indices (John C. Coffee 1999) and the particular values we have assigned to these variables, in part because of conceptual ambiguity (Holger Spamann 2006b).
We have corrected our mistakes and have also moved on to conceptually less ambiguous measures (Djankov et al. 2008). These improvements have strengthened the original results. The findings we discuss below use the most recent data.

To organize the discussion, we do not provide a full survey of the available evidence but rather a sampling with an emphasis on the breadth of the findings. The available studies have followed a similar pattern, shown in figure 2. They first consider the effect of legal origins on particular laws and regulations, and then the effects of these laws and regulations on the economic outcomes that they might influence most directly.

The available studies can be divided into three categories. First, several studies following LLSV (1997, 1998) examine the effects of legal origins on investor protection and then the effect of investor protection on financial development. Some of these studies look at stock markets. The LLSV measure of antidirector rights has been replaced by a measure of shareholder protection through securities laws in the offerings of new issues (La Porta et al. 2006) and by another measure of shareholder protection from self-dealing by corporate insiders through corporate law (Djankov et al. 2008). As outcomes, these studies use such measures as the ratio of stock market capitalization to GDP, the
pace of public offering activity, the voting premium (see Alexander Dyck and Luigi Zingales 2004), dividend payouts (La Porta et al. 2000), Tobin’s Q (La Porta et al. 2002), and ownership dispersion (La Porta et al. 1999). Predictions for each of these variables emerge from a standard agency model of corporate governance, in which investor protection shapes external finance (e.g., Shleifer and Daniel Wolfenzon 2002).

Other studies in this category look at creditor rights. The LLSV (1997, 1998) measure from bankruptcy laws has been updated by Djankov et al. (2007). Djankov et al. (2006) take a different approach to creditor protection by looking at the actual efficiency of debt enforcement, as measured by creditor recovery rates in a hypothetical case of an insolvent firm. The latter study addresses a common criticism that it is law enforcement, rather than rules on the books, that matters for investor protection by integrating legal rules and characteristics of enforcement in the efficiency measure. La Porta et al. (2002) focus on state involvement in financial markets by looking at government ownership of banks. These studies typically consider the size of debt markets as an outcome measure, although Djankov et al. (2007) also examine several subjective assessments of the quality of private debt markets.

In the second category, several papers consider government regulation, or even ownership, of particular economic activities. Djankov et al. (2002) look at the number of steps an entrepreneur must complete in order to begin operating a business legally, a number that in 1999 ranged from two in Australia and Canada to twenty-one in the Dominican Republic. They examine the impact of such entry regulation on corruption and the size of the unofficial economy. Botero et al. (2004) construct indices of labor market regulation and examine their effect on labor force participation rates and unemployment. Djankov et al. (2003c) examine government ownership of the media, which remains extensive around the world, particularly for television. Mulligan and Shleifer (2005a, 2005b) look at one of the ultimate forms of government intervention in private life, military conscription.

The third category of papers investigates the effects of legal origins on the characteristics of the judiciary (and other government institutions), and then the effect of those on the security of property rights and contract enforcement. Djankov et al. (2003b) look at the formalism of judicial procedures in various countries and its effect on the time it takes to evict a nonpaying tenant or to collect a bounced check. This variable can be interpreted more broadly as the efficiency of contract enforcement by courts, and in fact turns out to be highly correlated with the efficiency of debt collection obtained in an entirely different way by Djankov et al. (2006). La Porta et al. (2004) adopt a very different strategy and collect information from national constitutions on judicial independence (as measured by judicial tenure) and the acceptance of appellate court rulings as a source of law. They then ask directly whether judicial independence contributes to the quality of contract enforcement and the security of property rights.

Tables 1–3 show a sampling of results from each category of studies. In each table, the top panel presents the regressions of legal or regulatory institutions on legal origins, controlling only for per capita income. In the original papers, many more controls and robustness checks are included, but here we present the stripped down regressions. The bottom panel of each table then presents some results of regressions of outcomes on legal rules. We could of course combine the two panels in an instrumental variables specification, but, as we indicated previously, we do not recom-

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3 The theoretical prediction that investor protection leads to greater ownership dispersion is not unambiguous, and the data on ownership around the world is less clean and satisfactory than that on other variables. Nonetheless, much of the criticism of LLSV has focused on ownership dispersion.
mand such specifications since legal origins influence a broad range of rules and regulations and we cannot guarantee that the relevant ones are not omitted in the first stage.

Begin with table 1. Higher income per capita is associated with better shareholder and creditor protection, more efficient debt enforcement, and lower government ownership of banks (panel A). Civil law is generally associated with lower shareholder and creditor protection, less efficient debt enforcement, and higher government ownership of banks. The estimated coefficients imply that, compared to common law, French legal origin is associated with a reduction of 0.33 in the anti-self-dealing index (which ranges between 0.1 and 1), of 0.33 in the index of prospectus disclosure (which ranges between 0 and 1), of 0.84 in the creditor rights index (which ranges from 0 to 4), of 13.6 points in the efficiency of debt collection (out of 100), and a rise of 33 percentage points in government ownership of banks (which ranges between 0 and 100 percent). The effect of legal origins on legal rules and financial institutions is statistically significant and economically large.

Higher income per capita is generally associated with more developed financial markets, as reflected in a higher stock-market-to-GDP ratio, more firms per capita, less ownership concentration, and a higher private-credit-to-GDP ratio.\(^4\) Investor protection is associated with more developed financial markets (panel B). The estimated coefficients imply that a two-standard deviation increase in the anti-self-dealing index is associated with an increase in the stock-market-to-GDP ratio of 42 percentage points, an increase in listed firms per capita of 38 percent, and a reduction in ownership concentration of 6 percentage points. A two-standard deviation improvement in prospectus disclosure is associated with a reduction in the control premium of 15 percentage points (the mean premium is 11 percent). The effect of legal rules on debt markets is also large. A two-standard deviation increase in creditor rights is associated with an increase of 15 percentage points in the private-credit-to-GDP ratio. A two-standard deviation increase in the efficiency of debt collection is associated with an increase of 27 percentage points in the private-credit-to-GDP ratio. A two-standard deviation increase in government ownership of banks is associated with a 16 percentage point rise in the spread between lending and borrowing rates (the mean spread is 20).\(^5\)

Table 2 presents the results on regulation. Higher income per capita is correlated with lower entry regulation and government ownership of the media, but not with labor regulation or conscription (panel A). Relative to common law countries, French legal origin countries have more entry and labor regulation, higher state ownership of the media, and heavier reliance on conscription.\(^6\) The coefficients imply that, compared to common law countries, French and Italian banks lend to big enterprises rather than small ones. I. Serdar Dinc (2005) finds that government-owned banks sharply increase lending in election years. Asim Ijaz Khwaja and Atif Mian (2005) present evidence that politically connected firms in Pakistan get preferential treatment from government-owned banks. They borrow 45 percent more and have 50 percent higher default rates.


\(^5\) Paola Sapienza (2004) shows that government-owned banks in Italy lend to big enterprises rather than small ones. I. Serdar Dinc (2005) finds that government-owned banks sharply increase lending in election years. Asim Ijaz Khwaja and Atif Mian (2005) present evidence that politically connected firms in Pakistan get preferential treatment from government-owned banks. They borrow 45 percent more and have 50 percent higher default rates.

\(^6\) In a similar spirit, Avi Ben-Bassat and Momi Dahan (2008) show that constitutional commitments to “social rights” (the right to social security, education, health, housing, and workers rights) are less prevalent in common law countries than in the French civil law ones.
TABLE 1
FINANCIAL INSTITUTIONS AND CAPITAL MARKETS DEVELOPMENT

Panel A: Financial Institutions and Legal Origin

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<tr>
<td>French Legal Origin</td>
<td>-0.3334&lt;sup&gt;a&lt;/sup&gt; (0.0511)</td>
<td>-0.3298&lt;sup&gt;a&lt;/sup&gt; (0.0577)</td>
<td>-0.8394&lt;sup&gt;a&lt;/sup&gt; (0.2251)</td>
<td>-13.6361&lt;sup&gt;b&lt;/sup&gt; (5.6535)</td>
<td>0.3316&lt;sup&gt;a&lt;/sup&gt; (0.0755)</td>
</tr>
<tr>
<td>German Legal Origin</td>
<td>-0.3454&lt;sup&gt;a&lt;/sup&gt; (0.0736)</td>
<td>-0.2370&lt;sup&gt;b&lt;/sup&gt; (0.0966)</td>
<td>-0.1714 (0.2579)</td>
<td>-8.8577 (5.0222)</td>
<td>0.3456&lt;sup&gt;a&lt;/sup&gt; (0.1060)</td>
</tr>
<tr>
<td>Scandinavian Legal Origin</td>
<td>-0.3820&lt;sup&gt;a&lt;/sup&gt; (0.0642)</td>
<td>-0.2867&lt;sup&gt;a&lt;/sup&gt; (0.0478)</td>
<td>-0.9435&lt;sup&gt;c&lt;/sup&gt; (0.4865)</td>
<td>5.2707 (5.8212)</td>
<td>0.3109</td>
</tr>
<tr>
<td>Ln (GDP per capita)</td>
<td>0.0728&lt;sup&gt;a&lt;/sup&gt; (0.0263)</td>
<td>0.0618&lt;sup&gt;b&lt;/sup&gt; (0.0261)</td>
<td>0.2022&lt;sup&gt;b&lt;/sup&gt; (0.0875)</td>
<td>19.8980&lt;sup&gt;a&lt;/sup&gt; (2.7157)</td>
<td>-0.1808&lt;sup&gt;a&lt;/sup&gt; (0.0377)</td>
</tr>
<tr>
<td>Constant</td>
<td>0.0177 (0.2433)</td>
<td>0.2102 (0.2422)</td>
<td>0.6043 (0.7560)</td>
<td>-124.6692&lt;sup&gt;a&lt;/sup&gt; (26.9421)</td>
<td>1.6206&lt;sup&gt;a&lt;/sup&gt; (0.2876)</td>
</tr>
</tbody>
</table>

Observations | 71 | 49 | 130 | 85 | 74 |
R-squared | 45% | 0.45 | 18% | 0.57 | 37% |

Panel B: Financial Institutions and Capital Markets Development

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</tr>
</thead>
<tbody>
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<td>Anti-self-dealing Index</td>
<td>0.8940&lt;sup&gt;b&lt;/sup&gt; (0.3674)</td>
<td>0.5004&lt;sup&gt;a&lt;/sup&gt; (0.4750)</td>
<td>-0.1277&lt;sup&gt;c&lt;/sup&gt; (0.0724)</td>
<td>-0.3254&lt;sup&gt;a&lt;/sup&gt; (0.0807)</td>
<td>0.0645&lt;sup&gt;c&lt;/sup&gt; (0.0336)</td>
<td>0.0053&lt;sup&gt;a&lt;/sup&gt; (0.0015)</td>
</tr>
<tr>
<td>Prospectus Disclosure</td>
<td>0.5004&lt;sup&gt;a&lt;/sup&gt; (0.4750)</td>
<td>-0.1277&lt;sup&gt;c&lt;/sup&gt; (0.0724)</td>
<td>-0.3254&lt;sup&gt;a&lt;/sup&gt; (0.0807)</td>
<td>0.0645&lt;sup&gt;c&lt;/sup&gt; (0.0336)</td>
<td>0.0053&lt;sup&gt;a&lt;/sup&gt; (0.0015)</td>
<td>0.0053&lt;sup&gt;a&lt;/sup&gt; (0.0015)</td>
</tr>
<tr>
<td>Credit Rights Index</td>
<td>0.8940&lt;sup&gt;b&lt;/sup&gt; (0.3674)</td>
<td>0.5004&lt;sup&gt;a&lt;/sup&gt; (0.4750)</td>
<td>-0.1277&lt;sup&gt;c&lt;/sup&gt; (0.0724)</td>
<td>-0.3254&lt;sup&gt;a&lt;/sup&gt; (0.0807)</td>
<td>0.0645&lt;sup&gt;c&lt;/sup&gt; (0.0336)</td>
<td>0.0053&lt;sup&gt;a&lt;/sup&gt; (0.0015)</td>
</tr>
<tr>
<td>Government Ownership of Banks—1970</td>
<td>0.3204&lt;sup&gt;a&lt;/sup&gt; (0.0601)</td>
<td>0.9794&lt;sup&gt;a&lt;/sup&gt; (0.1346)</td>
<td>-0.0495&lt;sup&gt;b&lt;/sup&gt; (0.0200)</td>
<td>-0.0273 (0.0238)</td>
<td>0.2546&lt;sup&gt;a&lt;/sup&gt; (0.0604)</td>
<td>1.8522 (3.0169)</td>
</tr>
<tr>
<td>Ln (GDP per capita)</td>
<td>0.3204&lt;sup&gt;a&lt;/sup&gt; (0.0601)</td>
<td>0.9794&lt;sup&gt;a&lt;/sup&gt; (0.1346)</td>
<td>-0.0495&lt;sup&gt;b&lt;/sup&gt; (0.0200)</td>
<td>-0.0273 (0.0238)</td>
<td>0.2546&lt;sup&gt;a&lt;/sup&gt; (0.0604)</td>
<td>1.8522 (3.0169)</td>
</tr>
<tr>
<td>Constant</td>
<td>-2.7604&lt;sup&gt;a&lt;/sup&gt; (0.5558)</td>
<td>-6.9496&lt;sup&gt;a&lt;/sup&gt; (1.2352)</td>
<td>0.9844&lt;sup&gt;a&lt;/sup&gt; (0.1761)</td>
<td>0.5524&lt;sup&gt;b&lt;/sup&gt; (0.2202)</td>
<td>-2.1494&lt;sup&gt;a&lt;/sup&gt; (0.4912)</td>
<td>-4.4219 (23.0311)</td>
</tr>
</tbody>
</table>

Observations | 72 | 72 | 49 | 37 | 85 | 57 |
R-squared | 40% | 47% | 20% | 36% | 52% | 10% |

Notes:  
<sup>a</sup> Significant at the 1 percent level.  
<sup>b</sup> Significant at the 5 percent level.  
<sup>c</sup> Significant at the 10 percent level.
law, French legal origin is associated with an increase of 0.69 in the (log) number of steps to open a new business (which ranges from 0.69 to 3.0), a rise of 0.26 in the index of labor regulation (which ranges from 0.15 to 0.83), a 0.21 rise in government ownership of the media (which ranges from 0 to 1), and a 0.55 increase in conscription (which ranges from 0 to 1). According to the estimated coefficients in panel B, a two-standard deviation increase in the (log) number of steps to open a new business is associated with a 0.71 worsening of the corruption index and a 14 percentage point rise in employment in the unofficial economy. A two-standard deviation increase in the regulation of labor implies

**TABLE 2**

GOVERNMENT REGULATION

### Panel A: Government Regulation and Legal Origin

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>French Legal Origin</td>
<td>0.6927&lt;sup&gt;a&lt;/sup&gt; (0.0929)</td>
<td>0.2654&lt;sup&gt;a&lt;/sup&gt; (0.0362)</td>
<td>0.2095&lt;sup&gt;a&lt;/sup&gt; (0.0834)</td>
<td>0.5468&lt;sup&gt;a&lt;/sup&gt; (0.0772)</td>
</tr>
<tr>
<td>German Legal Origin</td>
<td>0.5224&lt;sup&gt;a&lt;/sup&gt; (0.1206)</td>
<td>0.2337&lt;sup&gt;a&lt;/sup&gt; (0.0473)</td>
<td>0.1100 (0.0926)</td>
<td>0.8281&lt;sup&gt;a&lt;/sup&gt; (0.0794)</td>
</tr>
<tr>
<td>Scandinavian Legal Origin</td>
<td>-0.1922 (0.1352)</td>
<td>0.3978&lt;sup&gt;a&lt;/sup&gt; (0.0443)</td>
<td>0.1308&lt;sup&gt;b&lt;/sup&gt; (0.0555)</td>
<td>0.7219&lt;sup&gt;a&lt;/sup&gt; (0.2015)</td>
</tr>
<tr>
<td>Ln (GDP per capita)</td>
<td>-0.1963&lt;sup&gt;a&lt;/sup&gt; (0.0367)</td>
<td>-0.0083 (0.0164)</td>
<td>-0.1753&lt;sup&gt;a&lt;/sup&gt; (0.0307)</td>
<td>-0.0382 (0.0331)</td>
</tr>
<tr>
<td>Constant</td>
<td>3.4367&lt;sup&gt;a&lt;/sup&gt; (0.3037)</td>
<td>0.3703&lt;sup&gt;b&lt;/sup&gt; (0.1520)</td>
<td>1.6565&lt;sup&gt;a&lt;/sup&gt; (0.3024)</td>
<td>0.4702&lt;sup&gt;c&lt;/sup&gt; (0.2502)</td>
</tr>
</tbody>
</table>

| Observations | 85 | 84 | 95 | 146 |
| R-squared    | 61% | 42% | 37% | 34% |

### Panel B: Government Regulation, Corruption, Unofficial Economy, and Labor Market Outcomes

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Regulation of Entry</td>
<td>-0.6733&lt;sup&gt;a&lt;/sup&gt; (0.0998)</td>
<td>13.2601&lt;sup&gt;a&lt;/sup&gt; (4.5659)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulation of Labor</td>
<td>-5.2009&lt;sup&gt;a&lt;/sup&gt; (1.7319)</td>
<td>-1.9305&lt;sup&gt;a&lt;/sup&gt; (0.3982)</td>
<td>6.0738&lt;sup&gt;b&lt;/sup&gt; (2.7868)</td>
<td>-0.9913&lt;sup&gt;c&lt;/sup&gt; (0.5795)</td>
<td>14.8363&lt;sup&gt;a&lt;/sup&gt; (4.2699)</td>
</tr>
<tr>
<td>Ln (GDP per capita)</td>
<td>0.6194&lt;sup&gt;a&lt;/sup&gt; (0.0537)</td>
<td>-5.7288&lt;sup&gt;a&lt;/sup&gt; (2.0969)</td>
<td>-1.9305&lt;sup&gt;a&lt;/sup&gt; (0.3982)</td>
<td>-0.9913&lt;sup&gt;c&lt;/sup&gt; (0.5795)</td>
<td>-1.1890 (1.3108)</td>
</tr>
<tr>
<td>Constant</td>
<td>-3.6273&lt;sup&gt;a&lt;/sup&gt; (0.5800)</td>
<td>58.7496&lt;sup&gt;b&lt;/sup&gt; (25.8820)</td>
<td>102.5096&lt;sup&gt;a&lt;/sup&gt; (3.3120)</td>
<td>14.8245&lt;sup&gt;b&lt;/sup&gt; (6.0449)</td>
<td>18.4049 (11.4316)</td>
</tr>
</tbody>
</table>

| Observations | 85 | 46 | 78 | 65 | 52 |
| R-squared    | 80% | 42% | 32% | 11% | 15% |

**Notes:**
- <sup>a</sup> Significant at the 1 percent level.
- <sup>b</sup> Significant at the 5 percent level.
- <sup>c</sup> Significant at the 10 percent level.
a 1.99 percentage point reduction in the male labor force participation rate, a 2.32 percentage point increase in the unemployment rate, and a 5.67 percentage point rise in the unemployment rate of young males.

Table 3 shows the results on judicial institutions. Higher income per capita is associated with less legal formalism but not with longer judicial tenure or the acceptance of case law (panel A). Here again, legal origin has a pronounced effect on institutions. Compared to common law countries, civil law countries generally have more legal formalism, lower judicial tenure, and sharply lower constitu-
tional acceptance of case law. The estimated coefficients imply that French legal origin is associated with an increase of 1.49 in the index of legal formalism, a reduction of 0.24 in judicial tenure, and of 0.67 in case law. These are large effects since legal formalism ranges from 0.73 to 6.0, and both judicial tenure and case law range from 0 to 1.

Judicial institutions matter for both the efficiency of contract enforcement and the security of property rights (panel B). The estimated coefficients imply that a two-standard deviation increase in legal formalism is associated with a 67 percentage point increase in the time to collect on a check and a reduction of 1.1 in the index of contract enforcement (the latter ranges from 3.5 to 8.9). Moreover, a two-standard deviation increase in judicial tenure is associated with a 0.8 point rise in the property rights index. Finally, a two-standard deviation increase in case law is associated with an improvement of 0.6 points in the property rights index, which ranges from 1 to 5.

3.2 Initial Criticisms

So, what do we learn from these tables? The economic consequences of legal origins are pervasive. Compared to French civil law, common law is associated with (a) better investor protection, which in turn is associated with improved financial development, better access to finance, and higher ownership dispersion, (b) lighter government ownership and regulation, which are in turn associated with less corruption, better functioning labor markets, and smaller unofficial economies, and (c) less formalized and more independent judicial systems, which are in turn associated with more secure property rights and better contract enforcement.

To us, the most important aspect of these results is how pervasive is the influence of legal origins. Many objections have been raised with respect to individual pieces of this evidence. We address later the most far-reaching criticism, that legal origin is a proxy for something else, but deal here with more parochial concerns. The key point to start with, however, is that objections rarely come to grips with the breadth of the influence of legal origins on economic outcomes.

We focus on objections to the law and finance evidence. The most immediate objection is reverse causality: countries improve their laws protecting investors as their financial markets develop, perhaps under political pressure from those investors. If instrumental variable techniques were appropriate in this context, a two stage procedure, in which in the first stage the rules are instrumented by legal origins, would address this objection. LLSV (1997, 1998) pursue this strategy. But even if instrumental variable techniques are inappropriate because legal origin influences finance through channels other than rules protecting investors, legal origins are still exogenous, and to the extent that they shape legal rules protecting investors, these rules cannot be just responding to market development. Moreover, this criticism in no way rejects the significance of legal origins in shaping outcomes; it speaks only to the difficulty of identifying the channel.

Recent evidence has gone beyond cross-section to look at changes in financial development in response to changes in legal rules, thereby relieving the reverse causality concerns. Michael Greenstone, Paul Oyer, and Annette Vissing-Jørgensen (2006) examine the effects of the 1964 Securities Act Amendments, which increased the disclosure requirements for U.S. over-the-counter firms. They find that firms subject to the new disclosure requirements had a statistically significant abnormal excess return of about 10 percent over the year and a half

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7 Daniel Berkowitz and Karen B. Clay (2005, 2006, 2007) exploit the fact that ten U.S. states were initially settled by France, Spain, or Mexico to examine the effects of legal origin. They find that states initially settled by civil law countries granted less independence to their judiciaries as recently as 1970–90, had lower quality courts in 2001–03, and used different procedures for setting judicial budgets as late as 1960–2000.
that the law was debated and passed relative to a comparison group of unaffected NYSE/AMEX firms. Brian J. Bushee and Christian Leuz (2005) obtain similar findings using a regulatory change in the U.S. over-the-counter markets. Nadia Linciano (2003) examines the impact of the Draghi reforms in Italy, which improved shareholder protection. The voting premium steadily declined over the period that the Draghi committee was in operation, culminating in a drop of 7 percent in the premium at the time of the passage of the law. Tatiana Nenova (2006) analyzes how the control premium is affected by changes in shareholder protection in Brazil. She documents that the control value more than doubled in the second half of 1997 in response to the introduction of Law 9457/1997, which weakened minority shareholder protection. Moreover, control values dropped to pre-1997 levels when in the beginning of 1999 some of the minority protection rules scrapped by the previous legal change were reinstated.

Turning to the evidence on credit markets, Djankov et al. (2007) show that private credit rises after improvements in creditor rights and in information sharing in a sample of 129 countries. For a sample of twelve transition economies, Rainer F. H. Haselmann, Pistor, and Vikrant Vig (2006) report that lending volume responds positively to improvements in creditor rights. Sujata Visaria (2006) estimates the impact of introducing specialized tribunals in India aimed at accelerating banks’ recovery of nonperforming loans. She finds that the establishment of tribunals reduces delinquency in loan repayment by between 3 and 10 percentage points. Aldo Musacchio (2008) finds that the development of bond markets in Brazil is correlated with changes in creditors’ rights. Mario Gamboa-Cavazos and Frank Schneider (2007), in an exhaustive study of recent bankruptcy reform in Mexico, show that changes in legal rules lowered the time it takes firms to go through bankruptcy proceedings and raised recovery rates.

A second concern about the law and finance evidence is omitted variables—the very reason IV techniques are not suitable for identifying the channels of influence. How do we know that legal origin influences financial development through legal rules, rather than some other channel (or perhaps even other rules)? The most cogent version of this critique holds that legal origin influences contract enforcement and the quality of the judiciary, and it is through this channel that it effects financial development. Indeed, we know from La Porta et al. (1999, 2004) and Djankov et al. (2003b), as illustrated in table 3 above, that common law is associated with better contract enforcement.

This objection is significant since, in reality, enforcement and rules are not entirely separable. A formalistic judiciary might be better able to enforce bright line rules than broad legal standards; an independent judiciary might have a comparative advantage at enforcing standards. One way to address this concern is to control for contract enforcement as best we can. In the regressions above, we control for per capita income, which is a crude proxy of the quality of the judiciary. More recent studies, such as Djankov et al. (2008) and La Porta et al. (2006), also control for the quality of contract enforcement from Djankov et al. (2003b), with the result that both the actual legal rules and the quality of contract enforcement matter. For the case of credit markets, Mehnaz Safavian and Siddharth Sharma (2007) show that creditor rights benefit debt markets if the country has a good enough court system, but not if it does not. Tullio Jappelli, Marco Pagano, and Magda Bianco (2005) find that credit is less widely available in Italian regions with longer trials and larger backlogs of pending trials. Djankov et al. (2006) combine the rules and their actual enforcement into an integrated measure of debt enforcement efficiency. This measure (see table 1 above) is highly predictive.

8 Matthieu Chemin (2007a, 2007b) shows that reforms of the judiciary improved firms’ access to finance and performance in India and Pakistan, respectively.
of debt market development. The available evidence suggests that both good rules and their enforcement matter, and that the combination of the two is generally most effective.

Another relevant distinction is between legal rules and their interpretation. One view is that the actual legal rules, which might have come from legislation, from appellate decisions, or from legislation codifying previous appellate decisions, are shaped by legal origins and in turn shape finance. For example, the extensive approval and disclosure procedures for self-dealing transactions discourage them in common law countries, as compared to the French civil law countries (Djankov et al. 2008).

Other writers emphasize the flexibility of judicial decision making under common law. One version of this argument suggests that common law judges are able or willing to enforce more flexible financial contracts, and that such flexibility promotes financial development (Nicola Gennaioli 2007). Josh Lerner and Antoinette Schoar (2005) and Nittai K. Bergman and Daniel Nicolaievy (2007) present some evidence in support of this view. Craig G. Doidge, Andrew Karolyi, and René M. Stulz (2007) and Reena Aggarwal et al. (2008) also find that national legal rules protecting investors improve the ability of firms to develop company-specific corporate governance mechanisms. In the context of labor markets, Beth Ahlering and Simon Deakin (2005) likewise argue that in civil law countries, unlike in common law ones, freedom of contract is counterbalanced by the exercise of public power for the protection of workers in the French tradition, and the communitarian conception of the enterprise in the German one. Pistor (2006) presents a legal and historical account of the greater contractual flexibility in common law, the reason being that contractual freedom is unencumbered by social conditionality.9

A second version of the flexibility thesis stresses the ability of common law courts to use broad standards rather than specific rules in rendering their decisions. This ability enables judges to “catch” self-dealing or tunneling, and thereby discourages it. Coffee (1999) has famously called this the smell-test of common law. Simon Johnson et al. (2000) examine several legal cases concerning tunneling of assets by corporate insiders in civil law countries, and find that the bright line rules of civil law allow corporate insiders to structure legal transactions that expropriate outside investors. In contrast, the broader standards of common law, such as fiduciary duty, discourage tunneling more effectively.

At this point, there is evidence supporting both the “laws on the books” and the “judicial flexibility” theories. As we argue in section 4, both interpretations are also consistent with the fundamental differences between common and civil law.

3.3 Recent Findings on Resource Allocation

Recent years have seen an explosion of research on the consequences of legal rules and regulations, many of which are related to legal origins, for resource allocation. We briefly review this evidence before turning to the interpretation.

Perhaps the largest body of work concerns the effect of financial development on resource allocation. Many of these papers use LLSV indicators of investor protection, as well as legal origins as instruments for financial development. The central paper here is Raghuram Rajan and Zingales (1998), who find that, in financially developed countries, sectors which for technological reasons depend more on external finance grow faster. In a similar spirit, Jeffrey Wurgler (2000) finds that financially developed

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9 Naomi R. Lamoreaux and Jean-Laurent Rosenthal (2005) dispute the flexibility hypothesis by pointing to the broader range of legally acceptable forms of business organization in France than in the United States in the nineteenth century.
countries exhibit a higher responsiveness of investment to growth opportunities.\footnote{Other papers in this area include Stijn Claessens and Luc Laeven (2003), Matias Braun (2003), Raymond Fisman and Inessa Love (2004), Thorsten Beck, Asli Demirgüç-Kunt, and Levine (2005), Enrico C. Perotti and Paolo F. Volpin (2004), Antonio Ciccone and Elia Papaioannou (2006a, 2006b), Alain De Serres et al. (2006), and Geert Bekaert et al. (2007).}

Several studies use the data from Botero et al. (2004) to examine the effects of labor regulation on resource allocation. Ricardo J. Caballero et al. (2004) find that, in countries with strong rule of law, higher job security is associated with slower adjustment to shocks and lower productivity growth. Gaëlle Pierre and Stefano Scarpetta (2007) show that employment regulations lead to substitution from permanent to temporary employment. Alejandro Cuñat and Marc J. Melitz (2006) find that countries with light labor market regulations specialize in volatile industries. Francine Lafontaine and Jagadeesh Sivadasan (2007) study one firm operating in forty-three countries, and find that employment protections lead to labor misallocation, delayed entry, and operation of fewer outlets.

Entry regulations, another sphere influenced by legal origins, also affect resource allocation. Fisman and Virginia Sarria-Allende (2004) find that entry regulations distort industry structure and promote concentration. Leora Klapper, Laeven, and Rajan (2006) and Djankov et al. (2007b) show that such regulations stifle entry. Ciccone and Papaioannou (2006c) report that countries with lower entry regulations see more entry in industries that experience expanding global demand and technology shifts.

Two other papers use our variables to examine the effects of contract enforcement on the structure of production. Nathan Nunn (2007) finds that countries with good contract enforcement specialize in the production of goods for which relationship-specific investments are more important. Pol Antrás, Mihir A. Desai, and C. Fritz Foley (2007) find that weak investor protections limit the scale of multinational firm activity, increase the reliance on FDI flows, and alter the decision to deploy technology through FDI rather than licensing.

Finally, a growing body of research shows that costly regulation can reduce the benefits of international trade. Jose Ernesto López-Córdova (2007) finds that exporting firms grow 4 percentage points faster after trade liberalization in countries with less burdensome labor regulations. Using cross-country data, Caroline Freund and Bineswaree Bolaky (2007) show that trade openness has a positive impact on per capita income only in countries with low regulation of entry. Norman Loayza, Linda Kaltani, and Roberto Chang (2005) present a similar finding for labor market regulation. Elhanan Helpman, Melitz, and Yona Rubinstein (2008) find that the probability that two countries trade is smaller when the cost of entry regulation is high in both countries.

All this evidence suggests that, through their effect on finance, labor markets, and competition, legal origins indeed influence resource allocation. This raises the question of whether one can take the next step and connect legal origins to aggregate economic growth. This, however, has proved to be difficult, as we explain next.

Mahoney (2001) shows that, in the recent period, common law countries have grown faster than French legal origin countries. Mahoney is indeed correct: during 1960–2000, compared to the common law countries, GDP per capita in the French legal origin countries has grown about 0.6 percentage point slower per year. On the other hand, German legal origin countries grew faster than the common law countries. Depending on the specification, there are similar differences in the growth rates of GDP per worker, capital stock per worker, and productivity.
These results, however, are not particularly robust. The growth effects of legal origins become weaker once we control for a measure of human capital, namely average years of schooling in 1960—a standard control in such regressions. Indeed, throughout the 1960–2000 period, years of schooling are sharply higher in common law countries than in French legal origin ones, even holding per capita income constant. Interestingly, Jacek Rostowski and Bogdan Stacescu (2006) argue that legal origins should enter the growth equation precisely through education because England pursued more enlightened educational policies in its colonies than did France. French colonial education was largely guided by the idea of assimilation, with French textbooks, French teachers, and instruction in French. The British, in contrast, adapted colonial education to local conditions and taught in vernacular. This is a very original theory, and we hope it is developed.

The most obvious potential channel of influence of legal origins on growth is financial development, since legal origins have such strong effects on finance. Using legal origins as instruments, Beck, Levine, and Loayza (2000) and Levine, Loayza, and Beck (2000) find that private debt market development is a statistically significant and quantitatively important predictor of growth. Again, however, one needs to be careful, both because (as we argued above) the exclusion restriction is unlikely to be satisfied and because the results are often sensitive to the inclusion of other variables, such as alternative measures of human capital.

In sum, there is by now a great deal of evidence that legal origins influence legal rules and regulations, which in turn have substantial impact on important economic outcomes—from financial development, to unemployment, to investment and entry, to the size of unofficial economy, to international trade. Much of this evidence suggests that common law is associated with better economic outcomes than French civil law. The evidence also shows that legal origins influence patterns of growth within industries, but it is less clear that legal origins predict aggregate growth. The last finding resonates with the obvious observation made by LLSV (1998) that countries like France and Belgium achieved high living standards despite their legal origin. One possible explanation of the aggregate growth evidence is that civil law countries have found compensating mechanisms to overcome the baggage of their legal tradition in the long run. Another possibility is that the last forty years have been unrepresentative and that, in the long run, there are periods that advantage civil law regimes (such as state-led growth). We do not know which of these, or some other explanation, is correct.11

All this evidence leaves us with a major question: why do legal origins matter, and why do they matter in such a pervasive way for both rules and economics outcomes? What are the historical and structural differences among common and civil law countries that have such pervasive consequences for both the specific legal and regulatory rules and major economic outcomes? We attempt to answer this question in the next section.

4. Explaining the Facts

The correlations documented in the previous section require an explanation. LLSV (1997, 1998) do not advance such an explanation, although in a broader study of government institutions, LLSV (1999) follow Friedrich A. Hayek (1960) and suggest that common law countries are more protective of private property than French legal origin ones. In the ensuing years, many academics, ourselves included, used the historical narrative to provide a theoretical foundation for the empirical evidence (see Glaeser

11 We note, however, that the evidence on the relationship between institutions and aggregate growth more generally, which seemed substantial a few years ago, has been crumbling (see Edward L. Glaeser et al. 2004).
and Shleifer 2002, Djankov et al. 2003a, and Mulligan and Shleifer 2005b). In this section, we begin with the alternative historical explanations and then try to revise, synthesize, and advance previous theoretical accounts into the Legal Origins Theory.¹²

4.1 Revolutionary Explanations

The standard explanation of the differences between common law and French civil law in particular, and to a lesser extent German law, focuses on seventeenth–nineteenth century developments (Merryman 1969, Zweigert and Kötz 1998, Daniel Klerman and Mahoney 2007). According to this theory, the English lawyers were on the same winning side as the property owners in the Glorious Revolution, and in opposition to the Crown and to its courts of royal prerogative. As a consequence, the English judges gained considerable independence from the Crown, including lifetime appointments in the 1701 Act of Settlement. A key corollary of such independence was the respect for private property in English law, especially against possible encroachments by the sovereign. Indeed, common law courts acquired the power to review administrative acts: the same principles applied to the deprivation of property by public and private actors (Mahoney 2001, p. 513). Another corollary is respect for the freedom of contract, including the ability of judges to interpret contracts without a reference to public interest (Pistor 2006). Still another was the reassertion of the ability of appellate common law courts to make legal rules, thereby becoming an independent source of legal change separate from Parliament. Judicial independence and law-making powers in turn made judging a highly attractive and prestigious occupation.

In contrast, the French judiciary was largely monarchist in the eighteenth century (many judges bought offices from the king) and ended up on the wrong side of the French Revolution. The revolutionaries reacted by seeking to deprive judges of independence and law-making powers, to turn them into automatons in Napoleon’s felicitous phrase. Following Charles M. de Secondat Montesquieu’s (1748) doctrine of separation of powers, the revolutionaries proclaimed legislation as the sole valid source of law and explicitly denied the acceptability of judge-made law. “For the first time, it was admitted that the sovereign is capable of defining law and of reforming it as a whole. True, this power is accorded to him in order to expound the principles of natural law. But as Cambaceres, principal legal adviser to Napoleon, once admitted, it was easy to change this purpose, and legislators, outside of any consideration for “natural laws” were to use this power to transform the basis of society” (David and Brierley 1985, p. 60).

Hayek (1960) traces the differences between common and civil law to distinct conceptions of freedom. He distinguishes two views of freedom directly traceable to the predominance of an essentially empiricist view of the world in England and a rationalist approach in France: “One finds the essence of freedom in spontaneity and the absence of coercion, the other believes it to be realized only in the pursuit and attainment of an absolute social purpose; one stands for organic, slow, self-conscious growth, the other for doctrinaire deliberateness; one for trial and error procedure, the other for the enforced solely valid pattern” (p. 56). To Hayek, the differences in legal systems reflect these profound differences in philosophies of freedom.

¹² Legal Origins Theory is intimately related to the discussion of the varieties of capitalism, which (typically in the context of the OECD economies) distinguishes between liberal and coordinated market economies, the latter having firms that “depend more heavily on non-market relationships to coordinate their endeavors with other actors to construct their core competencies” (Peter A. Hall and David Soskice 2001, p. 8). As Pistor (2006) points out, all the liberal market economies in the OECD are common law countries, and all the coordinated ones are civil law ones. The literature on the variety of capitalisms has long looked for an objective measure of different types; perhaps it should have looked no further than legal origins.
To implement his strategy, Napoleon promulgated several codes of law and procedure intended to control judicial decisions in all circumstances. Judges became bureaucrats employed by the State; their positions were seen as largely administrative, low-prestige occupations. The ordinary courts had no authority to review government action, rendering them useless as guarantors of property against the state.

The diminution of the judiciary was also accompanied by the growth of the administrative, as Napoleon created a huge and invasive bureaucracy to implement the state’s regulatory policies (Isser Woloch 1994). Under Napoleon, “the command orders were now unity of direction, hierarchically defined participation in public affairs, and above all the leading role assigned to the executive bureaucracy, whose duty was to force the pace and orient society through the application from above of increasingly comprehensive administrative regulations and practices” (Stuart Woolf 1992, p. 95).

Merryman (1969) explains the logic of codification: “If the legislature alone could make laws and the judiciary could only apply them (or, at a later time, interpret and apply them), such legislation had to be complete, coherent, and clear. If a judge were required to decide a case for which there was no legislative provision, he would in effect make law and thus violate the principle of rigid separation of powers. Hence it was necessary that the legislature draft a code without gaps. Similarly, if there were conflicting provisions in the code, the judge would make law by choosing one rather than another as more applicable to the situation. Hence there could be no conflicting provisions. Finally, if a judge were allowed to decide what meaning to give to an ambiguous provision or an obscure statement, he would again be making law. Hence the code had to be clear” (p. 30).

Yet, according to Merryman (1996), Napoleon’s experiment failed in France, as the notion that legislation can foresee all future circumstances proved unworkable. Over decades, new French courts were created, and they as well as older courts increasingly became involved in the interpretation of codes, which amounted to the creation of new legal rules. Even so, the law-making role of French courts was never explicitly acknowledged, and never achieved the scope of their English counterparts.

Perhaps more importantly for cross-country analysis, the developing countries into which the French legal system was transplanted apparently adhered faithfully to the Napoleonic vision. In those countries, judges stuck to the letter of the code, resolving disputes based on formalities even when the law needed refinement. Luca Enriques (2002) shows that, even today, Italian magistrates let corporate insiders expropriate investors with impunity, as long as formally correct corporate decision-making procedures are followed. In the transplant and to some extent even in the origin countries, legislation remained, at least approximately, the sole source of law, judicial law making stayed close to nonexistent, and judges retained their bureaucratic status. Merryman (1996) memorably writes that “when the French exported their system, they did not include the information that it really does not work that way, and failed to include the blueprint of how it actually does work” (p. 116). This analysis of the “French deviation” may explain the considerable dynamism of the French law as compared to its transplant countries, where legal development stagnated. The French emphasis on centralized bureaucratic control may have been the most enduring influence of transplantation.

Although less has been written about German law, it is fair to say that it is a bit of a hybrid (John P. Dawson 1960, 1968, Merryman 1969, Zweigert and Kötz 1998). Like the French courts, German courts had little independence. However, they had greater power to review administrative acts, and jurisprudence was explicitly recognized as a source of law, accommodating greater legal change.
The historical analysis has three key implications for the economic consequences of legal origins. First, the built-in judicial independence of common law, particularly in the cases of administrative acts affecting individuals, suggests that common law is likely to be more respectful of private property and contract than civil law.

Second, common law’s emphasis on judicial resolution of private disputes, as opposed to legislation, as a solution to social problems, suggests that we are likely to see greater emphasis on private contracts and orderings, and less emphasis on government regulation, in common law countries. To the extent that there is regulation, it aims to facilitate private contracting rather than to direct particular outcomes. Pistor (2006) describes French legal origin as embracing socially conditioned private contracting, in contrast to common law’s support for unconditioned private contracting. Damaska (1986) calls civil law “policy-implementing,” and common law “dispute resolving.”

Third, the greater respect for jurisprudence as a source of law in the common law countries, especially as compared to the French civil law countries, suggests that common law will be more adaptable to the changing circumstances, a point emphasized by Hayek (1960) and more recently Levine (2005). These adaptability benefits of common law have also been noted by scholars in law and economics (Richard Posner 1973, Paul H. Rubin 1977, George L. Priest 1977, Giacomo A. M. Ponzetto and Patricio A. Fernandez forthcoming), who have made the stronger claim that, through sequential decisions by appellate courts, common law evolves not only for the better but actually toward efficient legal rules. The extreme hypothesis of common law’s efficiency is difficult to sustain either theoretically or empirically, but recent research does suggest that the ability of judges to react to changing circumstances—the adaptability of common law—tends to improve the law’s quality over time. For example, Gennaioli and Shleifer (2007) argue in the spirit of Benjamin N. Cardozo (1921) and Julius Stone (1985) that the central strategy of judicial law making is distinguishing cases from precedents, which has an unintended benefit that the law responds to a changing environment. The quality of law improves on average even when judges pursue their policy preferences; law making does not need to be benevolent.

The theoretical research on the adaptability of common law has received some empirical support in the work of Beck, Demirguc-Kunt, and Levine (2003), who show that the acceptability of case law variable from La Porta et al. (2004) captures many of the benefits of common law for financial and other outcomes. On the other hand, a recent study of the evolution of legal doctrine governing construction disputes in the United States over the period of 1970–2005 finds little evidence either that legal rules converge over time, or that they move toward efficient solutions (Anthony Niblett, Posner, and Shleifer 2008).

4.2 Medieval Explanations

The idea that the differences between common and civil law manifest themselves for the first time during the Enlightenment seems a bit strange to anyone who has heard of Magna Carta. Some of the differences were surely sharpened, or even created, by the English and the French Revolutions. For example, judges looked to past judicial decisions for centuries in both England and France prior to the revolutions (Gino Gorla and Luigi Moccia 1981). However, the explicit reliance on precedent as a source of law (and the term precedent itself) is only a seventeenth and eighteenth century development in England (Harold J. Berman 2003). Likewise, the denial of the legal status of precedent in France is a Napoleonic rather than an earlier development.

But in other respects, important differences predate the revolutions. The English judges fought the royal prerogative, used juries to try criminal cases, and pressed the
argument that the King (James) was not above the law early in the seventeenth century. They looked down on the inquisitorial system that flourished on the Catholic continent. In light of such history, it is hard to sustain the argument that the differences between common and civil law only emerged through revolutions.

Several distinguished legal historians, including Dawson (1960) and Berman (1983), trace the divergence between French and English law to a much earlier period, namely the twelfth and thirteenth centuries. According to this view, the French Crown, which barely had full control over the Ile de France let alone other parts of France, adopted the bureaucratic inquisitorial system of the Roman Church as a way to unify and perhaps control the country. The system persisted in this form through the centuries, although judicial independence at times increased as judges bought their offices from the Crown. Napoleonic bureaucratization and centralization of the judiciary is seen as a culmination of a centuries-old tug of war between the center and the regions.

England, in contrast, developed jury trials as far back as the twelfth century and enshrined the idea that the Crown cannot take the life or property of the nobles without due process in the Magna Carta in 1215. The Magna Carta stated: “No freeman shall be taken or imprisoned or disseised or outlawed or exiled or in any way ruined, nor will we go or send against him, except by the lawful judgment of his peers or by the law of the land.” The Magna Carta established the foundations of the English legal order. As in France, such independence was continuously challenged by the Crown, and the courts of royal prerogative, subordinate to the Crown, grew in importance in the sixteenth century, during the reign of Queen Elizabeth. Yet, as we indicated earlier, even during Elizabeth’s reign, and much more so during those of James I and Charles I, Parliament and courts repeatedly reaffirmed the rights of individuals against royal demands. Chief Judge Edward Coke’s early seventeenth century insistence that the king is not above the law is neither a continental nor a postrevolutionary phenomenon. The Glorious Revolution eliminated the courts of royal prerogative, and eventually enshrined the principles of judicial independence in several acts of Parliament.

Glaeser and Shleifer (2002) present a theoretical model intended to capture this comparative twelfth and thirteenth century narrative, but with an economic twist. They argue that England was a relatively peaceful country during this period, in which decentralized dispute resolution on the testimony of independent knights (juries) was efficient. France was a less peaceful country, in which high nobles had the power to subvert decentralized justice, and hence a much more centralized system, organized, maintained, and protected by the sovereign, was required to administer the law. Roman law provided the backbone of such a system. This view sees the developments of seventeenth and eighteenth centuries as reinforcing the structures that evolved over the previous centuries.

Regardless of whether the revolutionary or the medieval story is correct, they have similar empirical predictions. In the medieval narrative, as in the revolutionary one, common law exhibits greater judicial independence than civil law, as well as greater sympathy of the judiciary toward private property and contract, especially against infringements by the executive. In both narratives, judicial law making and adaptation play a greater role in common than in civil law, although this particular difference might have been greatly expanded in the Age of Revolutions. The historical accounts may differ in detail, but they lead to the same place as to the fundamental features of law. These features, then, carry through the process of transplantation, and appear in the differences among legal families.

4.3 Legal Origins Theory

Legal Origins Theory has three basic ingredients. First, regardless or whether the
medieval or the revolutionary narrative is the correct one, by the eighteenth or nineteenth centuries England and Continental Europe, particularly France, have developed very different styles of social control of business, and institutions supporting these styles. Second, these styles of social control, as well as legal institutions supporting them, were transplanted by the origin countries to most of the world, rather than written from scratch. Third, although a great deal of legal and regulatory change has occurred, these styles have proved persistent in addressing social problems.

Djankov et al. (2003a) propose a particular way of thinking about the alternative legal styles. All legal systems seek to simultaneously address twin problems: the problem of disorder or market failure and the problem of dictatorship or state abuse. There is an inherent trade-off in addressing these twin problems: as the state becomes more assertive in dealing with disorder, it may also become more abusive. We can think of the French civil law family as a system of social control of economic life that is relatively more concerned with disorder, and relatively less with dictatorship, in finding solutions to social and economic problems. In contrast, the common law family is relatively more concerned with dictatorship and less with disorder. These are the basic attitudes or styles of the legal and regulatory systems, which influence the “tools” they use to deal with social concerns. Of course, common law does not mean anarchy, as the government has always maintained a heavy hand of social control; nor does civil law mean dictatorship. Indeed, both systems seek a balance between private disorder and public abuse of power. But they seek it in different ways: common law by shoring up markets, civil law by restricting them or even replacing them with state commands.

Legal Origins Theory raises the obvious question of how the influence of legal origins has persisted over the decades or even centuries. Why so much hysteresis? What is it that the British brought on the boats that was so different from what the French or the Spaniards brought, and that had such persistent consequences? They key point is that transplantation involves not just specific legal rules (many of which actually change later) but also legal institutions (or which judicial independence might be the most important), human capital of the participants in the legal system, and crucially the strategy of the law for dealing with new problems. Successive generations of judges, lawyers, and politicians all learn the same broad ideas of how the law and the state should work. The legal system supplies the fundamental tools for addressing social concerns and it is that system, as defined by Zweigert and Kötz, with its codes, distinctive institutions, modes of thought and even ideologies, that is very slow to change.

The fact that legal system is slow to change does not mean that specific legal rules and regulations never change. As we discuss below, governments in both common and civil law countries entered many new spheres of social control in the twentieth century, but typically in ways consistent with their legal traditions. In some more stable areas of law, such as legal procedure, there is sometimes a great deal of rigidity even in the specific rules. Aron Balas et al. (2008) compute the index of the formalism of legal procedure, considered in table 3, for twenty common law and twenty civil law countries over the period 1950–2000. Consistent with Djankov et al. (2003b), they find that formalism is higher in common than in civil law countries in 2000, but also in 1950. Perhaps more surprisingly, formalism is extraordinarily stable. Among common law countries, the average of the ratio of 2000 to 1950 procedural formalism is 0.90; among civil law countries, the average of this ratio is 1.10. The data reflects significant persistence of the differences among legal origins, with no evidence of convergence.

The reader might wonder at this point whether Legal Origin Theory simply identifies legal families with different “ideologies”
or “cultures.” To the extent that ideologies or cultures refer to the beliefs about how the law should deal with social problems, Legal Origin Theory clearly accepts the view that ideologies and cultures are crucial for the persistent influence of legal families. But the central point is that the reason for persistence is that the beliefs and ideologies become incorporated in legal rules, institutions, and education and, as such, are transmitted from one generation to the next. It is this incorporation of beliefs and ideologies into the legal and political infrastructure that enables legal origins to have such persistent consequences for rules, regulations, and economic outcomes.

The account of legal origins has implications for how the government responds to new needs both across activities and over time. Essentially, the toolkit of civil law features more prominently such policies as nationalization and direct state control; the toolkit of common law features more litigation and market-supporting regulation. Mulligan and Shleifer (2005b) argue that, by specializing in such “policy-implementing” solutions, the civil law system tends to expand the scope of government control to new activities when a need arises. Perhaps the best known historical example of this is the vast expansion of military conscription in France under Napoleon, made possible by the already existing presence of government bureaucracy that could administer the draft in every French village (Woloch 1994). Because the state’s presence on the ground is less pervasive under the common law, it tends not to rely as extensively on administrative solutions and more on “market-supporting” or “dispute-resolving” ones.

Likewise, one can argue that, when the market system gets into trouble or into a crisis, the civil law approach is to repress it or to replace it with state mandates, while the common law approach is to shore it up. One place to see this might be the regulatory response to the Great Depression and financial crises of the twentieth century. According to Randall K. Morck and Lloyd Steier (2005), “the responses of the Dutch, Italian, Japanese, and Swedish governments to the financial crisis of the 1920s and 1930s were to substitute various mechanisms of state-controlled capital allocation for their stock markets” (p. 39). “A similar succession of financial manias, panics, and crises in Britain, Canada, and the United States ultimately strengthened shareholder rights” (p. 39). The United States responded to the Great Depression by introducing securities regulation and deposit insurance. These strategies intended to rehabilitate and support markets, not to replace them. Even Roosevelt’s most radical aspirations fell short of nationalization. This contrast between the replacement of markets by state solutions in civil law countries and the rehabilitation of markets in common law countries appears quite pervasive.

One form of government reaction to new circumstances is the expansion of public involvement into new spheres. Economic historians have sometimes argued that, because legal origins have differed for centuries, one should observe equally sharp differences in rules and regulations in the nineteenth century as well. This, of course, does not follow. To the extent that public intervention in markets changes over time and responds to social needs or political imperatives, laws and regulations will change as well, but in ways that are consistent with legal traditions. Both labor laws and securities laws are creatures of the twentieth century; they were introduced as a response to perceived social needs. Yet, as the evidence in section 3 shows, these laws took different forms in countries from different legal traditions, consistent with broad strategies of how the state intervenes.

Ahlering and Deakin (2005) elaborate this point in the context of labor laws. They argue that the current differences between the labor laws of Britain and Continental Europe can be traced to the differences in the ways common and civil law systems saw the role of the enterprise as far back as the
Industrial Revolution. Common law saw the enterprise as an unencumbered property or the employer, with the workers relegated to contractual claims on the surplus from production. In contrast, civil law saw property and responsibility as two sides of the same coin. Thus, the support provided by the legal system to the freedom of contract and property rights was counterbalanced in the French tradition by the exercise of public power for the protection of workers, and in the Germanic tradition by the communitarian conception of the enterprise. Ahlering and Deakin suggest that these differences in "legal cultures" persist even today.

Crucially, the Legal Origins Theory does not say that common law always works better for the economy. As Glaeser and Shleifer (2002, 2003) show, regulation and state control may well be efficient responses to disorder, where common-law solutions fail to sustain markets. Indeed, all countries efficiently resort to the quintessentially civil law solution of planning in time of war and add good dollops of state intervention and control in response to major threats to order, such as terrorism. Glaeser and Shleifer (2003) interpret the early twentieth century rise of the regulatory state in the United States as an efficient response to the subversion of the justice system by large corporations.

Legal Origin Theory also does not imply that the outcomes we observe are always or even typically efficient within a given legal family. There are several reasons for inefficiency, quite aside from interest group politics. First, at the most basic level, the tools used by a legal system may lead to outcomes that are worse than the initial problem. Excessive regulation of entry in civil law countries is a good example. Second, courts or legislators in a country might bring into one domain a set of tools that has been used in another, based on either philosophical outlook or a desire for consistency, with adverse results. For example, the strategy of extensive interlocutory appeals that is standard in a civil law system can slow down a bankruptcy proceeding, where time is of the essence, and lead to a large loss of value (Djankov et al. 2006). Third, additional inefficiencies may arise from transplantation. A regulatory approach that works well in France may become little but a source of corruption and delay in a poor West African country. As we show in section 8, an understanding of regulatory inefficiencies afforded by the Legal Origins Theory can form the basis of reform.

To reiterate, no country exhibits a system of social control that is an ideal type; all countries mix the two approaches. Common law countries are quite capable of civil law solutions, and vice versa. Nonetheless, the empirical prediction of the Legal Origin Theory is that the differences between legal origins are deep enough that we observe them expressed in the different strategies of social control of economic life even after centuries of legal and regulatory evolution. Perhaps because the legal system is such a difficult-to-change element of social order, supported by legal institutions, human capital, and expectations, legal origins survive both time and transplantation. This, we submit, is what gives them explanatory power.

4.4 Interpretation of the Evidence

In interpreting the evidence in light of the Legal Origins Theory, it is easiest to proceed in reverse: from judicial independence to government regulation to finance. The evidence on judicial independence directly confirms the predictions. As we saw in table 3, compared to French civil law, common law countries have less formalized contract enforcement, longer constitutional tenure of Supreme Court judges (a direct indicator of independence), and greater recognition of case law as a source of law, which Beck,
Demirguc-Kunt, and Levine (2003) use as an indicator of adaptability. Also consistent with the Legal Origins Theory, these characteristics of legal systems predict both the efficiency of contract enforcement—measured objectively and subjectively—and the security of property rights.

The evidence on government regulation is consistent with the Legal Origins Theory as well. The historical evidence suggests that civil law countries are more likely to address social problems through government ownership and mandates, whereas common law countries are more likely to do so through private contract and litigation. When common law countries regulate, we expect their regulation to support private contracting rather than dictate outcomes. We see those differences across a broad range of activities—from entry and labor regulation to recruitment of armies. We also see that civil law countries exhibit heavier government ownership of both the media and banks.

The theory is also consistent with the evidence on finance. The better protection of both shareholders and creditors in common law countries than especially in the French civil law ones is consistent with the principal historical narrative of the greater security of private property and better contract enforcement under common law. Moreover, as noted by Beck, Demirguc-Kunt, and Levine (2003), financial markets may be an area where the adaptability of judge-made rules, as exemplified by the American Delaware courts, is especially beneficial.

Mark J. Roe (2006) points out that many of the legal rules protecting investors in common law countries are statutory rather than judge-made, so in many crucial respects regulation rather than judge-made law is responsible for investor protection. Securities laws in general, and disclosure rules in particular, which La Porta et al. (2006) show to provide some of the most effective investor protections, are entirely statutory. Howell Jackson and Roe (2007) further argue that the budgets and staffing levels of securities regulators, which are higher in common law countries, predict financial development. Is this evidence consistent with Legal Origins Theory?

The answer, we believe, is yes. Common law countries succeed in finance because their regulatory strategies seek to sustain markets rather than replace them. Returning to the examples of securities regulation and of the often-statutory regulation of self-dealing transactions, the statutory requirements of disclosure originate in the common law of fiduciary relationships. Market forces on their own are not strong enough, and contract claims not cheap enough to pursue, to protect investors from being cheated. A regulatory framework that offers and enforces such protection, and makes it easier for investors to seek legal remedies to rectify the wrongs even when doing so relies on public action, allows more extensive financial contracting. The form of statutory protection of investors in common law countries, as compared to civil law countries, is consistent with Legal Origins Theory. Finance falls into line with other evidence.

5. Legal Origins and Culture

In this section and the next two, we address the central criticism of research on legal origins: that they are merely proxy for other factors influencing legal rules and outcomes. The three factors we consider are culture, history, and politics. We stress from the outset that it is not our position, nor our objective in these sections, to show that culture, history, or politics are unimportant for legal and regulatory rules. All of them are clearly important, and there is a great deal of evidence confirming their roles (see, e.g., Luigi Guiso, Sapienza, and Zingales 2004, 2006 on the role of culture). Our point is rather to establish, as clearly as possible, a much more modest yet central to the Legal Origins Theory proposition that legal origins are not proxies for something else.

We begin with culture, which has been considered as a potential explanation of the
evidence on legal origins. Stulz and Rohan Williamson (2003) suggest that, in light of the hostility of some of the religious traditions to lending on interest, religion may be a more fundamental determinant of legal rules governing creditor protection than legal tradition. Amir N. Licht, Chanan Goldschmidt, and Shalom H. Schwartz (2005) present a more sweeping case, using psychological measures of cultural attitudes to predict legal rules. So are legal origins merely proxies for cultural variables?

Table 4 shows the facts. First, religion is not nearly as important a determinant of creditor rights as legal origin (see Djankov et al. 2007). Second, most indices of cultural attitudes do not influence creditor rights holding legal origin constant. There is some evidence that a nation’s masculinity (defined as “the degree to which the society reinforces, or does not reinforce, the traditional masculine work role model of achievement, control, and power”) is not conducive to creditor protection, while belief in the independence of children is, but neither variable makes much of a dent in the effect of legal origin on creditor rights.

Cultural variables, then, do not make much of a dent in the explanatory power of legal origins. We note, however, that the notions of culture we consider focus on religion and broad social attitudes. One can alternatively include in culture beliefs about the law, regulation, and the role of the state. This theory of culture is of course broadly consistent with our views.

6. Legal Origins and Politics

A broader challenge to the explanatory power of legal origins has been posed by political theories of corporate finance. There are now many papers in this literature, including Martin Hellwig (2000), Rajan and Zingales (2003), Pagano and Volpin (2005, 2006), Perotti and Ernst-Ludwig Von Thadden (2006), and Roe (2000, 2006), and even a recent survey by Stephen Haber and Perotti (2007). Although the papers differ in detail, they have a common theme, so we take the liberty of providing an integrated account. Also, while some of the papers cover developing countries, virtually all of them deal with Western Europe, or the Wealthy West, a point we return to below.

According to the political theories, sometime in the middle of the twentieth century, Continental European countries formed alliances between families that controlled firms and (typically organized) labor. In many cases, these alliances were a response to crises from hyperinflation, depression, or defeat in war. These political alliances sought to win elections in order to secure the economic rents of the insiders, and to keep them from the “outsiders,” such as unorganized labor, minority shareholders, corporate challengers, or potential entrants. When these alliances won elections, they wrote legal rules to benefit themselves. The families secured poor protection of outside shareholders, so they could hold on to the private benefits of control. Labor got social security and worker protection laws, which maintained employment and wages of the insiders. Both the families and labor secured the laws protecting them against product market competition, such as regulation of entry. The legal rules observed in the data, then, are outcomes of this democratic process and not of any “permanent” conditions, such as legal origins.

The political story is part of a broader narrative of Continental European history in the twentieth century, in which the response to crisis is variously characterized by the rise of proportional representation (Albino Alesina and Glaeser 2004, Torsten Persson and Guido Tabellini 2003), socialist politics (Alesina and Glaeser 2004), and social democracy (Roe 2000). The United States was spared these political developments and, therefore, did not get the laws adopted on the Continent. Some implications of these theories are broadly consistent with the evidence: countries that have strong shareholder protection indeed have weak protection of labor
and low regulation of entry. The suggestion of this research is that legal origin enters the various regressions summarized in section 3 spuriously, with French (and German) legal origins serving as proxies for—depending on the exact paper—social democracy, leftist politics, or proportional representation. If politics were appropriately controlled for in the regressions, legal origin would not matter.
The political story is plausible, since we see social democracies in Continental Europe but not in the United States. For this reason, we consider it in some detail. We do so in three steps. First, we briefly look at the logic of the story. Second, we show what happens when some of the political variables proposed in this literature are actually added to the regressions. Third, we test an implication of the available political models, namely that the formation of laws is a consequence of democratic politics. This prediction implies, most immediately, that the relationship between legal origins and laws should not hold outside democracies.

With respect to the logic of the story, it is hard to understand why organized labor accepts rules that facilitate the diversion of corporate wealth, or tunneling—something we see on a fairly large scale in, say, Italy or Belgium. We can see the argument for the Swedish system, in which the leading families stay in control but are kept on a tight leash through norms and regulations and certainly not allowed to expropriate investors. Sweden indeed has a valuable stock market and low private benefits of control. It is harder to accept the notion that organized labor endorses tunneling of corporate wealth, since presumably such wealth could be taxed or shared with the workers.

But what do the data say? Table 5 presents regressions of the legal and institutional rules on three variables considered by the political theories. The first one is proportional representation, the form of democracy seen as an adaptation to political demands of labor in the early twentieth century (Alesina and Glaeser 2004, Persson and Tabellini 2003). We obviously run these regressions for democracies only. The second variable, collected by Botero et al. (2004) for eighty-five countries, is the share of years between 1928–95 when the chief executive and the largest party in the legislature were leftist or centrist. The third variable is union density, defined as the percentage of the total work force affiliated to labor unions in 1997. The regressions in table 5 cover the whole sample and are not confined to Western Europe or the OECD.

For all three variables, the results in table 5 are straightforward. Political variables explain the variation in legal rules only occasionally. In contrast, legal origins continue to explain the variation even with political variables in the regression, and the difference between common law and French civil law remains highly statistically significant. This is true for all three political variables aiming to get at the political explanation of legal rules. While each political variable is surely measured with error, and our specifications surely do not capture the full subtlety of the political theories, political variables are rarely significant. In contrast, legal origins are consistently significant, even with political variables in the regression.

We next ask whether legal origins only have an effect in democracies, which would be the case if they were proxies for the political sentiment of the majority. In this scenario, legal origins would not predict legal rules in autocracies. In contrast, under Legal Origins Theory, they should predict legal rules in autocracies as well. In table 6, we focus on autocracies (countries with a positive autocracy score from Adam Przeworski et al. 2000). For nearly all our variables, the differences between common law and French legal origin remain significant among autocracies. This result holds for other measures of nondemocratic government as well. We see this evidence as a direct rejection of the hypothesis that legal origins are proxies for the political sentiment of the democratic majority. Political theories can perhaps be adjusted to incorporate autocracies but the data suggest that

14 Haber and Perotti (2007) write: “Recent explanations suggest that a democratic majority in countries hit by a major redistribution of wealth may shift in favor of low minority investor protection and less corporate restructuring and competition to protect established labor rents” (p. 4).
### Panel A: Legal Origin and Proportional Representation

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### Panel B: Legal Origin and Power of the Left

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### Panel C: Legal Origin and Union Density

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### Notes
- ** Significant at the 1 percent level.
- * Significant at the 5 percent level.
- ** Significant at the 10 percent level.
legal origins are quite distinct from political sentiment.

None of this is to say that politics is unimportant for either legal rules or economic outcomes. Indeed, political change may provide the impetus for countries to revise their laws and regulations. But the thrust of Legal Origins Theory is that, even in response to political demands, countries will design reforms consistently with their legal traditions. Legal origins are not proxies for leftist politics.

7. Legal Origins and History

Perhaps the most difficult challenge to the hypothesis that legal origins cause outcomes has been posed by historical arguments. Because virtually all of these arguments focus on finance, we likewise focus on finance in this section, but bearing in mind that an alternative theory must address all the evidence. At the broadest level, historical arguments suggest that the positive correlation between common law and finance is a twentieth century phenomenon. According to the critics, if one looks at historical data, particularly from the early twentieth century, the correlation does not exist. Because legal traditions predate the twentieth century, they cannot, say the critics, account for the differences in financial development.

It is useful to break down the historical argument into three component parts and to address them sequentially. This also allows us to consider several influential papers.

First, Rajan and Zingales (2003) present evidence showing that in 1913, French civil law countries had more developed financial markets than common law countries. In their sample, as of 1913, the five common law countries had the average stock market to GDP ratio of 53 percent, compared to 66 percent for the ten French civil law countries.

Second, several writers maintain that shareholder protection in Britain at the beginning of the twentieth century was minimal. The evidence that Britain was financially developed at the time, including having some ownership dispersion, must therefore be accounted for not by law but by alternative mechanisms, such as trust and financial intermediaries (Brian R. Cheffins 2001, Julian Franks, Colin Mayer, and Stefano Rossi 2005).

Third, the historical critique holds that the correlation between common law and financial development emerges over the twentieth
century, a finding it sees as inconsistent with LLSV. In contrast to the superiority of financial development in the French legal origin countries, as compared to the common law countries, circa 1913, Rajan and Zingales find that the respective average stock market for common law and French civil law countries were 130 percent and 74 percent by 1999. They call this the Great Reversal (see figure 3).

Critics propose two explanations of how common law countries came to excel in finance. The first is the political argument, namely that common law countries happened to have more favorable democratic politics, which we have already discussed. In addition, according to Roe (2006), civil law countries suffered greater destruction during World War II, which radicalized their politics and in this way led to pro-labor and anti-capital laws and regulations.

It is easiest to take up the three pieces of the historical critique in turn.

7.1 Stock Markets at the Start of the Twentieth Century

Rajan and Zingales (2003) present data on stock market development for six common

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![Figure 3. Stock Market Capitalization over GDP (Based on Rajan and Zingales 2003)](image)
exchanges were bonds rather than stocks, and most of those were government bonds. Second, many of the companies listed on the exchanges of developing countries were incorporated (and therefore subject to shareholder protection rules), and even had their primary listings, in Europe or the United States (see Mira Wilkins and Harm Schroter 1998). For a developing country, both of these factors may lead to an overestimate of market value of equities subject to national shareholder protection laws.

Take a few examples. In 1913, the most financially developed country in the Rajan and Zingales sample is Cuba. Cuba at that time is a French legal origin country, but also an American colony, with a reported stock market capitalization to GDP ratio of 219 percent. We have looked at this observation and discovered that, if one excludes bonds and only looks at stocks, the actual ratio falls to 33 percent. Moreover, by far the largest company with its stock listed in Cuba is Havana Electric, a company incorporated in New Jersey, subject to New Jersey laws, and with a primary listing in New York. We suspect that concerns of Havana Electric shareholders would have been addressed by either New Jersey courts or the U.S. marines. Many other companies listed in Cuba appear to be like Havana Electric; indeed—and perhaps not surprisingly—there does not seem

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to be much of an indigenously Cuban stock market capitalization at all. Given the small size of their sample, the elimination of bonds from the Cuban data point by itself reduces the Rajan and Zingales 1913 average French civil law stock market to capitalization ratio from 66 percent to 47 percent, below their common law estimated average.

The second most financially developed country in the 1913 Rajan and Zingales sample is also a French civil law country, namely Egypt, with a stock market to GDP ratio of 109 percent. It appears from Robert L. Tignor (1984) that this ratio, like that for Cuba, includes debt. Moreover, virtually all of the largest companies listed in Egypt were incorporated in England or in France, and many were listed there as well. (Egypt in 1913 was under British protection.) We estimate that a correct observation for Egypt (specifically, a stock market to GDP ratio of at most 40 percent) would further reduce the Rajan–Zingales French civil law average in 1913 by 6 percentage points.

Some corrections appear to be in order for the rich countries as well. For France, Rajan and Zingales estimate a ratio of 78 percent. A more recent estimate by Antoine Bozio (2002) puts this number at 54 percent. Richard Sylla (2006) criticizes Rajan and Zingales for presenting too low a number of 39 percent for the United States and proposes the alternative 95 percent from Raymond W. Goldsmith (1985). Both of these corrections favor the common law countries. The various corrections together, especially the one for Cuba, put the common law average stock market to GDP ratio comfortably ahead of the French civil law one in 1913.

To be sure, we have selected Cuba and Egypt nonrandomly as two obviously bizarre observations. A more systematic treatment of the data would reveal overestimates in common law, and not just civil law, countries. Some such errors are inevitable, and we have ourselves made many even with more recent data. What is beyond doubt, however, is that the strong conclusions reached by Rajan and Zingales on comparative financial development cannot be drawn from their sample.

Perhaps a better way to get at this issue is to compare the two mother countries: England and France. Rajan and Zingales recognize that England was more financially developed than France at the start of the century, but the comparison can be expanded because Bozio (2002) reports new numbers for France and adequate data are available for Britain from Ranald Michie (1999). Michie’s numbers of the value of the stock market include corporate bonds, so we correct them using data from Goldsmith (1985).

In figure 4, we present Bozio’s numbers for France and adjusted numbers for domestic stocks in Britain. The results show that Britain always had a higher stock market capitalization to GDP ratio than France, often by a wide margin. This is true in 1913, but also before and after.

We can also look at Goldsmith’s (1985) data on the ratio of stock market to GDP, reproduced in table 8. The first point that emerges from the table is that, consistent with Charles P. Kindleberger’s (1984) assessment of Paris as a financial backwater, Britain is ahead of France as far back as the middle of the nineteenth century and perhaps even earlier. So, interestingly, is the United States. Goldsmith’s sample allows also for a more general comparison of common and civil law countries in 1913. If we pull in the U.S. observation from 1912, Goldsmith only has four common law countries and seven civil law ones. Even so, with India pulling the common law average sharply down and no poor civil law countries in the sample, the common law average in 1913 is 88 percent, the French legal origin average based only on France and Belgium is 77 percent, and the overall civil law average is 69 percent.

15 Goldsmith’s (1985) data for corporate stock includes unlisted firms. In practice, information on corporate shares “...is generally limited to securities listed on exchanges, so that comprehensive figures must be derived, if at all, by a blowup, often on a precarious basis” (p. 337).
Goldsmith’s data have many problems of their own and we have not examined them closely. But they confirm independently the point that the relative financial underdevelopment of common law countries at the start of the twentieth century is a myth.

We conclude that common law countries appear to be more financially developed than civil law ones at the start of the twentieth century and, in particular, Britain is ahead of France. Over the course of the twentieth century, the differences widen, a divergence that needs to be explained. But the puzzle is divergence, not reversal.

7.2 Britain at the Start of the Twentieth Century

A small but lively historical literature argues that Britain had a well developed stock market at the beginning of the twentieth century, with beginnings of ownership dispersion, but that this had nothing to do with the law (Cheffins 2001, Franks, Mayer, and Rossi 2005). Looking both at the LLSV indices of shareholder protection and at legal rulings, this research sees the rights of minority shareholders in the United Kingdom as only weakly protected. With the law playing a minor role, the researchers credit financial development in England to other mechanisms, such as the bonding role of intermediaries and trust.

The position that British shareholders were utterly unprotected has proved controversial. Several authors, for example, argue that Britain led the world in securities regulation in general, and corporate disclosure in particular (Coffee 2001, Laurence Gower 1954, Sylla and George Smith 1995). Britain passed the Directors Liability Act in 1890 and Companies Act in 1900, with the effects of both mandating significant disclosure in the prospectus and of holding directors accountable for inaccuracies. Subsequent legislation in the early twentieth century, according to Coffee (2001), mandated on-going financial disclosure and addressed some abuses in the new issues market. Britain also had perhaps the best commercial courts in the world, with most professional and least corrupt judges, with centuries of precedents and experience in dealing with fraud.

This small literature is at a standstill, with some writers arguing the British shareholder
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Source: Goldsmith (1985).
protection glass was half empty and others countering that it was half full. What makes this debate utterly frustrating is that it is not comparative, so except with a few remarks on Britain versus the United States (Coffee 2001), we know very little of how the British shareholders were protected compared to the French and German ones. To the extent that the literature has a bottom line, it is that shareholder rights have improved enormously in Britain over the course of the twentieth century, parallel to the growth of its markets. Explaining this parallel growth is a challenge to the Legal Origins Theory.

7.3 World War II Destruction

Roe (2006) claims that poor economic performance, particularly associated with the destruction of capital stocks in World War II, radicalized continental European politics, leading to legal rules that were hostile to financial markets and favorable to labor. To test this theory, Roe regresses modern ownership concentration—as proxied by the percentage of widely held medium-sized firms—on Angus Maddison’s (2003) estimates of GDP growth between 1913 and 1945 in a sample of twenty-four mostly developed countries. Figure 5 illustrates the strong positive relationship between ownership dispersion and 1913–45 GDP growth (see left graph). Countries with worse economic growth have higher ownership concentration. However, these results fall apart if we use a broader sample of countries, if we use alternative measures of financial development, or if we look at other predictions of Roe’s theory.

Begin with ownership. An alternative measure of ownership dispersion—the percentage not owned by the three largest shareholders—is available for thirty-four of the countries with GDP growth data. When we use the larger sample, the correlation reported by Roe disappears, as illustrated in figure 5 (right graph). This may not be surprising; many developing countries stayed out of World War II, yet remained financially underdeveloped. Continue with alternative measures of financial development. The pairwise correlations between GDP growth 1913–45 and stock market capitalization, block premium, listed firms per capita, initial public offerings to GDP, and private credit are either insignificant or have the wrong sign for both the twenty-four and thirty-four observation samples. Finally, consider Roe’s other prediction that World War II devastation leads to pro-labor laws. This only is true in univariate regressions using the sample of twenty-four observations as illustrated in figure 6 (left panel), but not when controlling for common law (right panel). This is also not true in univariate regressions using the sample of thirty-four observations, as illustrated in figure 7. The data are inconsistent with the theory that World War II destruction explains LLSV evidence.

7.4 Explaining Divergence

Although we do not see any evidence for the reversal of rankings between common and civil law countries in financial development over the course of the twentieth century, the historical research yields two important findings that require an explanation. First, as shown by Rajan and Zingales (2003) and in figure 3, common law countries appear to have moved sharply ahead of civil law ones in financial development over the course of the twentieth century. Second, investor protection improved sharply in the common law countries over the same time period (Coffee 1999, Cheffins 2001, Franks, Mayer, and Rossi 2005). We suggest that Legal Origins Theory naturally accounts for these findings.

The twentieth century represented a period of explosive growth of the world econ-

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16 Legal origin continues to have a large and statistically significant effect on ownership concentration after controlling for 1913–45 GDP growth. In contrast, growth is not significant when controlling for French legal origin (although it is significant when controlling for common law).
omy, including of countries that were the wealthiest at the beginning of that century. That growth relied to a significant extent on outside capital. That growth was also far from smooth: it was punctuated by World Wars, the Great Depression, and significant economic and financial crises. The countries that grew successfully found their own ways to deliver capital to firms and to survive the crises. For some countries, such success involved massive state involvement in finance and development. For other countries, such success to a much greater extent relied on shoring up markets.

Here is where legal origins come in. As Morek and Steier (2005) make clear, civil law countries in the middle of the century relied heavily on state supply of finance, bank nationalization, and state investment companies to promote economic growth and resolve crises. These were the standard civil law solutions to addressing social problems, going back at least to Napoleon. Common law countries, particularly the United States and the United Kingdom, in contrast, relied more heavily on market-supporting regulations, such as securities laws, deposit insurance, and court-led improvements in the corporate law. These differences were not absolute, with nationalizations in common law countries and many market-supporting reforms in civil law ones, but they were pronounced nonetheless. We saw this, for example, in the La Porta et al. (2002) data on government ownership of banks.

In these very different ways, both some of the civil law countries and some of the common law ones successfully solved their

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**Figure 5. Ownership Concentration and GDP Growth, 1913–45**

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coeff = 0.18698655, (robust) se = 0.08753752, t = 2.14

coeff = −0.00529849, (robust) se = 0.01612937, t = −0.33
problems. In the second half of the century, however, the world became a good deal more peaceful and orderly. In such a world, the market-supporting solutions of the common law system, whether in the form of judicial decisions, regulations, or market adaptations worked better than the policy-implementing solutions of the civil law system. As a consequence of their twentieth century legal and regulatory evolution, common law countries ended up with sharply better investor protection. Their financial markets ran away from the civil law ones, as we see in the data. Looking back over the course of the twentieth century, we see the basic differences in the legal traditions and regulatory strategies playing out in how both the laws and the markets evolve.

8. A Blueprint for Policy Reform

Legal Origins Theory points to three important ways in which prevailing legal and regulatory rules might be inefficient. First, to the extent that a country has a particular legal or regulatory style shaped by its legal tradition, it might apply the tools characteristic of that style to areas of regulation where they are inappropriate. A good example of this that we already mentioned is the reliance on frequent interlocutory appeals in civil law bankruptcy procedures. Such appeals are central to the civil procedure of civil law countries, yet result in massive destruction of value in bankruptcy (Djankov et al. 2006, Gamboa-Cavazos and Schneider 2007). Second, a country that introduces legal and regulatory
rules in a situation of extreme disorder may fail to dismantle them when the situation returns to normal. Heavy government ownership of banks, which might have a purpose at the time of extreme financial underdevelopment, becomes a burden under normal circumstances (La Porta et al. 2002). Third, transplantation of legal and regulatory rules might itself become an important source of inefficiency, as rules suitable for developed economies become a source of massive delay and corruption in the developing countries that copy them (Pistor et al. 2003a, 2003b, Spamann 2006a).

The inefficiency of the prevailing legal and regulatory rules points to a blueprint for reforms. Such reforms would focus on the design of what Djankov et al. (2003a) called “appropriate institutions,” those that seek to achieve the optimal trade-off between dictatorship and disorder in ways compatible with each country’s level of economic development and legal tradition. In many instances, the direction of such reforms is simply less government intervention. Neither underdevelopment nor the legal tradition justifies heavy regulation of entry, so the reduction in those barriers is uncontroversial from the efficiency perspective. Likewise, aspects of the formalism of bankruptcy procedures, which probably are the heritage of civil law, appear detrimental to efficiency at all levels of economic development and could be reduced without impinging the foundations of legal order. In other instances, the best solutions might differ across legal systems. For example, while common law countries depend on investor protection to support their debt markets, many civil law countries have successfully relied on information

![Figure 7. Labor Laws and GDP Growth, 1913–45](sample of 34 observations)
sharing institutions, such as credit bureaus, for the same purpose (Djankov et al. 2007). Finally, in situations of extreme disorder, such as participation or recovery from war, even more aggressive government interventions might be appropriate.

The crucial requirement of reform is the availability of objective data on legal and regulatory rules, preferably in a comparative form so that the consequences of particular rules can be evaluated. Perhaps the most useful contribution of our research has been to establish the possibility of collecting such data in a broad range of areas. More recently, the data collection project has made substantial strides through a World Bank Doing Business initiative, which assembles and updates much of the information on laws and regulations discussed in this paper, as well as some additional indicators. Even the publication of this report has proved controversial, with the French government accusing its authors of an Anglo–Saxon bias. Nonetheless, the report has proved popular, and has encouraged regulatory reforms in dozens of countries.

The pace of legal and regulatory reform stimulated by the evidence is quickening. Perhaps the greatest progress has been made in the reductions of entry regulations. According to the 2006 Doing Business report, fifty-five countries undertook reforms in 2005 and 2006 that lowered administrative costs of starting a business and obtaining a license. Evgeny Yakovlev and Ekaterina Zhuravskaya (2008) for the case of Russia and David S. Kaplan, Eduardo Piedra, and Enrique Seira (2007) for the case of Mexico find that reductions in entry regulations increase new business start-ups.

The picture is more mixed for labor markets. OECD (2006) reports that labor markets were liberalized in OECD countries in the last fifteen years, although most reforms pertained to temporary rather than permanent employment. Deakin, Priya P. Lele, and Mathias M. Siems (2007) actually find some divergence in labor laws between common law and civil law countries since 1970, with the U.K. deregulating and France doing the opposite. James J. Heckman and Pagés (2004) see no tendency for liberalization in Latin America during the 1990s.

With respect to investor protection, Pagano and Volpin (2005) report gains in shareholder rights in OECD countries during the 1990s. Enriques and Volpin (2007) describe a tendency toward improving shareholder rights in the European Union. At the same time, they note that “far too little has been done to resolve the problem of related-party transactions, which is the most common form of self-dealing in Europe.” We are aware of no systematic evidence for emerging markets, although there are examples of improvement, such as the Mexican bankruptcy reform (Gamboa-Cavazos and Schneider 2007).

The use of our indicators of laws and regulations, with their clear correlations with legal origins, for policy analysis has stimulated two objections. Some accuse us of claiming that legal origin is destiny, so any reform of investor protection or of other regulations short of wholesale replacement of the legal system is futile. This is not what Legal Origin Theory says. The theory indeed holds that some aspects of the legal tradition are so hard-wired that changing them would be extremely costly and that reforms must be sensitive to legal traditions. Nonetheless, many legal and regulatory rules, such as entry regulations, disclosure requirements, or some procedural rules in litigation, can be reformed without disturbing the fundamentals of the legal tradition.

Some critics also argue that the legal rules we measure are not the right ones. Even if these rules capture the broad stance of the law toward investor or worker protection, the most relevant legal rules, doctrines, or even patterns of judicial behavior responsible for the observed outcomes might be different from what we measure. Focusing the reforms formalistically on our subindices will then be futile. For example, if judges are reluctant to take on corporate self-dealing cases and
find technical or procedural excuses to throw them out, changing the rules of approval of self-dealing transactions will be futile. As Berkowitz, Pistor, and Jean-Francois Richard (2003) and Paolo Mauro, Nathan Sussman, and Yishay Yafeh (2006) find, reforms are more likely to succeed when people they affect choose to accept them.

We definitely agree with this point and believe that legal or regulatory reform in any country must be sensitive to the actual legal or regulatory bottlenecks. Understanding what actually happens on the ground is essential. So if judges throw out self-dealing cases, one might want to find out why they do so and focus on how to get them to change. If labor courts rule for employees regardless of what the law says, labor market reformers should take note. Having said this, in many circumstances the actual laws on the books that we measure are indeed the reason for inefficient outcomes. The heavy regulations of entry are one such example, procedural formalism is another. And even when the legal rules we measure are not the entire problem, and thoughtless formalistic reforms are likely to fail, the rules can point the reformer closer to where the problem actually lies. In either case, the measured rules provide highly relevant data.

Although the evidence on reforms is just beginning to come in and much of it is unfortunately confined to the developed world, many countries seem to be moving toward market-friendlier government interventions. If the world remains peaceful and orderly, the attraction of such reforms will only grow.

9. Conclusion

Since their publication a decade ago, the two LLSV articles have taken some bumps. We now use different measures of shareholder protection and are skeptical about the use of instrumental variables. Our interpretation of the meaning of legal origins has evolved considerably over time. But the bumps notwithstanding, the basic contribution appears to us to still be standing, perhaps even taller than a decade ago. And that is the idea that legal origins—broadly interpreted as highly persistent systems of social control of economic life—have significant consequences for the legal and regulatory framework of the society, as well as for economic outcomes. The range of empirically documented legal, economic, and social spheres where legal origins have consequences has expanded over the past decade.

At the end of our overview, we believe that four propositions are correct, at least given the current state of our knowledge. First, legal rules and regulations differ systematically across countries, and these differences can be measured and quantified. Second, these differences in legal rules and regulations are accounted for to a significant extent by legal origins. Third, the basic historical divergence in the styles of legal traditions—the policy-implementing focus of civil law versus the market-supporting focus of common law—explains well why legal rules differ. Fourth, the measured differences in legal rules matter for economic and social outcomes.

The fact that the outlines of a coherent theory have emerged over the last decade does not mean that all, or most, of the empirical issues have been settled or, for that matter, that the theory will survive further scrutiny. From our perspective, the crucial open questions deal with the evolution of legal systems: How do they deal with crises? How do they enter new spheres of regulation? How do they approach reforms? We have offered many illustrations from the historical record, but a comprehensive account of legal and regulatory evolution under common and civil law does not exist.

Such an account might clarify an issue that has generated tremendous heat, and not much light, throughout this research, namely the circumstances under which each legal tradition “works better.” Legal Origins Theory does not point to the overall superiority of common law; to the contrary, it points to the superiority of civil law and reg-
ulatory solutions when the problem of disorder is sufficiently (but not too) severe. On the other hand, our attempt to find evidence for the commonly made defense of civil law that it provides greater fairness or better access to justice have failed; the data suggest the opposite (Djankov et al. 2003b).

A deeper understanding of the dynamics of legal traditions may also inform the crucial question of whether the differences between common and civil law will persist into the future. Since we have shown legal origins to be closely related to the types of capitalism, this question can be rephrased as follows: what kind of capitalism is likely to prevail in the long run? Will it be the more market-focused Anglo–Saxon capitalism, or the more state-centered capitalism of Continental Europe and perhaps Asia?

There are many arguments for convergence. Globalization leads to a much faster exchange of ideas, including ideas about laws and regulations, and therefore encourages the transfer of legal knowledge. Globalization also encourages competition among countries for foreign direct investment, for capital, and for business in general, which must as well put some pressure toward the adoption of good legal rules and regulations.

The convergence is working both by civil law countries increasingly accepting common law solutions, and vice versa. In one area where heavy regulation appears patently absurd—the entry of new firms—countries are rapidly tearing down the barriers. In Europe at least, there are some reductions in labor regulations, as well as gains in shareholder rights. At the same time, common law countries are increasingly resorting to legislation to address social problems, the Sarbanes–Oxley Act being the most recent example of such financial regulation in the United States. Mediating against convergence is the fact that civil law countries continue to resort to “policy-implementing” solutions to newly arising problems. The bias toward using state mandates to solve social problems, such as the thirty-five hour workweek in France, is huge.

All this, of course, leaves open the question of which legal rules and regulations the countries are likely to move toward, even if they do not converge. So, in conclusion, we again rely on theory to make a prediction. The world economy in the last quarter century has been surprisingly calm, and has moved sharply toward capitalism and markets. In that environment, our framework suggests that the common law approach to social control of economic life performs better than the civil law approach. When markets do or can work well, it is better to support than to replace them. As long as the world economy remains free of war, major financial crises, or order extraordinary disturbances, the competitive pressures for market-supporting regulation will remain strong and we are likely to see continued liberalization. Of course, underlying this prediction is a hopeful assumption that nothing like World War II or the Great Depression will repeat itself. If it does, countries are likely to embrace civil law solutions, just as they did back then.

References


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