

## FORM, FUNCTION AND FICTION: A TAXONOMY OF CORPORATE LAW AND THE EVOLUTION OF EFFICIENT RULES

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### I INTRODUCTION

A common phenomenon that blights many areas of scholarship is the situation that arises when academic factions begin to ‘talk past’ each other. When the arguments of the opposite ends of the academy are no longer directed towards the same things, debate evaporates and walls gradually form around distinct lines of discourse, which are rarely traversed. Corporate law shows signs of becoming one of these areas, at least in the United States. During the 1980s, debate was genuinely joined between disparate factions around the topic of contractual freedom in corporate law.<sup>1</sup> However, by the time of the publication in 1991 of Easterbrook and Fischel’s *Economic Structure of Corporate Law*,<sup>2</sup> something had changed. The law and economics faction had accepted the concept of the corporation as a nexus of contracts as an approximation of reality that was sufficiently accurate to warrant little further debate. They proceeded to explore the implications for the concept of more sophisticated economic models<sup>3</sup> and to

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1 See, eg, Lucian A Bebchuck (ed), ‘The Debate on Contractual Freedom in Corporate Law’ (1989) 89 *Columbia Law Review* 1395.

2 Francis H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (1991).

3 Examples include: the adoption of game theory (eg, ‘Symposium – Just Winners and Losers: the Application of Game Theory to Corporate Law and Practice’ (1991) 60 *University of Cincinnati Law Review* 285); the use of network economics (eg, Marcel Kahan and Michael Klausner, ‘Standardization and Innovation in Corporate Contracting (or “the Economics of Boilerplate”)’ (1997) 83 *Virginia Law Review* 713); theories of path dependence (Lucian A Bebchuk and Mark J Roe, ‘A Theory of Path Dependence in Corporate Ownership and Governance’ (1999) 52 *Stanford Law Review* 127); and most recently, norms (‘Symposium 2000: Norms and Corporate Law’ (2001) 149 *University of Pennsylvania Law Review* forthcoming).

seek empirical evidence on a range of theoretical conjectures,<sup>4</sup> and lost any interest in legal theory. The factions that were more inclined to progressive liberalism saw little return in playing the economists on their home grounds, and looked instead for policy-relevant analysis in communitarian theory, amongst other sources.<sup>5</sup>

In Commonwealth jurisdictions, a similar bifurcation has not yet occurred, perhaps in part because the greater regard for doctrinal analysis constrains such developments. However, many scholars in these jurisdictions have been understandably keen to enrich doctrinal discourse by reference to American scholarship.<sup>6</sup> There are two dangers in this: one is the risk of a literature with essentially undebated theoretical assertions — a replication of American impasses in microcosm — with the particular risk of a doctrine versus theory-policy divide. The other is the danger of missing the opportunity to theorise parts of the Commonwealth inheritance that are not replicated in American law, in particular, the greater incidence of legal fictions and conceptual reasoning. I maintain, as the justification of this article, that by taking this opportunity to theorise parts of the English law tradition, it is possible to simultaneously work to bring doctrinal lawyers closer to those more willing to apply theoretical work.

Perhaps the most important distinction between the Anglo-Australian and American corporate law traditions is the persistence in the former of the entity concept. The notion of the corporation's separate legal personality has been entrenched at least since the decision in *Salomon v Salomon & Co Ltd* ('*Salomon*'),<sup>7</sup> and had manifested itself in various doctrines prior even to that case.<sup>8</sup> The 'party line' for most economists is that the notion of legal personality is a convenient fiction that the law uses to overlay a nexus of contracts; lawyer-economists ascribe to this position almost unanimously. When there has been debate, it has often been in the unedifying terms of 'contract versus concession', which had only passing relevance to English law of old, and virtually none to modern law.<sup>9</sup> This has therefore been an important barrier preventing doctrinal lawyers from appreciating that economists have anything useful to contribute to the study of law — it suggests that one of the sides must be wrong.

This article is a study of how an economist and a lawyer might work together to read this persistent riddle. The explanation I offer shows how the legal fiction

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4 For a review of an extensive body of empirical work, see Roberta Romano, 'Corporate Law and Corporate Governance' (1996) 5 *Industrial and Corporate Change* 277. There is also an emerging body of Australian empirical work: see, eg, Ian M Ramsay and Mark Blair, 'Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies' (1993) 19 *Melbourne University Law Review* 153.

5 See, eg, Larry Mitchell (ed), *Progressive Corporate Law* (1996).

6 For Australian research influenced by economic analysis, see the references in Michael Whincop, 'Contractarianism as a Theory of Anglo-Australian Law' (1997) 21 *Melbourne University Law Review* 187, fn 11. For an example of analysis employing communitarian theory, see Peta Spender, 'Guns And Greenmail: Fear And Loathing After Gambotto' (1998) 22 *Melbourne University Law Review* 96.

7 [1897] AC 22.

8 See the discussion below Part III.

9 See, eg, Robert Hessen, 'A New Concept of Corporations: A Contractual and Private Property Model' (1979) 30 *Hastings Law Journal* 1327. Cf Stephen Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 *Federal Law Review* 203.

of the entity concept can mediate between the function of particular rules, and the form that those rules might take to best fulfil their respective functions. Because functions naturally differ from rule to rule, the entity concept itself performs multiple roles. This study therefore requires me to tap a vein of recent policy and jurisprudential analysis of, inter alia, the optimal form that rules should take, the discretion they should repose in adjudicators, and their relation to contracts. In order to do this, I develop a functional taxonomy, which distinguishes between the proprietary and governance functions of the law on one hand, and the definition and alteration of proprietary and governance entitlements on the other. This involves a positivist undertaking: an explanation of how different rules perform these functions and the role of the entity concept in each case. What is interesting about this exercise is that it helps reveal connections and similarities between the function and operation of traditionally separate doctrinal areas. Corporate law ceases to sprawl, and this has expository and pedagogic value, at the very least.

The second part of this study is more controversial. It seeks to use economic theory to provide an efficiency justification of the form and content of the traditional legal rules in at least some of these distinct areas. It is possible to see this as a straightforward normative exercise — an argument for what the law should be, and a criticism of the more prescriptive character of modern law. Alternatively, these arguments might be seen as evidence tending to support the positive efficiency theory of the common law, that is, as part of the claim that non-statutory law has evolved towards efficient rules.<sup>10</sup> One of the reasons I have undertaken this study is to demonstrate to doctrinal lawyers that, quite independently of parvenu reform programs such as the Corporate Law Economic Reform Program ('CLERP'),<sup>11</sup> efficiency concerns have influenced, or at least have not been at odds with, the emergence of the law. Their absence from the explicit language of judges is not a sufficient objection to this argument.

In Part II of this article, I show how the development of the orthodox economic definition of the corporation can be refined. Part III uses this refined definition of the corporation to describe the core functions of corporate law. Part IV links this functional account to a discussion of alternative forms of legal rules, and the efficiency logic for differentiating form to correspond to function. One aspect of the conclusions that may surprise those familiar with the economic debate is the advocacy of the use of imprecise, discretionary standards in cases involving the alteration of governance entitlements. Law and economics research has traditionally advocated clear, precise rules, and castigated imprecise rules as either giving rise to excessive litigation or having rent-seeking origins. I develop a worked game-theoretic illustration, which compares a strict rule against

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10 See George Priest, 'The Common Law Process and the Selection of Efficient Rules' (1977) 6 *Journal of Legal Studies* 65; Paul Rubin, 'Why is the Common Law Efficient?' (1977) 6 *Journal of Legal Studies* 51.

11 So far, CLERP's principal impact on corporate law has been the enactment of the *Corporate Law Economic Reform Act 1999* (Cth). In the English context, see United Kingdom, Department of Trade and Industry, Company Law Reform Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999).

defensive action to a rule taking a more discretionary approach. This demonstrates that there may be good reasons to prefer discretionary, fact-contingent standards to 'bright-line' rules. This is so in spite of, and perhaps because of, the risk that judges in these areas sometimes err in selecting the outcome that is *ex post* efficient. In fact, the incidence of error may actually have economic value in some cases. Part V concludes with a few brief references to some current issues in corporate law to demonstrate the potential applications of this framework.

## II THE ROLE OF PROPERTY IN DEFINING THE CORPORATION

### A The Nexus of Contracts

The economic definition of a corporation as a nexus of contracts derives from Jensen and Meckling's famous attempt to develop a neoclassical theory of the firm. Jensen and Meckling argued that

[v]iewing the firm as a nexus of a set of contracting relationships ... serves to make clear that the ... firm is not an individual [but] ... a focus for a complete process in which the conflicting objectives of individuals ... are brought into equilibrium within a framework of contractual relations.<sup>12</sup>

Often lawyers who read this definition are understandably puzzled by it. Not only does it require them to translate relationships between managers and shareholders into contractual terms, but also to understand the mysterious nature and significance of a 'nexus'. The source of this difficulty lies, in part, in what Jensen and Meckling were trying to do in their paper. Their ambition was not really to offer a theory of the firm, despite the title of their article. Like any good economic argument, Jensen and Meckling intended to explain much with little; they explained how contracting costs associated with debt and equity finance would influence the overall capital structure of a firm and other aspects of the governance of those financing relations. But this theorisation does not provide a complete picture of corporations. In this section, I propose to fill in some of that picture.

The idea of explaining firms in contractual terms was first formulated by Coase.<sup>13</sup> But Coase never suggested at any stage that this multi-contract explanation was unique to firms. On the contrary, Coase's paper won the Nobel Prize for demonstrating that the firm's multi-contract character is analogous to a market. Coase explained some of the important differences between firms and markets, but none of these are summed up in the 'nexus of contracts' appellation. As economics permeated other areas of law, these contractual explanations were applied to other legal devices. Thus, a trustee of a trust is also a nexus of contracts or exchange relations, between the settlor and the trustee, the trustee

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12 Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 311-12.

13 Ronald H Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

and the beneficiaries, the trustee and lenders to the trust, and so on.<sup>14</sup> Partnerships can also be explained in these terms.<sup>15</sup> So the nexus of contracts concept is principally useful only as a device to debunk the process of attributing to the corporation a set of discrete, discoverable interests separate from those of the contracting parties.

With this sparse ontology, law and economics scholarship has principally analysed the governance of the contracts constituting corporations. Jensen and Meckling's enduring contribution was the recognition of contracting problems, the costs of addressing such problems, and the governance means dedicated to economising on them.<sup>16</sup> But these analyses of governance simply apply a more general economic theory of contracts. To provide a total picture of corporations, and to distinguish this from other areas of the law on business organisations, we need to add to the contractual theory a dimension that describes and defines the property associated with the contracts.

## B Property

Property has been taken for granted in the economic discourse on corporations. An exception is a recent paper by Hansmann and Kraakman,<sup>17</sup> which argues that organisational forms can be differentiated by how they partition assets belonging to the firm and its owners with respect to different debts and claims. Assets can be partitioned, according to Hansmann and Kraakman, affirmatively and defensively. Affirmative asset partitioning is the degree of insulation of the firm's assets against 'personal' claims by the creditors of the owners. Defensive asset partitioning is the degree of insulation of the owners' assets against the firm's debts; it describes the availability of limited liability. Whereas corporations limited by shares have a very high degree of both partitioning forms, a sole, unincorporated proprietor has neither.

These insights expand the economic definition of the corporation. One of the characteristics of the corporate form is that the contracts of which it is the nexus are defined by reference to a discrete pool of assets: those to which a corporate entity is recognised as having title.<sup>18</sup> The pool is discrete in two senses. First, the assets to which the corporation's owners have title do not normally supplement the pool, given limited liability (ie, defensive asset partitioning). Second, as a consequence of affirmative asset partitioning, no claim can be made against the pool of assets unless it lies directly against the corporate entity. These

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14 See, eg, John H Langbein, 'The Contractarian Basis of the Law of Trusts' (1995) 105 *Yale Law Journal* 625; cf Henry Hansmann and Ugo Mattei, 'The Functions of Trust Law: A Comparative Legal and Economic Analysis' (1998) 73 *New York University Law Review* 434.

15 See, eg, Larry E Ribstein, 'A Statutory Approach to Partner Dissociation' (1987) 65 *Washington University Law Quarterly* 357.

16 See also Armen A Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62 *American Economic Review* 777. This article has been less influential in shaping debate in corporate law.

17 Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110 *Yale Law Journal* 387. I am indebted to this paper for the definition of corporations that follows.

18 Or is entitled to claim under exceptional provisions of the law, such as the insolvent trading provisions and fraudulent conveyance provisions.

characteristics enable the corporation's shareholders to secure promises made on their behalf by reference to the assets owned by the corporation. Lenders and other creditors can satisfy their claims from the assets of the company by execution or liquidation, while some of them may have more direct rights against particular assets through security arrangements or other contracts.

Why is this proprietary definition of corporations important? By limiting all claims against the corporation to claims against the assets to which the corporate entity has title, corporations can define their value in a straightforward way. Their value is the value of assets to which they have title, less the present value of claims that properly lie against the corporation. This in turn facilitates the unitisation of that capital into shares (and thus the development of share markets and optimal risk sharing). However, the same is not true of unincorporated firms. For example, the contracts of which a sole proprietor is the nexus are not defined by reference to the assets of the business to which those contracts relate, but to all of the proprietor's assets. Incorporation thus enables related assets and claims to be coupled with each other, while uncoupling these claims from other, unrelated ones. This plasticity allows great sophistication in the fracturing of and transacting in the risk associated with assets.

It is appropriate to acknowledge that some economists have emphasised the significance of property rights in the theory of the firm, most notably in the so-called 'property rights' literature developed by Grossman, Hart and Moore ('GHM').<sup>19</sup> GHM argued that a firm is a collection of assets subject to common ownership. I wish to make three points about this argument. First, the GHM approach has been much neglected in the law and economics literature in favour of the nexus of contracts conception, so there is little to say about its application to doctrinal questions.<sup>20</sup> Second, the emphasis on property rights by GHM is, in fact, justified by the capacity of property rights to serve a governance function. This logic holds that in a world where transaction costs are zero, parties would write state-contingent contracts in relation to the use and application of assets<sup>21</sup> and the making of investments in match.<sup>22</sup> This is not possible in a world where transaction costs are substantial, and, in particular, where foresight is imperfect and where courts are incapable of verifying the information upon which such a contract would make obligations conditional. In such a world, property rights can function as a substitute since they allow the right to control assets to be allocated

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19 See Sanford Grossman and Oliver Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration' (1986) 94 *Journal of Political Economy* 691; Oliver Hart and John Moore, 'Property Rights and the Nature of the Firm' (1990) 98 *Journal of Political Economy* 1119. These works are synthesised in a more accessible form in Oliver Hart, *Firms, Contracts, and Financial Structure* (1995).

20 Cf Edward Rock and Michael L Wachter, 'Islands of Conscious Power: Law, Norms and the Self-Governing Corporation' (2001) 149 *University of Pennsylvania Law Review* forthcoming.

21 That is, their contracts would define obligations and payoffs for every possible state the world could assume during the contract.

22 A match investment is made in anticipation of its capacity to generate supra-competitive returns by using it in conjunction with another asset: see Rock and Wachter, above n 20. The concept of 'match' is substantially coterminous with the term, 'firm-specific' assets, used extensively in Oliver E Williamson, *The Economic Institutions of Capitalism* (1985), except that 'match' does not imply anything about the ownership of the investment in match or the match asset.

between the parties, subject to the occurrence of certain contingencies (for example, insolvency or takeover). This is a powerful insight, but it treats property rights as pre-specified and straightforward, whereas lawyers, at least, may be interested in the legal processes associated with the definition and alteration of these proprietary entitlements. Third, GHM's analysis, like the nexus of contracts paradigm, is fundamentally bilateral: it is interested in the role of property rights in the governance of a relation between A and B. However, an enduring characteristic of property rights is that they use constructive (rather than consensual) rights to enable the rights of A or B to be effective against the entire world.<sup>23</sup> The GHM approach leaves these issues unexplored.

### C Governance

If property is the subject of the contract, governance represents the explicit or dispositive terms of the contract. Governance describes the rights relating to the residual control and disposition of assets, either individually or as a pool, and the mechanisms for control of the agents responsible for making these decisions. It therefore includes the right of lenders to appoint receivers and the right of shareholders to ratify a conflict of interest. There are three main rational objectives of a governance system: first, to place the right of residual control over a corporation's assets in the hands of those in the best position to maximise the value of those assets.<sup>24</sup> The second, familiar from the GHM analysis, is to allocate residual control in a way that encourages parties (such as managers and employees) to make investments that create value through their match with the assets of the firm. Despite the value that these specialised (or firm-specific) investments can add to the firm, parties are discouraged from making them where they do not own the 'match' assets, because of the risk that the owner will hold them up *ex post* in order to capture the surplus from the investment — to the disadvantage of the investing party.<sup>25</sup> The third objective is to minimise the agency costs associated with conferring residual control on persons who do not internalise the residual income produced by their decisions.<sup>26</sup>

The governance advantages of the corporation are linked to its capacity to partition assets. A well-known advantage of limited liability is that it eliminates the need for mutual monitoring by shareholders, since the value of one's investment in the firm no longer depends on the collateral and personal assets of the shareholders.<sup>27</sup> The converse proposition is that affirmative asset partitioning eliminates the need for shareholders to protect the assets against the insolvency

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23 Wesley N Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning* (Walter Wheeler Cook ed, 1920) 72.

24 Cf Jonathan R Macey, 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 *Stetson Law Review* 23.

25 Hart, above n 19. 'Hold up' behaviour includes non-performance, excluding the other party from access to the assets, and other threats that can be made for the purpose of causing a redistribution of the gains from trade that is adverse to the party held up.

26 Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301.

27 Easterbrook and Fischel, above n 2, 42, 45-6.

of, or other forms of default by, other shareholders.<sup>28</sup> Provided, therefore, that there is a sufficiently wide range of substitute investments (in terms of risk-return attributes), the ideal governance attributes of the firm will be independent of the attributes of the shareholders. Those ideal governance attributes will depend only on the corporation's assets — the property to be governed.

Thus, property and its availability to satisfy claims are defining features of any particular corporation, and of corporations compared to other legal forms. It follows that a corporate entity must also be important, at the least, as a device which holds property and mediates claims against that property. It could be argued that this proves very little: the corporate entity exists purely because our concepts of property law require that title be owned by someone or something. The question, then, is whether the corporation does anything more than function as a mere vessel for title. I evaluate this claim in the following sections.

### III CORPORATE LAW'S FUNCTIONS

In Part II, I disaggregated the notion that a corporation is a nexus of contracts by linking those contracts to partitioned assets and noting that a central purpose of those contracts is to address governance concerns. Given such a definition of a corporation, we should expect corporate law to be adapted to these proprietary and governance concerns.

In attempting to demonstrate that this is in fact the case, it is necessary to recognise an important temporal dimension. A number of features of corporate law, including the capital maintenance rule and the use of majority requirements for voluntary winding up, allow the corporation to function indefinitely as a governance structure for its asset pool. We can therefore look at corporations both as static phenomena at some cross-section in time, but also as dynamic systems that expand or contract. A static analysis describes a system state and the mechanisms adapted to protect it. A dynamic analysis addresses the means by which the system state may change, including the permissible changes and the means that may or must be used to effect the change.

This static-dynamic distinction can be used to analyse the manner in which corporate law affects the private ordering of the proprietary and governance aspects of corporations. Table 1 depicts the structure of the examination. Each of the table's cells contains some aspect of the private ordering of corporations to which corporate law (together with other bodies of law) is adapted. My analysis in the following sections shows how doctrinal areas serve these functions, although these functions are not hermetically sealed and do overlap.

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28 See generally Hansmann and Kraakman, above n 17.



TABLE 1: CORPORATE LAW’S ROLE IN PRIVATE ORDERING

	Static Definition	Dynamic Process
Property	Corporate endowment	Contracting processes
Governance	Corporate governance	Regulating transitions

**A Defining and Protecting the Corporate Endowment**

Since the pool of assets belonging to the corporate entity is an essential part of the economic definition of the corporation that I have offered, knowing how corporate property is defined and protected is important. This would be difficult to do without corporate law providing the corporation with the capacity to hold property, to enter into contracts, to have perpetual succession, and to sue and be sued. In a single stroke, this economises on the need for legislation or private contracts, since it enables the corporation to function like a natural person in dealing with property interests. These capacity provisions, together with limited liability and the law on external administration (for example, who has standing to seek liquidation, and which debts can be proved), allow for affirmative and defensive asset partitioning. Because of the presence of these ‘structural’ provisions, corporate law can defer to property law in defining and protecting corporate property.

These provisions of property law are necessarily supplemented by principles that countenance the lifting of the corporate veil<sup>29</sup> and the imposition of personal liability on officers,<sup>30</sup> both of which function to define corporate property by qualifying limited liability. Legal rules that define the rights of a liquidator to recover conveyances anticipating insolvency reinforce the pool of corporate property. These could perhaps also be described as dynamic rules that regulate transitions, given their inherent association with the period of transition from solvency to insolvency.

There are, however, other important corporate law principles which also serve, in less obvious ways, to define and protect corporate property.<sup>31</sup> These provisions are similar in that they seek to allocate entitlements between the contracting parties, or to narrow the scope of residual control normally associated with property rights. They do this by specifying qualifications on the use of assets in a way that confers certain ‘property-like’ entitlements on the party who does not have residual control over those assets. There are two groups of such corporate laws. The first group is composed of legal rules allocating rights between the residual claimants on the corporate asset pool (the shareholders) and those with residual control. Of these, the most important are fiduciary rules, which allocate property entitlements between shareholders

<sup>29</sup> *Gilford Motor Co Ltd v Horne* [1933] 1 Ch 935; *Jones v Lipman* [1962] 1 WLR 832.

<sup>30</sup> *Corporations Law* s 588G.

<sup>31</sup> These areas of the law closely overlap with the static governance function through their role in defining the scope of residual control over certain forms of assets or certain uses of those assets.

collectively and officers of the corporation.<sup>32</sup> This is obviously true of the corporate opportunity doctrine and equitable duties of confidence,<sup>33</sup> which allocate proprietary entitlements to business opportunities and confidential information. It is also (though less obviously) true of the conflict rule. By providing a prima facie prohibition on contracts in which fiduciaries are interested<sup>34</sup> but permitting the opportunity for fully informed trade with the consent of a majority of shareholders,<sup>35</sup> corporate law protects the assets of the corporation against its directors by means of what economists call 'property rules'.<sup>36</sup> A property rule requires the owner's consent to the trade of an entitlement, and is the modal entitlement in most of property law.

The second group of corporate laws that seek to allocate entitlements to corporate assets are those which define and protect the pool of corporate property by controlling the power of shareholders to distribute that property amongst themselves. The most obvious means by which the law does this is through capital maintenance requirements<sup>37</sup> (and other laws on share capital)<sup>38</sup>, and through the rules governing dividends. The law thus serves a roughly equivalent function as between creditors and shareholders as fiduciary rules do between officers and shareholders.

The definition and protection of corporate property is not a good context within which to test whether the corporate entity serves purposes beyond being a mere vessel for proprietary interests and trades.<sup>39</sup> However, the corporate entity plays an important role in several of the legal rules just mentioned. For example, the corporate opportunity doctrine typically refers to opportunities connected to the corporation's business or the fiduciary's office.<sup>40</sup> Here, the entity concept is used not to describe interests independent of shareholders, but to protect the business assets within the asset pool by linking the obligation to the process by which the opportunity came to hand. This process, where the corporation is used to define the limits of the protection that shareholders are entitled to expect from the law, is consistent with the essentially instrumental qualities of the entity

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32 Michael Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 *Oxford Journal of Legal Studies* 19.

33 See, eg, *Ansell Rubber Co Pty Ltd v Allied Rubber Industries Pty Ltd* [1967] VR 37; *Rosetex v Licata* (1994) 12 ACSR 779.

34 See *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461, 473; *Chan v Zacharia* (1984) 154 CLR 178.

35 See *Parker v McKenna* (1874) 10 Ch App 96, 124; *Miller v Miller* (1995) 16 ACSR 73.

36 Whincop, above n 32. The 'property rule' concept was introduced to the literature in Guido Calabresi and A Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089.

37 See *Trevor v Whitworth* (1887) 12 App Cas 409.

38 John H Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63 *Modern Law Review* 355.

39 Could this title holding function be performed without a legal entity? The alternative is to use trustees, as would-be incorporators did prior to general incorporation legislation. However, it is clear that the form of a corporation has advantages when suing or being sued: R R Formoy, *The Historical Foundations of Modern Company Law* (1923) 33-7.

40 See, eg, *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134, 149; *Peso Silver Mines Ltd v Cropper* (1966) 58 DLR (2d) 1; *Industrial Development Consultants Ltd v Cooley* [1972] 2 All ER 162, 173-4; *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1; *Chan v Zacharia* (1984) 154 CLR 178.

concept. I will return to similar ideas in the descriptions of the next three functions.

## B The Contracting Process and the Creation of Claims

The static property function ascertains and protects the firm's endowment. But the corporation's property endowment changes over time, as a result of transacting with customers and suppliers (including employees). Moreover, the firm's need for finance requires it to contract with lenders and new equity investors. In these ways, the property in the corporate pool of assets can legitimately change.

Just as property law per se addresses static property functions, contract law and related areas address dynamic aspects of property. However, there are a number of unique issues that corporate law must address. The first issue is how an entity that lacks a corporeal existence can contract at all. Corporate law resolves this issue through a two-step process. The first step, which I discuss in Part III(C), is to recognise corporate organs, such as the board and the general meeting, which have the capacity to bind the corporation to transactions. The second step is to recognise the grant of authority to officers, employees and agents to transact on behalf of the corporation. The theoretical work on this topic recognises that this body of law should (and for the most part, does) aspire to minimise the costs associated with transactions lacking or exceeding authority.<sup>41</sup> These costs include the damage associated with such transactions (for example, reliance losses), and the costs incurred by parties to prevent such transactions (for example, control investments and search costs). Thus, the law provides efficient principles in order to operationalise the delegation of authority to managerial hierarchies and enable new claims to corporate property to be created.

Corporate law also addresses aspects of the formation of uniquely corporate transactions. Of these, the most important are the transactions that occur in the context of capital formation. Efficient capital allocation is vital to the functioning of capital markets.<sup>42</sup> In addition, the principal terms of the governance contract of the corporation will be established and, via the offering, priced in the initial public offerings of equity securities. In this way, capital formation is crucial to the future governance of the firm — corporate law's third function.<sup>43</sup> Today, statutory securities law substantially addresses capital formation. However, certain aspects of corporate law addressed these subjects

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41 See George M Cohen, 'The Collusion Problem in Agency Law' (Legal Studies Working Paper No 00-2, University of Virginia School of Law, March 2000); Eric Rasmusen, 'The Economics of Agency Law and Contract Formation' (1995) <<http://php.Indiana.edu/~erasmuse/papers/agency.1995.pdf>> at 25 June 2001; Michael Whincop, 'Nexus of Contracts, Corporate Authority Doctrine and Doctrinal Indeterminacy: From Formalism to Law and Economics' (1997) 20 *University of New South Wales Law Journal* 274.

42 See, eg, John C Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717. Cf Francis H Easterbrook and Daniel R Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 *Virginia Law Review* 669.

43 Paul G Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 *University of Chicago Law Review* 1047.

before legislation did. The principal body of law was the equitable obligations of company promoters.<sup>44</sup> The law purports to apply fiduciary principles. However, a closer look at the law's context and history suggests that the law in this area is concerned with the adequacy of corporate governance processes and the disclosure of information concerning potentially prejudicial transactions.<sup>45</sup>

Similar policy concerns underpin the law on pre-incorporation (or pre-registration) contracts.<sup>46</sup> There is something to be said for the dysfunctional qualities of this area of law, especially as it has developed in the twentieth century.<sup>47</sup> However, in the nineteenth century, the law presumed that the party negotiating the contract was personally liable for its non-performance.<sup>48</sup> That rule encouraged promoters to form the contract through established governance processes — the participants in which might then be held accountable as promoters or as directors in respect of that contract — rather than attempting to bind the corporation as it came into existence. The personal liability rule also addressed a moral hazard problem arising from the uncertainty of what the corporation's pool of assets actually was: namely, that the promoter would undercapitalise the company in order to breach that contract. Promoters trying to avoid liability contractually would also have to signal the contract's pre-incorporation status.

The corporate entity has been ubiquitous in the law on corporate agents, promoters and pre-incorporation contracts. Principles that deal with the authority of corporate agents are based on the notion of the devolution of power from the corporation to its active agents and employees.<sup>49</sup> The corporate entity is the beneficiary of the fiduciary duty owed by promoters. Pre-incorporation contracts determine the limits within which the corporation can be treated as the principal. However, the economic functions of these areas of law primarily concern risk allocation, the integrity of governance, and the disclosure of information. They do not imply any separate set of interests to which a legal entity concept might correspond. Does this suggest that the economic accounts are wrong, or that the doctrine is demonstrably inefficient?

There are inefficient aspects of these areas of law, and all of them have either been varied or substantially displaced by statute. I believe, however, that the

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44 Ibid; Michael Whincop, 'Promoters, Prospectuses, and Pragmatism: Updating Fiduciary Duties in a Time of Economic Reform' (1998) 24 *Monash University Law Review* 454. Common law deceit also played a role in this area.

45 Compare the references above n 44. Mahoney argues that the law addressed a fiduciary problem; my argument is directed at disclosure.

46 See A J Easson and D A Soberman, 'Pre-Incorporation Contracts: Common Law Confusion and Statutory Complexity' (1992) 17 *Queen's Law Journal* 414; Andrew Griffiths, 'Agents Without Principals: Pre-Incorporation Contracts and Section 36C of the *Companies Act 1985*' (1993) 13 *Legal Studies* 241; Michael Whincop, 'Of Dragons and Horses: Filling Gaps in Pre-Incorporation Contracts' (1998) 12 *Journal of Contract Law* 217. Under the *Corporations Law* s 131, these should now properly be described by the neologism 'pre-registration contracts'.

47 See generally J P Hambrook, 'Pre-incorporation Contracts and the National Companies Code: What Does Section 81 Really Mean?' (1982) 8 *Adelaide Law Review* 119.

48 See *Kelner v Baxter* (1866) 2 LR CP 174; *Summergreene v Parker* (1950) 80 CLR 304; *Vickery v Woods* (1952) 85 CLR 336.

49 See *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480.

entity concept historically functioned in these areas as a device that allowed innovative judicial responses to relatively new problems, without affording judges unlimited licence as lawmakers. In capital formation, for example, disclosure was an obvious response to then current concerns about fraud by promoters.<sup>50</sup> Positing the corporate entity as an object of a duty allowed judges to employ disclosure obligations familiar from other areas of the law. The employment of the concept of a 'conflict of interest' in cases involving promotion had the advantage for judges of simply applying the duty to easily verified circumstances, such as on-sold assets.<sup>51</sup> They did not have to create a full-blown duty obliging the promoter to disclose the value of all assets. Likewise, subjecting agents to liability for pre-incorporation contracts was achieved by the instrumental expedient of using a corporate entity. In this way, judges could prevent promoters sheltering behind limited liability (in respect of transactions consummated before the corporation had a clearly partitioned asset pool), without articulating a general principle of lifting the corporate veil. On the other hand, the entity concept provided a simple means of avoiding liability by incorporating the company first. It is likewise arguable that the law on corporate authority is not a 'top-down' imposition of principles derived by apodictic reasoning from the entity concept, but a cautious, incremental response that begins with existing concepts and modifies them to suit the increasing complexity of managerial hierarchies. Examples include the development of such principles as the indoor management rule,<sup>52</sup> and the equation of representations of authority with things employees are permitted to do or are not prevented from doing,<sup>53</sup> both of which employ the entity concept doctrinally. Thus, the entity concept can be seen as providing an heuristic method for articulating complex conclusions justifiable on other instrumental grounds — an especially valuable method when it is not clear to what extent the conclusion should apply to situations other than that arising in the particular case at hand.

### **C The Constitution and Facilitation of Corporate Governance**

I have defined 'governance' as the allocation of the residual control over corporate assets (that is, the disposition of power to manage, control and dispose of assets), as well as the control of agents to whom residual control has been allocated. Those rights can be defined by law, but contract also plays an important role. Obvious instances in which contracts are critical include: the conferral of management power on the board and the provisions for director election in the constitution, the rights reserved to an individual shareholder under a shareholders' agreement, and the rights conferred on creditors under debt contracts (for example, the right to appoint a receiver).

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50 See Joseph Gold, 'The Liability of Promoters for Secret Profits in English Law' (1943) 5 *University of Toronto Law Journal* 21.

51 This is because a breach was constituted where the promoter (a) sold assets to the corporation; and (b) did not establish an independent board or make sufficient disclosure of the conflict. These factual predicates are easy to prove and do not require valuations.

52 *The Royal British Bank v Turquand* (1856) 6 El and Bl 327; 119 ER 886.

53 See Whincop, above n 41.

The major areas of law addressing these concerns include the doctrine on the powers and interrelationships of the board and the general meeting, the law governing directors' powers and duties, and the law governing members' rights. On the other hand, I have already noted that parts of these bodies of law (including significant parts of the law on directors' fiduciary duties) protect property rights. This reflects an overlap between the goals of controlling assets and protecting property.

The entity concept pervades these areas of law. A key historical principle which affects standing to enforce rights, and thus, the extent of control over agents, is found in *Foss v Harbottle*,<sup>54</sup> which employs the entity principle in distinguishing corporate and personal rights. The interests of the 'company as a whole' are frequently used to define the nature of the duty the director is expected to discharge.<sup>55</sup> Similar concepts reappear in the law on members' rights, especially in the context of the power to amend the constitution.<sup>56</sup> The entity concept allows factual considerations to be used to differentiate the way in which legal rules are applied to corporations. For example, cases indicate that whether or not particular behaviour is oppressive to a shareholder can be determined by reference to the nature and history of the corporation.<sup>57</sup> At the most general level, the case law reveals the use of the entity concept to justify a 'constitutional' approach to corporations, in which legitimate power is wielded by identified and properly convened bodies according to specified processes, rather than by transient majorities. Despite the fact that shareholders are the ultimate beneficiaries of directors' duties, courts have refused to treat shareholders as synonymous with the corporation, in order to compel them to proceed constitutionally.<sup>58</sup>

These various usages of the entity concept have straightforward economic explanations. First, imposing formal obligations on the company can be used to establish a duty to maximise the value of the assets, rather than the welfare of some individual shareholder or faction. This is particularly important in cases of insolvency, when shareholder incentives to maximise the value of assets can be perverted and the attractions of wealth transfer are considerable.<sup>59</sup> Second, referring to the concept or form of the corporation creates a means of tailoring a legal rule to the corporation, focusing particularly on its norms and other aspects

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54 (1843) 2 Hare 46; (1843) 67 ER 189.

55 See generally J D Heydon, 'Directors' Duties and the Company's Interests' in Paul D Finn (ed), *Equity and Commercial Relationships* (1987) 120.

56 See *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 ('Allen'); *Ngurli Ltd v McCann* (1953) 90 CLR 425, 438. The issues raised in *Allen* are characteristically dynamic governance concerns. See also *Gambotto v WCP Ltd* (1995) 182 CLR 432.

57 See, eg, *Re H W Thomas Ltd* (1984) 2 ACLC 610.

58 See especially *Automatic Self Cleansing Filter Syndicate v Cunningham* [1906] 2 Ch 34; *John Shaw and Sons (Salford) Ltd v Shaw* [1935] 2 KB 113; *Turner v Berner* [1978] 1 NSWLR 66. See generally Stephen Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 *Sydney Law Review* 277.

59 See, eg, *Walker v Wimborne* (1976) 137 CLR 1. See generally Laura S Lin, 'Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors' (1993) 46 *Vanderbilt Law Review* 1485. This area can also be seen as one that involves regulating transitions.

of governance.<sup>60</sup> This allows for more specific legal rules, an issue I discuss in detail in Part IV(D). Third, and most importantly, the constitutionalist approach allows courts to treat corporations as self-governing systems. Much of the law on constituting and facilitating governance has deferred to the exercise of discretion vested in the board and majority rule in the general meeting. Were the corporation recognised simply as a nexus of contracts, this passivity in the enforcement of rights would have been at odds with the nineteenth century paradigm of classical contract law, which identified with precision the required performance and corresponding remedy. Thus, entity concepts provided a shell for the emergence of a kind of contract law that better suited long-term, multi-party relations.<sup>61</sup> In these relations, majoritarian governance instrumentalities, while regarded as a principal means of adjustment over time, were nonetheless subject to certain limitations to prevent the power of these instrumentalities from being abused. I consider these limitations in the following section.

### D The Regulation of Transitions

What does it mean to speak of dynamic governance? Dynamic governance issues arise in the context of substantial changes to the governance equilibrium prevailing in the corporation. Dynamic governance divides into two overlapping categories. In the last section, I defined static governance as concerned with the allocation of residual control, which in turn is defined by reference to the occurrence of certain contingencies.<sup>62</sup> For example, the right of the directors to control the assets is referable to the non-occurrence of two major contingencies — a decision by a majority of shareholders to sack the directors (either in a proxy fight or after a takeover), and insolvency. Dynamic governance is directed towards, first, the regulation of the ‘approach’ to contingencies, and second, attempts to change either the contingency or the scope of control given to a party.

These issues are therefore transitional in quality, and it is the regulation of the transition that arouses the interest of the law. Of particular concern is the use of the static governance apparatus itself in mediating these transitions. For example, dynamic governance issues arise in control contests, such as takeovers. Some of the issues that arise in takeovers are basic, contract-like issues of dynamic property, including the disclosure of information and the absence of coercion. Dynamic governance issues intrude upon the use of the static governance apparatus during the takeover (an example of which is the defensive tactics employed by incumbent management). Thus, the exercise of some powers (such as the issuing of shares) is uncontroversial in most cases, but becomes controversial when a contest for control is pendent, since it alters the formal

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60 The concept of tailoring legal rules is discussed in Ian Ayres and Robert H Gertner, ‘Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules’ (1989) 99 *Yale Law Journal* 87, and in Ian Ayres, ‘Preliminary Thoughts on Optimal Tailoring of Contractual Rules’ (1993) 3 *Southern Californian Interdisciplinary Law Journal* 1. See below nn 85-7.

61 See generally Ian R Macneil, *The New Social Contract: An Inquiry into Modern Contractual Relations* (1980).

62 See generally Grossman and Hart, above n 19; Hart and Moore, above n 19.

contingency defining management's control over the firm (that is, the number of shares the bidder must buy to take control). These contrasts provide the justification for a dynamic analysis of governance.

For an example concerned with changing the scope of control, consider the case where a majority seeks to use power, not in dispute in static cases, to alter the ex ante governance structure (ie, contracts and background law).<sup>63</sup> Examples include altering the constitution to empower minority expropriations, changes to the structure of voting rights or the distribution of returns (the latter is an aspect of static property), and various other oppressive tactics carried out under the auspices of governance.

Dynamic issues frequently involve disputes between factions within the corporation and the means (permitted by law) to resolve those disputes. This is an important point because it illustrates one of the main weaknesses of the various justifications of the corporate entity concept. I said in Part III(C) that the entity concept was helpful because it could be linked to the maximisation of asset value. However, this is no longer useful when the issue ceases to involve the use of assets but rather disputation between rival claimants to those assets.<sup>64</sup>

Thus, we might expect that the entity concept would not appear at all in the relevant doctrine. Yet that is not the case. In situations involving directors, probably the single most important set of principles are those associated with the doctrine that powers can only be used for proper purposes — sometimes, it is said, for corporate purposes.<sup>65</sup> The entity concept also surfaces when courts inquire into whether the corporation was better off as a result of the action, since in some of these cases the value of assets will be affected.<sup>66</sup> One notable transitional case in recent times is the Australian High Court decision in *Gambotto v WCP Ltd* ('*Gambotto*'),<sup>67</sup> in which the Court held that expropriation could only be valid if a proper purpose (ie, one which would benefit the corporation) could be demonstrated. In a takeover case, the capacity of the defensive action to fulfil financing requirements, achieve strategic alliances, or create options for shareholders, could all help to uphold the directors' action; whereas actions that destroy a majority are more likely to be invalid than those which merely dilute an existing minority interest. Thus, courts often seem to weigh the detriment to the party that currently lacks control against the value added to the assets.

In these cases, Australian courts do not apply fiduciary rules to situations involving conflicts of interest and directors' duties with anything like the strictness with which they apply them to cases of self-dealing or

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63 American jurisdictions have often addressed these problems by way of an appraisal remedy. A study of this remedy is beyond the scope of this article, but it tends to be applied in a less discretionary manner than the doctrines described here.

64 See generally *Peters' American Delicacy Company Ltd v Heath* (1939) 61 CLR 457, 507-12.

65 See, eg, *Australian Metropolitan Life Assurance Company Ltd v Ure* (1923) 33 CLR 199, 215.

66 See *ibid*; *Teck Corp Ltd v Millar* (1973) 33 DLR (3rd) 288; *Pine Vale Investments Ltd v McDonnell and East Ltd* (1983) 1 ACLC 1294; *Darvall v North Sydney Brick and Tile Co Ltd (No 2)* (1989) 7 ACLC 659. A similar approach has been taken at various times in American law: see, eg, *Unocal Corp v Mesa Petroleum Co*, 493 A2d 946 (Del, 1985).

67 (1995) 182 CLR 432, 445-7.



misappropriation of business opportunities. In the latter transactions, the courts have long emphasised the law's strictness and inflexibility,<sup>68</sup> and the irrelevance of the merits or justifiability of the transaction.<sup>69</sup> Although judges do not highlight the discrepancy, the reality is that they often tolerate self-interest in these transitional cases, especially if the benefits associated with defensive action are counted in favour of its validity. Yet there is a difference in approach between Australian and English cases with regard to defensive action. 'Proper purpose' cases involving the issue of shares during a control contest in a public company are treated less strictly by Australian courts than English courts.<sup>70</sup> Australian courts rely on a line of authority that looks for an improper purpose but for which the power would not have been exercised.<sup>71</sup> The strict version of the fiduciary principle applied by the English courts is, by contrast, indifferent to motivation or to proof that the transaction would have occurred in any event.

The entity concept therefore frequently appears in this area of law. It seems, however, that the concept is simply part of the highly discretionary approach the law often takes to dynamic governance cases, and the scope (though not a requirement) for courts to consider whether the transaction has explicit welfare-increasing properties. The references to the entity concept may also be heuristically valuable, as in the dynamic property function: they enable courts to resolve issues on a case by case basis, without committing to a principle of general application.

## E Conclusions

In this Part, I have offered a functional account of corporate law. These functions correspond to the static and dynamic attributes of corporate property and governance. Between them, they define the corporation as a nexus of contracts predicated on a pool of property, both at a specific cross-section in time and across time and changes in equilibrium. I have argued that the corporation as an entity has various important roles to play. First, it functions as a vehicle for title to property; its role in this respect is pivotal to asset partitioning. Second, it functions as an heuristic method for approaching new and complex applications or expansions of doctrine. Third, it proxies for the assets of the corporation which governance processes are encouraged to maximise. Fourth, it encourages the endogenous development of governance processes and norms, to which the law may either defer or use for the differentiation of legal obligations. Fifth, it has the scope to allow differentiation and discretion in specific cases. In each of its roles, the entity concept performs economic functions without violating the more fundamental economic claim that

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68 See, eg, *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461, 473.

69 See, eg, *Furs Ltd v Tomkies* (1936) 54 CLR 583.

70 In England, see *Fraser v Whalley*; *Gartside v Whalley* (1864) 2 Hom and M 10; *Punt v Symons and Co Ltd* [1903] 2 Ch 506; *Piercy v S Mills and Co Ltd* [1920] 1 Ch 77; *Hogg v Cramphorn Ltd* [1967] Ch 254. In Australia, see *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 183.

71 See *Mills v Mills* (1937) 60 CLR 150, 163; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 838; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, 294.

the corporation lacks interests of its own, separate from those of the contracting parties. Part IV builds on this discussion of the functions that corporate law serves by focusing on the form that the law takes.

## IV THE CORRELATION BETWEEN FUNCTION AND FORM

### A Introduction and Terminology

An enduring theme of jurisprudence is analysis of the form of a legal rule. The most commonly made distinction is between rules and standards, which vary in the degree to which the rule reposes adjudicatory discretion in a judge.<sup>72</sup> A rule restricts the considerations relevant to the application of the legal rule in question; a standard leaves these considerations open to a greater extent. Although very important, the distinction is somewhat oversimplified. It fails to reflect the fact that both rules and standards differ in their complexity.<sup>73</sup> To take an obvious example, the traditional rule on conflicts of interest is very simple (it depends only on the presence of a potential conflict), whereas the standard of care is very complex. The standard of care predicates on many things, most notably the circumstances in which the director is alleged to have been negligent, but also the role the director serves on the board, any special expertise, the functions being performed by employees, reasons for suspicion, and so on. The former then is a relatively simple rule; the latter is a complex standard. However, not every rule is simple. Statutory rules allowing compulsory acquisition of minority shareholders after a takeover are an example of more complex rules. Not every standard is complex, either, as the considerations relevant to the standard may be restricted. As discussed above in Part III(D), the Australian law in relation to the issue of shares when a takeover is pendent is more complex than the English law.

A second theme of jurisprudence, emerging from the economics of contracts, is the passivity of the law.<sup>74</sup> Passivity describes the scope for adjudication and the information required for adjudication. There are several hallmarks of passive adjudication, which is particularly associated with the enforcement of relational contracts. First, passive adjudication tends to defer to private ordering, either by

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72 For economic work on the subject see Colin S Diver, 'The Optimal Precision of Administrative Rules' (1983) 93 *Yale Law Journal* 65; Isaac Ehrlich and Richard A Posner, 'An Economic Analysis of Legal Rulemaking' (1974) 3 *Journal of Legal Studies* 257; Louis Kaplow, 'Rules Versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557. Other notable jurisprudential contributions include: Ronald M Dworkin, 'The Model of Rules' (1967) 35 *University of Chicago Law Review* 14; Duncan Kennedy, 'Form and Substance in Private Law Adjudication' (1976) 89 *Harvard Law Review* 1685; Friederick Schauer, *Playing by the Rules: A Philosophical Examination Of Rule-Based Decisionmaking In Law And In Life* (1991).

73 See Kaplow, above n 72.

74 The concept of passivity draws from the various works of Alan Schwartz, of which the most important is Alan Schwartz, 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 *Journal of Legal Studies* 271. Other analyses of passivity include Scott's: Robert E Scott, 'The Case for Formalism in Relational Contract' (2000) 94 *Northwestern University Law Review* 847.

enforcing contracts in a literal, formalistic manner, or by treating as authoritative the resolutions reached by governance processes endogenous to the firm or the exchange. Second, background allocation of rights and entitlements will tend to be absolute, or at the least, will not be conditional on factors that are difficult for a court to verify.<sup>75</sup> Passivity is related to simplicity: passive rules are generally a subset of simple rules that restrict the facts and circumstances on which legal rules are based to ones that can be easily verified.

A third theme is understanding how the law varies in its means of recognising and protecting legal entitlements.<sup>76</sup> This is relevant to corporate law because of the importance of property.<sup>77</sup> The conventional distinction is between property rules, which require bilateral consent to the transfer of a recognised entitlement, and liability rules, which enable a party wishing to acquire the entitlement to take it without consent conditional on the payment of compensation. Although the economic analysis of these rules has now become exquisitely complex,<sup>78</sup> it is often thought that property rules have advantages where costs of transacting are relatively low, since they encourage the formation of markets.<sup>79</sup> Liability rules overcome the non-formation of markets where transaction costs are high, but are vulnerable to difficulties of verifying the entitlement's value.<sup>80</sup>

A fourth theme is the way in which the protection of entitlements varies in the discretion associated with adjudication. Most analyses of liability rules and property rules assume that the grantee and extent of protection is known *ex ante*. However, entitlements may be allocated *ex post* using discretionary standards. One might describe a regime which allocates standards in this way as involving contingent, *ex post* entitlements. One of the most important insights in the economic literature is that contingent *ex post* entitlements can actually function to encourage parties to contract.<sup>81</sup> Where entitlements are *ex ante* certain, they can encourage parties to hold out from contracting in the hope of higher offers, where the grantor's valuation of the entitlement is both variable and unobservable by the would-be acquirer. In these circumstances, the would-be acquirer has only one weapon against hold-out behaviour, and that is to impose delay costs. By contrast, contingent *ex post* entitlements change the bargaining game. Johnston has modelled the effect of inaccuracy and error in awarding these entitlements.<sup>82</sup> The fact that the highest-valuing entitlement owner is not guaranteed success can actually create the conditions for both parties to agree to

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75 Schwartz, above n 74, gives an economic analysis of the impact of verifiable information on contract adjudication.

76 See Calabresi and Melamed, above n 36. A useful review of the literature can be found in James E Krier and Stewart J Schwab, 'Property Rules and Liability Rules: The Cathedral in Another Light' (1995) 70 *New York University Law Review* 440.

77 See Whincop, above n 32.

78 See, eg, Ian Ayres and Eric Talley, 'Solomonic Bargaining: Dividing an Entitlement to Facilitate Coasean Trade' (1995) 104 *Yale Law Journal* 1027; Jason Scott Johnston, 'Bargaining Under Rules Versus Standards' (1995) 11 *Journal of Law, Economics and Organization* 256.

79 For a review and critique, see Krier and Schwab, above n 76.

80 See A Mitchell Polinsky, 'Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies' (1980) 32 *Stanford Law Review* 1075.

81 Johnston, above n 78.

82 *Ibid.*

ex post efficient trade immediately, rather than after delays. This is because the party wanting the entitlement can reinforce an offer of trade with a credible threat to bypass bargaining by seeking adjudication (which may well leave the other party with nothing), if the offer is rejected.

The final theme of jurisprudence that I wish to advert to here, which is familiar in the economic analysis of corporate law, is the relationship between legal rules and contracts.<sup>83</sup> Default rules permit contrary contracting; mandatory rules do not.<sup>84</sup> The literature discusses various objectives for setting defaults, which can include the saving of negotiation and drafting costs by the provision of rules likely to be preferred by a majority of contracting parties, and forcing parties to disclose private information.<sup>85</sup> Many of the themes and distinctions discussed above can be integrated with these claims.<sup>86</sup> For example, defaults can take the form of standards, such as oppression, which demand some form of contingent ex post adjudication. Defaults can take rule-like form; there is scope for variation in the passivity of these rules, depending on whether the rules have informational motivations. Property and liability rules are important in this context since they are often relevant to violations of unexcluded default rules: liability rules characteristically demand damages; property rules require injunctions and specific performance. A second form of analysing defaults relies on the point in time at which parties actually contract around them. Most corporate law and economics addresses ex ante contracting in relation to the corporation's constitution and other constitutive documents. In this context, the legal rules so excluded have a contract-like flavour. By contrast, contracting may occur after the initial governance contracts are in place, as, for example, strict fiduciary rules require. The legal rules creating these rights have, in contrast, a property-like flavour.<sup>87</sup>

Many different forms of law could perform the functions I have attributed to corporate law. And, indeed, corporate law provides a multitude of examples of forms in relation to each function. However, I will argue that each of the main functions of corporate law relies principally on a single law form, and that there is an economic rationale for this correspondence.

## **B Defining and Protecting Corporate Property: Property Rules**

It is not surprising that the law defining and protecting corporate property mostly consists of property rules. Those with residual control over assets to which the corporation has title are permitted to withhold their consent to the transfer of those assets as they see fit. The economic logic of this connection is straightforward — corporate firms function within markets and depend on straightforward allocations of title for most investment and transactional purposes.

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83 The principal reference remains Easterbrook and Fischel, above n 2.

84 On the relationship between the two in corporate law, see Bernard S Black, 'Is Corporate Law Trivial? A Political and Economic Analysis' (1990) 84 *Northwestern University Law Review* 542.

85 Cf Ayres and Gertner, above n 60, and Scott, above n 74.

86 Ayres, above n 60, illuminates some of these connections.

87 See generally Whincop, above n 32.

The inflexible fiduciary principles applying to self-dealing and expropriation of assets and opportunities also operate in a manner analogous to property rules.<sup>88</sup> These principles deny a right on the part of the fiduciary — like anyone else — to take assets, either with or without compensation. Those rules are appropriately described as property rules because they are not inimical to consensual trade between shareholders and fiduciaries, provided trade is fully informed and non-coercive.<sup>89</sup> Moreover, the property rule description is supported by the remedies for violations of these rules: the creation of constructive trusts or rescission by *restitutio in integrum*.<sup>90</sup> These are proprietary remedies which do not require the court to value the taking of the assets for the purposes of determining compensation. In this sense, they are also passive rules which make low information demands.

Capital maintenance rules define and protect corporate property by limiting the distributional freedom of shareholders, as mentioned above in Part III(A). These also function like property rules. Legislation historically provided a procedure whereby the creditors could express to a court an opinion about whether a capital reduction could proceed, and there are now other obligations protecting the corporation's assets.<sup>91</sup> Further, violation of the prohibition is usually addressed by injunctive relief, rather than obligations to compensate.

The law on lifting the corporate veil defines corporate property by fixing the permeability of defensive asset partitioning. The law here transcends the choice between property rules and liability rules — it addresses the antecedent question of what property belongs to the corporation. The sheer infrequency of lifting the corporate veil in cases other than fraud and statutory compensation cases suggests that defensive asset partitioning is strong, which in turn reinforces the other property rules protecting corporate assets.

### C The Contracting Process and the Creation of Claims: Liability Rules

Dynamic property issues arise in the creation of new claims against, and change within, the pool of corporate assets. For the most part, the contracts that cause these changes are governed by contract law or other bodies of exchange-based law, and most of the rights contained in them are enforced by damages obligations, not by specific performance. Thus, liability rules are the dominant law form in this area. The one exception to this is the enforcement of rights in relation to governance that are provided for in the constitution; these are enforced injunctively.<sup>92</sup> This exception, however, could better be classified as an aspect of static governance. That classification is appropriate since the injunctive enforcement of governance provisions is an example of the 'passive' character of the law on static governance. In other cases, employees, customers, suppliers, and lenders look to courts for compensatory relief rather than specific

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88 Ibid.

89 *Parker v McKenna* (1874) 10 Ch App 96, 124.

90 See *Peninsular and Oriental Steam Navigation Co Ltd v Johnson* (1938) 60 CLR 189.

91 The current provisions of the *Corporations Law* are ss 256A-256D, replacing s 195.

92 This point was recently reaffirmed by the High Court of Australia in *Bailey v New South Wales Medical Defence Union Ltd* (1995) 18 ACSR 521.

performance. The economic logic of liability rules is consistent with the usual economic justifications of damages. They enable promisors to make efficient selections between performance and breach, by using their superior information about the cost and value of performance.<sup>93</sup>

It is also worth mentioning that modern securities statutes also have liability rules built into them to cover cases of culpable false disclosures or omissions. This is a dynamic property issue (rather than a governance issue) since it regulates the process of contracting between the corporation and its investors (rather than being concerned with the control of assets). This use of liability rules has the explicit purpose of deterring interference with the investors' entitlement to disclosure.

In Part III, I mentioned several important corporate law principles which are also relevant under this heading because they enable contract law to be adapted to the transactions of bodies corporate. The allocation of authority to agents is not explicitly a body of liability rules. However, it functions, as noted above, as a device for risk allocation, which, of course, contract law does also. Historically, those risk allocations were quite blurry, consistent with the heuristic quality I ascribed to the corporate entity in this context. It is notable that where changes have been made to legislation in modern times, they have resulted in much more straightforward risk allocations to the corporation, unless the third party contractor is aware of the violation of authority.<sup>94</sup> There are sound reasons for this, such as the greater capacity of the corporation to force the agent to internalise the cost of unauthorised transactions, and the fact that controlling unauthorised transactions may have a low marginal cost to the corporation given other incentives to install management controls.<sup>95</sup> By creating more easily enforceable obligations against the corporation, these statutes enhance the application of liability rules to contracts with corporations. Similar comments could be made in relation to pre-registration contracts. These also allocate risks, and provide a limited attenuation of defensive asset partitioning by imposing personal liabilities on agents contracting on the firm's behalf. Again, statutory intervention has been designed to increase the security of these contracts, for example, by allowing the corporation to ratify the contract or by subjecting the agent to personal liability.<sup>96</sup> This increases their similarity with other contracts and enables their enforcement by liability rules.

Promoters' duties do not fit quite so well with characteristic liability rules, however, in part because they share remedies (principally rescission) with other fiduciary duties.<sup>97</sup> The justification for this is simply that a liability rule for the breach of promoters' duties would be very difficult to apply; it would require the

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93 Richard Posner, *Economic Analysis of Law* (5<sup>th</sup> ed, 1998) 131-2.

94 See *Corporations Law* ss 128-30.

95 For example, for reporting or administrative purposes.

96 See *Corporations Law* s 131.

97 Rescission is the principal remedy in such cases, see, eg: *Erlanger v The New Sombbrero Phosphate Co* (1878) 3 App Cas 1218, 1235; *In re Cape Breton Co* (1885) 29 Ch D 795, 804; *Ladywell Mining Co v Brookes* (1887) 35 Ch D 406, 408; *In re Lady Forrest (Murchison) Gold Mine Ltd* [1901] 1 Ch 583, 590; *Wheal Ellen Gold Mining Co NL v Read* (1908) 7 CLR 34, 43; *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215, 239-40.

court to undertake complex exercises associated with the valuation of businesses, whereas rescission avoids the need for such excursions into potentially unverifiable territory. To the extent that the role of promoters' duties has been displaced by modern securities legislation, their emphasis on compensatory remedies has, notwithstanding difficult valuation questions, reaffirmed the liability rule character of the formation of these contracts.

#### D The Constitution and Facilitation of Corporate Governance: Passive Rules

The laws addressing static governance in corporations have traditionally been passive (in several senses). The law in this area has typically yielded to alternative contractual solutions.<sup>98</sup> The law has recognised and deferred to the solutions reached by endogenous governance functions.<sup>99</sup> Finally, the law has typically been absolute in its conferral of discretions on boards and majorities (where dynamic governance and static property issues were not raised), and, where it has been conditional in form, the conferral of discretion has been predicated upon conditions that are easy to observe and verify.

Many traditional corporate law rules operate in this way. Although fiduciary rules sanction a potentially large role for judicial intervention, other passive rules cut in the opposite direction. First, rules on conflicts of interest were traditionally subject to contract, both *ex ante* modification (which typically allowed directors to maintain conflicting interests that were disclosed to the board) and *ex post* trade.<sup>100</sup> Second, the use of rescission as a remedy for conflicts of interest eliminated the incentive to litigate unless the contract was actually welfare-decreasing for the shareholders.<sup>101</sup> Third, the rules on conflict of interest were subject to the rule in *Foss v Harbottle*, which vitiated the capacity of individual shareholders to litigate these transactions in all but straightforward cases of impoverishment. Fourth, the traditional standard of care of directors was not completely 'breach-proof', but its subjectivity made it difficult to breach honestly. (*Foss v Harbottle* was again a major obstacle to litigating these cases.) Quite apart from these cases of breach of duty, the law has always taken a permissive and passive approach to the exercise of managerial authority by the directors of a corporation;<sup>102</sup> even the recent liberalisation of oppression provisions has not encroached on this liberty, unless its exercise is associated with clear overreaching.<sup>103</sup> Fifth, there is empirical evidence that most companies excluded liability for the standard of care contractually in one way or another.<sup>104</sup>

98 For more extreme examples, see *Imperial Mercantile Credit Association v Coleman* (1871) 6 LR Ch 558; (1873) 6 LRHL 189; *Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425.

99 The rule in *Foss v Harbottle* is a classic example: *Burland v Earle* [1902] AC 83, 93-4.

100 See Whincop, above n 6.

101 See Whincop, above n 32.

102 See, eg, *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

103 See, eg, *New South Wales Rugby League Ltd v Wayde* (1985) 3 ACLC 799.

104 See *Re City Equitable Fire Insurance Corp* [1925] Ch 407; *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425. See also Michael Whincop, 'Reintroducing Releases of Officer Liability into Australian Corporate Law' (2000) 26 *Monash University Law Review* 15.

Legal principles also tend to take a passive approach to the enforcement of majority rule in the general meeting. Apart from rights allocated to shareholders individually (such as the right to vote or to attend general meetings), the exercise by the majority of other rights vested in the shareholders collectively were traditionally subject to very few limitations.<sup>105</sup> These additional rights included the capacity to ratify or affirm any breaches of duty, to agree to allow a director to contract with the corporation, to elect or sack directors, to amend the constitution, and so on. There are limits on these principles, namely the exception to the rule in *Foss v Harbottle* (fraud on the minority) and the rule in *Allen v Gold Reefs of West Africa Ltd* ('Allen')<sup>106</sup> (fraud on the power), but these seem to be aimed primarily at dynamic governance issues or obvious overreaching.

Passivity has a clear economic justification. Static governance issues are best addressed by endogenous governance structures and norms, not by law.<sup>107</sup> Governance issues raise questions which depend on information that courts find difficult to verify, such as valuations and estimates. Provided claimants on the firm are protected against expropriation and overreaching by the law on static property, and against opportunistic changes to rights and control entitlements by the law on dynamic governance, courts do best to take a minimalist, hands-off approach to governance. This encourages the formation and functioning of endogenous governance structures. The incentive to use governance structures to maximise welfare is usually strong and comes from various sources. In small corporations and in boards, the incentive may derive from the possible development over time of relational norms, such as increased cooperation and mutual identification with organisational goals.<sup>108</sup> In all forms of corporations, the limitations imposed by static property rules on dividends and capital maintenance has the effect of locking the parties into the enterprise. This lock-in effect encourages parties to maximise the value of assets which they share through (typically) fungible equity investments.<sup>109</sup> The willingness to enforce contracts allows parties to tailor their governance structure to intensify incentives or to provide special protection where that is needed. By minimising recourse to courts, the capacity of parties to engage in rent-seeking behaviour is limited, since the capacity to litigate strategically is truncated.<sup>110</sup> If disputes do arise, the use of passive rules with clear and absolute allocations allows the

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105 *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.

106 [1900] 1 Ch 656.

107 The following analysis draws substantially from Schwartz, above n 74.

108 The organisational behaviour literature supports this claim: Robyn M Dawes, Alphons J C van de Kragt and John M Orbell, 'Cooperation for the Benefit of Us — Not Me, or My Conscience' in Jane J Mansbridge (ed), *Beyond Self-Interest* (1990) 97; Walter W Powell, 'Trust-Based Forms of Governance' in Roderick M Kramer and Tom R Tyler (eds), *Trust in Organizations: Frontiers of Theory and Research* (1995); Lynn A Stout and Margaret M Blair, 'Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law' (Georgetown Law and Economics Research Paper No 241403, 2000).

109 See Edward Rock and Michael L Wachter, 'Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in the Close Corporation' (1999) 24 *Journal of Corporation Law* 913.

110 *Ibid.*



parties to know what the payoffs will be if they fail to reach agreement, which seems to encourage out of court settlement.<sup>111</sup>

We may observe that both the static governance and static property functions of corporate law are served by legal rules which encourage private ordering and trade and discourage litigation. By contrast, a greater and more complex role for the courts is preserved in the enforcement of other contracts and in the regulation of transitions.

## E The Regulation of Transitions: Contingent Ex Post Entitlements

### 1 Analysis

Most of the important legal principles that make up the law on dynamic governance represent the exceptions to the legal rules that defer passively to governance processes (such as the rules in *Foss v Harbottle* and *Allen*). They therefore mark the border between passivity and a willingness to intervene in governance. The principles here, however, are imprecise — as is also true of other important legal principles in this area, such as the principles applying to improper purposes. They tend to use a blurry, almost rhetorical rubric to define the nature of the jurisdiction, without attempting to list the relevant considerations.

The jurisdiction is thus substantially unique in corporate law, as it relies on contingent ex post entitlements, which other areas of corporate law generally eschew. Although expositions of legal principle do not clearly articulate the nature of the analysis involved in these cases, the courts often appear to be engaged in a form of balancing. The existence of a substantial advantage to the corporation counts in favour of non-intervention, as do actions that have the effect of increasing options for shareholders.<sup>112</sup> Dilution of an existing majority is more likely to be struck down than, say, committing assets desired by a bidder to other, apparently productive uses.<sup>113</sup> Expropriation of shares is prima facie impermissible, although advantages to the corporation may validate it in exceptional cases. In sum, the area is imprecise and discretionary.

The need for some form of law in this area may be conceded. Attempts to use governance procedures to alter control contingencies or to expropriate wealth discourage investment by facilitating opportunism and rent-seeking. Unilateral resolution of factional disputes through governance organs is tainted by self-interest, and the suppression of certain transitions, such as the sale of control, can decrease social welfare.<sup>114</sup> Transitions in governance are also, by definition, 'final period' problems, since they alter or transform rights and entitlements fundamentally. Final period problems are frequently associated with the possibility of opportunism, because the parties cease to envisage a future in

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111 See Schwartz, above n 74; Robert D Cooter and Daniel L Rubinfeld, 'Economic Analysis of Legal Disputes and Their Resolution' (1989) 27 *Journal of Economic Literature* 1067.

112 See above nn 65-71 and accompanying text.

113 Roman Tomasic and Stephen Bottomley, *Corporations Law in Australia* (1995) 356-60.

114 See Frank H Easterbrook and Daniel R Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161.

which they need to cooperate.<sup>115</sup> However, conceding a role to the law does not tell us why the law in this area takes an imprecise form.

Why then, are contingent ex post entitlements pervasive? It is easier to understand first why the earlier forms or solutions discussed in this Part would be difficult to apply to such transitional events. Passive rules that defer to norms are inappropriate when the situation is one in which norms themselves are undergoing transition, or have so broken down that parties rely on formal governance entitlements in preference to cooperation. Property rules and liability rules depend on the ex ante certain identification of rights and entitlements. One way to achieve ex ante certainty is simply to treat dynamic governance cases in an identical manner as other static governance cases (ie, passively), but that would be to ignore the problems with passivity in dynamic cases. Furthermore, liability rules are vexed by complex valuation questions. These are difficult enough when determining the value of the shares of a minority shareholder, but it would be harder still to quantify, for example, the deprivation of a minority shareholders' right to participate in meetings since these rights are never traded, except as part of a bundle of rights comprised in the shares.

My first affirmative justification for contingent ex post entitlements relies on their advantages as defaults. It may be true that the law on dynamic governance can be varied by an appropriately specified ex ante contract (for example, one permitting issues of shares in a takeover to facilitate a control auction).<sup>116</sup> There are two arguments supporting the assertion that these legal principles make good defaults. First, more tailored legal principles are preferred where relevant contingencies have a very low risk of occurring (because of the reduced likelihood of ex ante contracting).<sup>117</sup> The ex ante likelihood of any particular dynamic governance configuration is very low. The second argument is that although contingent ex post entitlements can easily be excluded contractually in favour of a straightforward rule, the reverse is not true without the existence of a body of decided case law giving meaning to the rubric employed in cases in this area.<sup>118</sup> A third and related argument is that an imprecise standard has heuristic value, in the sense that it allows more precise precedents to be generated when certain forms of behaviour arise that are undesirable on any view.

My second justification is that this type of rule arguably increases the incidence of agreement when a transition looms. I summarised Johnston's argument (in Part IV(A)) that these entitlements enable a party to credibly threaten to bypass trade and impose, with positive probability, an uncompensated loss if an offer of trade is rejected. These bargaining properties depend on some imperfection in the balancing of competing merits, and require that the party

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115 See Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288.

116 *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285. Although it is difficult to alter the constitution to expropriate shares, including a provision in the original constitution seems less problematic: *Gambotto* (1995) 182 CLR 432, 447. Modern statute law often restricts the scope of contractual freedom. One cannot opt out of ch 6 of the *Corporations Law* for example.

117 Ayres, above n 60.

118 Ian Ayres, 'Making a Difference: The Contractual Contributions of Easterbrook and Fischel' (1992) 59 *University of Chicago Law Review* 1391.

who offers to trade must incur some costs associated with the attempt to bypass trade.<sup>119</sup> It is not difficult to see these conditions as being met in some dynamic governance cases, especially in cases of expropriation. A balancing test (such as that found in *Allen*) seems to capture the 'balancing' dynamic well. Yet that is not true of the principle articulated by the Australian High Court in *Gambotto*. In that case, the High Court drew, in my opinion, a dysfunctional and wholly specious distinction between benefits to the corporation from expropriation and benefits to the majority shareholder. That test increases the hold-out capacity of the minority shareholder. However, it is appropriate to note that an imprecise rule may not be optimal in some cases. For example, where ex post efficiencies are likely to be large (as is often true of the profile of minority shareholdings after a takeover), a simple liability rule allowing compulsory acquisition may be superior to either a balancing test or a rule against such acquisitions. This is how most modern statutes resolve the problem.

What can we say of the use of imprecise principles in takeovers? First, these principles blunt the sharp edge of the incentive effects of the hostile takeover. However, other mechanisms (such as pressure from institutional investors) may function as a substitute in this respect, so the net effect is unclear.<sup>120</sup> Second, legal principles which provide some scope for defence provide greater security for those managers who make firm-specific investments of their human capital.<sup>121</sup> In particular, these legal principles enable the directors to make a deal while they retain control of the company, which increases their expected returns at the time they decide to make firm-specific investments. At the same time, the principles provide an inherent advantage for bidders who might be expected to place the highest value on the assets (as a result of economies of scale or special technological advantages). This is because courts have the discretion to favour defence where it encourages some degree of auction-like competition or, at least, counter-bids from bidders likely to add value to the assets.<sup>122</sup>

## 2 Game Theoretic Illustration

This conclusion, advocating imprecise legal principles, is perhaps the most controversial aspect of this article in relation to the corporate law and economics literature. The advocacy for precise rules in that literature is almost overwhelming, and the economic works I have relied on as justifications are a long conceptual distance away from corporate scholarship. Thus the following worked example is intended to take my argument beyond mere assertion.

The example studies the optimal rule that should govern defensive action in a takeover. We may consider three different rules that could apply to such defence: a rule permitting any form of defence; a rule prohibiting every form of defence; and a more contingent approach in which defence is upheld as valid with probability,  $p$ . We can dismiss the first rule (which no-one has ever advocated):

119 Johnston, above n 78.

120 See generally G P Stapledon, *Institutional Investors and Corporate Governance* (1996).

121 See David Haddock, Jonathan R Macey and Fred S McChesney, 'Property Rights in Assets and Resistance to Tender Offers' (1987) 73 *Virginia Law Review* 701.

122 See, eg, *Darvall v North Sydney Brick and Tile Co Ltd (No 2)* (1989) 7 ACLC 659.

it would effectively destroy hostile bids and cancel an important managerial discipline. Further, the first rule would provide no real incentive for management to make firm-specific investments. The competition is therefore between absolute and probabilistic prohibitions.

It may be helpful to understand the intuition underlying the following model. I argue that the contingent approach to takeovers is generally superior to the absolute rule because it provides stronger security for the making of firm-specific investments of human capital.<sup>123</sup> This provides a wider range of parameters within which management will defend a hostile bid, which in turn boosts the probability that there will be a deal agreed to by the bidder and management. However, I show one drawback of contingent law — there are a (limited) range of parameters within which parties are actually willing to litigate, despite this being the worst of all outcomes. Litigation does not occur under an absolute prohibition, where management always loses.

The model is undoubtedly a considerable simplification of reality. It does not take into account the possible use of contracts between managers and shareholders to create other incentives for managers to make investments, such as golden parachutes. Nonetheless, contracts are limited in real world situations by the constraints of verifiability. It is also unclear if contracts are more or less likely to occur under contingently specified legal rules or bright-line rules.

There are three time periods in this model. At time 0, managers must make a decision whether or not to make a firm-specific investment of their human capital (eg, by acquiring expertise relating to the firm that adds value to the firm but has zero opportunity cost). At time 1, a bidder decides whether to bargain with management or announce a hostile bid, and management must decide (where there is a hostile bid) whether or not to engage in defensive action. If the parties bargain, they share the gains from trade equally, net of all costs. If management decides not to defend, the takeover will succeed, and management loses the value of its investment and all of the quasi-rents associated with it. In both of these cases, the parties receive their payoffs in time 1. If however, management decides to defend, payoffs are deferred until time 2. At time 2, the court either upholds or strikes down the defensive action. If it is upheld, management remains in control; if struck down, the takeover succeeds.

Let the cost of management's investment equal \$1.5. Let the cost to bargain be \$1 to each party, the cost to litigate be \$2 to each party, and the cost to bid be \$3 to the bidder. Let  $\delta = 0.9$ , such that the present value of \$10 at time 2 equals \$9 in time 1. Let the gross gains from the takeover where management makes its investment be \$13.5, and \$9 where no investment is made. From this, we can see that the investment produces an appropriable quasi-rent of \$4.5, being  $13.5 - 9$ . Let the private value to management of remaining in control be \$8 where management has invested; otherwise, it is \$3. Finally, if management defends, the bidder litigates the case and succeeds with some probability,  $p$ . Where the law absolutely prohibits defence,  $p = 1$ . If management defends and wins, it earns the payoff associated with control.

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123 See Haddock, Macey and McChesney, above n 121.

FIGURE 1: BID, BARGAIN OR LITIGATE GAME (EXTENSIVE FORM)

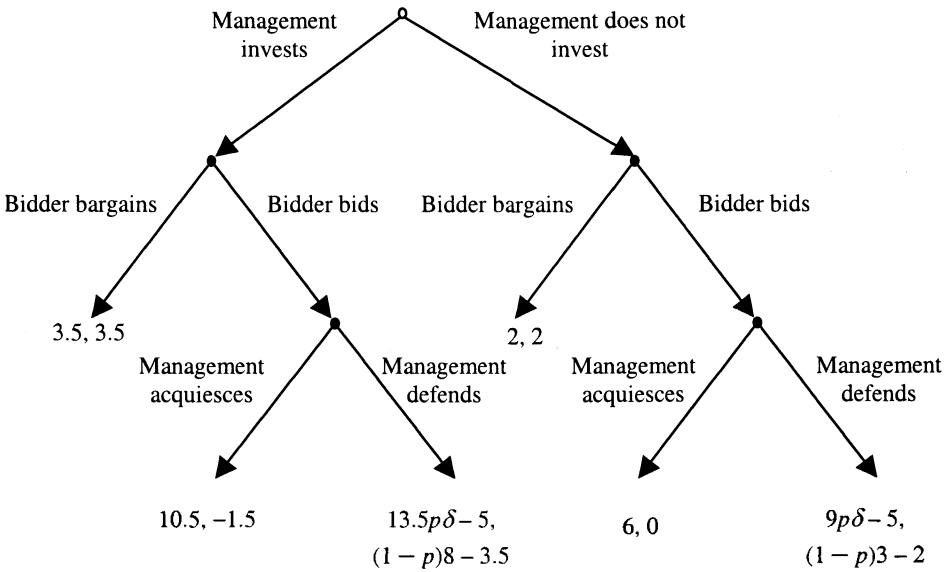


Figure 1 shows the game in ‘extensive’ form. For readers unfamiliar with game theory, we employ the solution concept, backward induction, by working backwards for both of the ‘subgames’ (that is, where management has invested, and where it has not invested). Once we know how management responds to a hostile bid, we can tell what the bidder will do (bargain or bid), which will then tell us whether management will invest or not.

What is the solution to the ‘invest subgame’ on the left hand side of Figure 1? Where  $p < 0.75$ , management is better off defending than acquiescing.<sup>124</sup> The bidder is better off bargaining than bidding for all  $p > 0.7$ .<sup>125</sup> We therefore have the following equilibrium:

$$\begin{cases} p < 0.7 & \text{B and M bargain} \\ 0.7 > p > 0.75 & \text{B bids, M defends} \\ p > 0.75 & \text{B bids, M acquiesces} \end{cases}$$

Therefore, over a small range of values of  $p$  (0.7 to 0.75), litigating actually serves each party’s self-interest.<sup>126</sup> Social welfare, however, is much lower

124 The payoff to acquiescing is  $-1.5$ . The payoff to defending is  $(1 - p)8 - 3.5$ , so the payoff from defending is at least as high as  $-1.5$  for all  $p < 0.75$ .  
 125 The payoff to bargaining is  $3.5$ . The payoff to defending is  $13.5p\delta - 5$ , which is  $12.15p - 5$  where  $\delta = 0.9$ . Thus, the payoff from defending is at least as high as  $3.5$  where  $p > 0.7$ .  
 126 The bidder is better defending than bargaining, and management is better defending than acquiescing.

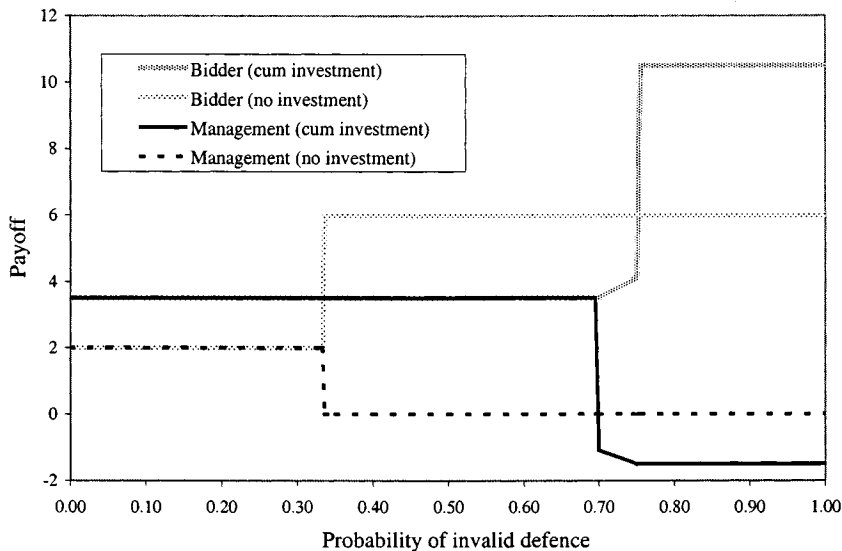
(between \$2.40–\$2.60) compared to where the parties bargain (where welfare is \$7) or management acquiesces to a bid (\$9).<sup>127</sup> Litigation is not, however, inevitable — the parameters driving it are a low discount rate<sup>128</sup> and a high value that management places on control.<sup>129</sup>

In the ‘does not invest subgame’, the solution is more straightforward:

$$\begin{cases} p < 0.33 & \text{B and M bargain} \\ p > 0.33 & \text{B bids, M acquiesces} \end{cases}$$

Although there is no wasteful litigation in this subgame, Figures 2 and 3 show that social welfare is higher where management makes the firm-specific investment over all probabilities except the litigation range  $0.7 < p < 0.75$ . Figure 2 maps the bidder’s and management’s payoffs with and without the investment. Figure 3 maps the respective social welfare functions.

FIGURE 2: PAYOFFS TO BIDDER AND MANAGER

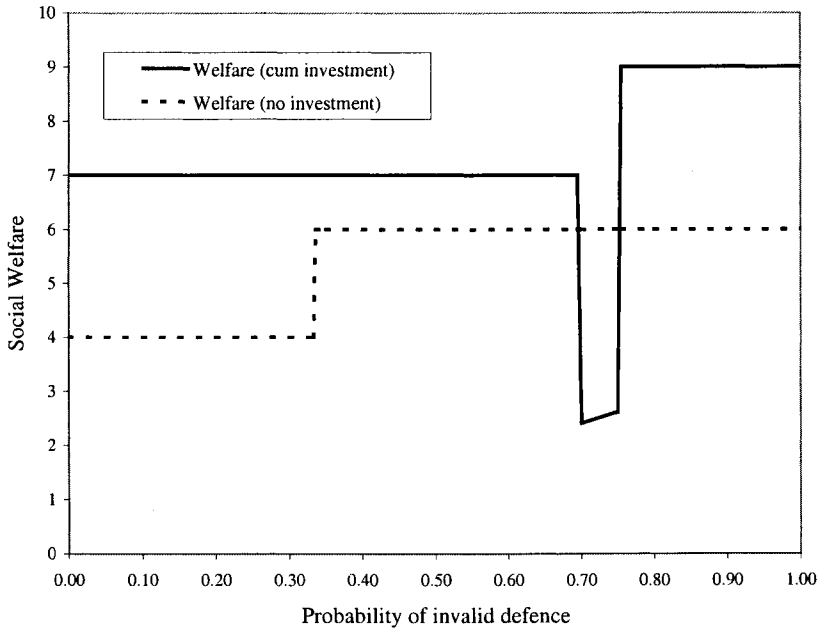


127 As Figure 3 shows, social welfare is not constant across this range. It rises somewhat, because as  $p$  rises, the bidder’s expected payoff rises faster than management’s expected payoff falls, reflecting the fact that in this example the gains from the bidder succeeding are higher than the value of control to management.

128 The higher the discount rate, the less attractive taking the time to litigate is to management.

129 The higher the value of control, the more attractive defence is as against acquiescence.

FIGURE 3: SOCIAL WELFARE FUNCTION



We may now solve the game by determining what move management will make when deciding whether or not to invest. First, we know that for  $p < 0.7$ , management maximises its welfare by investing. In this range, the bidder will always bargain. Even though management would not bargain where  $p > 0.33$  where the investment is not made, the bidder will be worse off bidding if  $0.33 < p < 0.7$  where the investment is made, because management's best response to a hostile bid is to defend. In effect, making the investment allows management to commit in advance to defending a hostile takeover under a wider range of values of  $p$ . Second, we know that where  $0.7 < p < 0.75$ , management and the bidder will litigate if management has invested. But management will not rationally invest under these conditions. Its payoff from investing in this range is between  $-1.1$  and  $-1.5$ . It is therefore better off not investing at all and acquiescing to a bid, as this earns it a payoff of 0. A fortiori, where  $p > 0.75$  management will not invest, the bidder will not bargain, and management will acquiesce. Thus, the equilibrium is:

$$\begin{cases} p < 0.7 & \text{M invests, B and M bargain} \\ p > 0.7 & \text{M does not invest, B bids, M acquiesces} \end{cases}$$

It follows that in this game, litigation never occurs (technically, it is not subgame perfect). Welfare equals \$7 where  $p < 0.7$ , and \$6 where  $p > 0.7$ .<sup>130</sup> To conclude, in this example, the highest attainable social welfare is under a rule in which defensive action is permitted in at least some cases, since it provides a positive incentive to invest.

The point of this demonstration is to show how a legal regime equidistant from those permitting defence and those requiring managerial passivity can provide better incentives than either. Although the factor driving the specific results in this example is management's investment, the example is consistent with a much more general point: transitions are highly complex events in which merits vary greatly, and which the law needs to approach flexibly. Incentives could be improved even further if the value of  $p$  varies in direct proportion to the magnitude and value of firm-specific investments. Variability is also necessary if courts are to be able to distinguish the use of governance processes from their abuse — that is, if they are to recognise the static governance cases from amongst the dynamic governance cases.

### 3 Conclusions

To conclude, dynamic governance functions are arguably best served by contingent ex post entitlements. These allow the law to apply flexibly to endgame situations, which occur infrequently and often in highly differentiated form (by definition, the circumstances in which the tailoring of legal rules is of most value). This form of law corresponds to the elastic and partly obscure boundary between static and dynamic governance cases. Contingent ex post entitlements encourage bargaining in the shadow of the imperfect balancing procedures the rules predict, at least in majority-minority cases involving attempts to appropriate minority rights and in takeover cases. They may also provide scope to protect firm-specific investments of human capital by managers. By linking the probability of allocating entitlements to the value added by various uses of governance mechanisms, the law can provide, at least at the margins, a means by which to decrease the incidence of pure rent-seeking. Finally, the variability of the law reflects the imprecise distinction between static and dynamic governance. The ambiguous meaning of the 'corporation' running through the law permits these complex demarcations to be made, if judges are willing to recognise these instrumental considerations.

## V CONCLUSION

Our theories shape our perceptions, and not least the evidence we put forward to confirm or deny them. Economists have focused their efforts on governance questions; looking at the issues which form the core subjects for contracting, it is little wonder that they have found support for their contractual characterisations

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130 First-best efficiency (\$9) is not achieved, since management will never invest and acquiesce to a hostile bid.



of corporations. Lawyers, by contrast, have had more to say about how juristic entities fit with other legal concepts, which include the *sui generis* issues associated with the corporation as a contractor and other static property functions. However, their concept of the corporation as entity is pathological, not only because lawyers have long ignored the central contracting and governance issues, but also because they have neglected the instrumentalism of the concept within the law itself.

In this article, I have addressed the weaknesses of both approaches by bringing elements of each together. The first step lies in bringing to the foreground corporate property: corporate contracts define various claims to it, and performance of such contracts transforms that property over time. Yet economic theories have only begun to address proprietary issues, and much of the property law analysis remains incomplete. The essential lines of inquiry lie in the definition and protection of property, and in the means by which contracts affecting that property are entered into. These are not purely questions of property and contract law; they raise unique corporate law issues worthy of theoretical treatment, in addition to their many doctrinal implications.

Concern with governance is, of course, firmly established in modern policy and scholarship. But the subject is not a wholly happy one, for we vacillate between the deregulatory, minimalist credo of economists and the willingness of modern regulators to intervene in private ordering. The answer lies not in striking a 'balance', and justifying some mandatory law as consistent with a mixed economy,<sup>131</sup> but in more appropriate distinctions between governance issues in terms of the circumstances in which the state can play a meaningful role. The critical juncture I have identified in this article is in important transitions, especially in the use of governance processes to suppress or promote these transitions or to vary important parts of the static governance structure of the firm.

I have argued that, seen in these terms, corporate law principles have, at least traditionally, been sharply differentiated. Static property issues have employed principles that define and protect the corporation's property rights. This explains the literal treatment of the corporation as an entity, since it most easily facilitates the identification and transfer of title. It also explains the use of inflexible principles subject to *ex post* permission in areas as divergent as fiduciary duties and capital maintenance. Dynamic property issues utilise the liability rules of contract law and corporate law principles designed to allocate risks in a way that is most consistent with the working of the market. In this area, corporate law has faced complexities; the entity concept has functioned as a heuristic model for working these principles out. Statute, however, is playing an increasingly important role, often simplifying the application of the somewhat complex and occasionally dysfunctional characteristics of the common law.

The hallmark of much of corporate law's relation to governance is passivity, and thus self-enforcement. Self-enforcement can be facilitated through passive

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131 Dimity Kingsford Smith, 'Interpreting the Corporations Law — Purpose, Practical Reasoning and the Public Interest' (1999) 21 *Sydney Law Review* 161.

deference to the operation of governance structures and by the static property functions of corporate law that lock shareholders, as a body, into corporations. The parties remain at liberty to enforce any explicit deal they may agree to. Corporate entity concepts function instrumentally in this area, by standing in the place of the value of assets, and also by legitimating the importance of constitutional structures to which the law may defer. The fault line that separates passivity from intervention becomes relevant in the areas in which normative and governance systems are transformed — what I have called dynamic governance issues. Here, traditional corporate law had developed a more discriminating ex post jurisdiction. It allocated ex post contingent entitlements, a jurisdiction I have advanced tentative economic justifications for, both in its flexibility as a regulatory standard and in light of its incentive to enter ex post efficient trade.

Apart from its value in clarifying the connection between the entity concept and the economic analysis of corporate law, my analysis has, at the very least, suggestive value for various contentious policy issues. For example, it affirms the orthodox economic scepticism of the value of an intensified standard of care for directors, unless it is coupled with an explicit freedom to contract for releases of liability in cases where overreaching is not involved. Second, it suggests that attempts to widen the scope for derivative suits by directors is substantially undesirable, in part because there are few rights shareholders should desirably enforce by way of liability rules, and in part, because the blurred quality of the key exception, fraud on the minority, is something the law should preserve. However, my analysis is by no means a complete defence of the *ancien régime*. The entity concept's value as a heuristic tool should not blind us to the fact that it often failed to achieve its purpose, especially as judges came to apply it as a formalistic concept, requiring legislative intervention in areas such as ultra vires actions and pre-incorporation contracts.

To conclude, it is clear that economic analysis has unnecessarily divorced itself from the entity concept. The entity concept provides a way of analysing the role of property in a theory of the incorporated firm. The concept generally has played a vital part in the evolution of corporate law, pushing the law towards efficiency. The ontological imprecision of the concept allows it to take a role in discrete functional areas of corporate law and to support quite distinct legal forms. The law accepts fictions that resolve important questions: both economic and legal formalists would do well to understand this characteristic before venturing either to dismantle or overload the current law.