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# Reforming Corporate Governance: What History Can Teach Us

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## INTRODUCTION

For more than two decades, a debate has raged among scholars interested in corporate law, governance, and finance about how control over key corporate decisions should be allocated between shareholders and directors. The debate was incited by the spate of hostile tender offers that took place in the 1980s, spurring academic interest in the legal obligations of directors in response to these kinds of transactions. Over the years since, corporate law scholars have generally divided into two camps,<sup>1</sup> one arguing that corporate directors should not be permitted to engage in defensive actions that pose barriers to shareholders' acceptance of tender offers,<sup>2</sup> the other arguing that corporate

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\* Professor of Law, Georgetown University Law Center. I would like to thank the Georgetown-Sloan Project on Business Institutions for research support while I worked on this Article. I would also like to thank KC Goyer and Amir Raz for devoted research assistance, and participants in the symposium on "The Role of Law in Promoting Long-term Value for Public Shareholders," sponsored by the *Berkeley Business Law Journal* and the Mercatus Center (2003), for helpful comments and feedback. All remaining errors of fact or logic are, of course, my own.

1. Marcel Kahan and Edward P. Rock summarize the positions of the two sides in this debate, labeling those who believe shareholders should always decide "Jacksonians" and those who believe directors should always decide "Hamiltonians." Marcel Kahan & Edward P. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, 152 U. PA L. REV. 473 (2003).

2. See e.g., Lucian Arye Bebchuk, Comment, *The Case for Facilitating Tender Offers*, 95 HARV. L. REV. 1028 (1982) (arguing that directors should not be allowed to frustrate takeover bids but should advise shareholders as to fairness and seek competing bids); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001) (proposing that shareholders should be entitled to opt into a body of federal takeover law that would require the board to remove a pill if a majority of outstanding shares vote in favor of a takeover bid); John C. Coates, IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323 (2001) (arguing that even shareholder bylaws cannot effectively eliminate the takeover-chilling effect of poison pills); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing that the decision about whether to accept a tender offer should rest with the shareholders alone, and that directors should be required to be passive in the face of a takeover bid); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) (same); Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997) (arguing that shareholders should be able to adopt a bylaw that would allow them to control the use of poison pills in takeover battles); Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)* (June 2000) (Columbia Law School, The Center for Law and Economics, Working Paper No. 177) (arguing that shareholder bylaws can restore to shareholders decision-making power with respect to tender offers that had been denied them by poison pills); William W. Bratton & Joseph A. McCahery, *Regulatory*

directors, not shareholders, should decide whether control of a company should be sold, and should have protection under the business judgment rule for whatever decision they make.<sup>3</sup>

In addition to the question of who should decide whether a company should be sold to a hostile bidder, the corporate scandals of the last few years have raised serious questions about the quality and effectiveness of the governance of U.S. corporations and have prompted numerous reform proposals as well as at least one major, new piece of legislation addressing corporate governance arrangements.<sup>4</sup> Again, competing diagnoses of the problem and corresponding reform proposals generally fall into two camps: one set of reforms based on the

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*Competition, Regulatory Capture, and Corporate Self Regulation*, 73 N.C. L. REV. 1861, 1926-27 (1995) (proposing a federally mandated privilege of direct shareholder access to amend the charter). See also Lucian Arye Bebchuk, *The Case for Empowering Shareholders* (Apr. 2003) (Berkeley Olin Program in Law and Economics, Working Paper No. 86) (arguing that shareholders should have the right not only to vote for or against any merger or acquisition plan, but to initiate the sale of the firm or its assets), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=387940](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387940).

3. See, e.g., Leo Herzel et al., *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980) (arguing that directors' actions in response to a takeover bid should be protected by the business judgment rule); Martin Lipton, *Takeover Bids in the Boardroom*, 35 BUS. LAW. 101 (1979) (same); Martin Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981) (same); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1991) (showing how constituency statutes bring state laws that constrain management decision-making more in line with case law equating stockholders' interests with the corporation's interests); Steven M. H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991) (arguing that directors' duties are owed to the corporation itself, and not directly to shareholders, and that existing law protects them if they make decisions in the face of hostile takeovers to consider "corporate" interests as well as shareholders' immediate financial interest). Early opinions of the Delaware courts seemed to support the idea that corporate responses to unwanted takeover bids were a matter of business judgment. See *Unocal v. Mesa Petroleum Corp.*, 493 A.2d 946 (Del. 1985); *Panter v. Marshall Field*, 646 F.2d 271, 293 (7th Cir. 1981) (upholding use of business judgment rule to dismiss plaintiffs' claims against directors for successfully defending against takeovers); *Johnson v. Trueblood*, 629 F.2d 287, 283 (3d Cir. 1980) (holding that the business judgment rule protects majority shareholders' decisions unless control is the sole or primary motive); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 701-02 (2d Cir. 1980) (applying business judgment rules to directors' attempts to defend against takeover). Citing *Unocal*, Robert Thompson notes, "the [initial] response of the Delaware Supreme Court was a resounding affirmation of the board's primary and active role and its 'fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived irrespective of its source.'" Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No"*, 67 U. CHI. L. REV. 999, 1006 (1999). See also Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002) (defending the key choices of the Delaware Courts since *Unocal* as providing an appropriate balance between director control and accountability).

4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C. and 28 U.S.C.) [hereinafter Sarbanes-Oxley Act]. Other changes include the proposed new New York Stock Exchange listing rules and the proposed new NASDAQ rules. See New York Stock Exchange, Report of the Corporate Accountability and Listing Standards Committee (June 6, 2002), available at [http://www.nyse.com/pdfs/corp\\_govreport.pdf](http://www.nyse.com/pdfs/corp_govreport.pdf); Amendments of April 4, 2003, available at <http://www.nyse.com/pdfs/amend1-04-09-03.pdf>; Amendments of June 20, 2003, available at <http://www.nyse.com/pdfs/2002-46am2.pdf>; NASDAQ, Summary of NASDAQ Corporate Governance Proposals as of September 10, 2003, available at [http://www.nasdaq.com/about/Corp\\_Gov\\_Summary.pdf](http://www.nasdaq.com/about/Corp_Gov_Summary.pdf). See also The Conference Board Commission on Public Trust and Private Enterprise, 2002-03 (advocating various corporate governance reforms), available at <http://www.conference-board.org/PublicTrust.htm>.

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idea that shareholders need more direct ways to monitor and influence corporate managers and directors, and another set based on the idea that corporations should be run by managers and directors rather than shareholders, but that directors need to be more independent of managers, better informed, and more conscientious in their duties.

In this Article, I turn to the history of corporate law for insight into the role that the corporate form plays in the organization of business enterprises. I then draw implications from this history for thinking about circumstances and situations in which corporate directors should have unimpeded control over business decisions, versus situations in which shareholders should have more input and control over business decisions. In Part I, I review historical evidence of the rapid growth in demand for the corporate form to organize businesses in the United States during the early nineteenth century. I compare the law that governed corporations at that time to the law that governed partnerships and so-called “joint-stock” companies. This comparison, together with anecdotal evidence from the period, suggests that businesspeople found the corporate form to be a superior mechanism for organizing certain businesses largely because it allowed the entrepreneurs and managers to “lock in” the capital invested in the enterprise, thereby making it possible to invest in long-lived, highly specific assets.<sup>5</sup>

In Part II, I compare corporate law and the law of partnership and other organizational forms today to see whether these forms provide substantially different default rules. I conclude that the lock-in of assets under corporate law default rules is still one of the most important distinguishing characteristics of this organizational form. In Part III, I argue that the decision of a firm’s organizers to choose one organizational form or another, given the wide array of legal form choices available, should be taken as a signal that the organizers wanted the features of the form they chose. I also argue that the default rules of the chosen organizational form, as well as any special charter provisions that alter those default rules, should be taken as evidence of a pre-commitment by firm organizers to the decision-rules implied by that choice of organizational form. In particular, I argue that, in choosing the corporate form, organizers opt into a set of rules and a body of law (unless otherwise specifically indicated in the charter) that yields important decision rights to corporate directors. Among the most important types of decisions yielded to directors in choosing the corporate form are decisions about the dissolution of the firm, distributions of assets, transactions that would fundamentally alter the business or its organizational form, and sales of securities that would effectively transfer

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5. This section is taken in large part from an article I recently published in the UCLA Law Review. Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the 19th Century*, 51 UCLA L. REV. 387 (2003) (providing a detailed history of the emergence of corporate law in the U.S. in the nineteenth century).

control of the company. If business organizers wanted to make it easier for investors to withdraw assets from the firm, or to make it easier to transfer control to another set of managers for any reason, they could have organized the business as a general partnership or a limited partnership and made provisions in the partnership agreement to give investors control over these decisions. In recent decades, business organizers have had even more options, given the possibility in most states of organizing as a limited liability partnership (LLP), limited liability limited partnership (LLLP), or as a limited liability company (LLC)—forms that can be thought of as hybrids between corporations and partnerships.

Under default rules of the corporate form, equity investors cannot unilaterally decide to withdraw “their” share of assets. Default rules in all of the other forms, however, give non-passive “members” or investors leeway to withdraw from membership at will, and in many cases withdrawal by a member requires either dissolution of the firm or buyout of their shares by remaining members. Thus, I argue that corporate governance proposals that would make it easier for individual shareholders (or shareholders as a group) to “exit” the firm and withdraw capital contradict one of the purposes of choosing the corporate form over other organizational forms. Because the corporate form is the only form that provides effective lock-in of the capital used in the business, investors would lose the ability to pre-commit their capital if corporate law were changed to give shareholders the right to exit easily. Such a reform would, in effect, reduce the number of distinct organizational options now available to investors, and hence, without substantial proof that the option to lock in capital is harmful, or at least not needed or wanted, the presumption should be against such “reforms.”

On the other hand, reform proposals that enhance shareholder “voice” or strengthen the independence of directors are not inconsistent with the original purpose of the corporate form, and may add value by helping to reduce agency costs.

## I. WHY BUSINESS ORGANIZERS WANTED TO USE THE CORPORATE FORM IN THE NINETEENTH CENTURY.

In 1800, there were only 335 chartered business corporations in the United States, and most of these had been chartered after 1790.<sup>6</sup> By 1890, there were nearly 500,000 chartered business corporations in the United States,<sup>7</sup> far more than in any other country.<sup>8</sup> During this same period, the United States was

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6. See JOSEPH S. DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS, Tbl. I and surrounding text (1917).

7. See DOW VOTAW, MODERN CORPORATIONS 24 (1965).

8. See ROBERT WRIGHT, THE WEALTH OF NATIONS REDISCOVERED: INTEGRATION AND

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transformed from an economically weak and dependent country into a world leader in industrial production. How did this happen? This section argues that as the technical advances of the industrial revolution enabled businesspeople to undertake larger, more complex, and more long-lived business ventures, these businesspeople also sought organizational innovations to take advantage of expanding markets and new mass production technologies. In particular, they began to experiment with new organizational forms that had what we now consider to be corporate-like features, including capital raised from passive investors with tradable shares, centralized management, limited liability, and, as I will argue below, some ability to “lock in” capital contributions.

### *A. The Industrial Revolution and the Need for Long-Lived Business Institutions*

In 1800, most commercial activity consisted of small local transactions between individuals who produced products in their homes and other individuals who wanted to buy and use them, or sometimes between the individual producers and merchants who bought products produced by many households and then transported them to markets where they were sold to households that wanted to buy and use them. Only a few types of commercial activity—trading expeditions, banking and insurance, for example—required a significant amount of capital investment to be tied up over an extended period of time. And even for these activities, the capital commitments usually lasted only a few years. From 1800 to 1860, however, the United States witnessed massive advances in transportation, communications, and manufacturing technology that greatly increased productive capabilities in agriculture, mining, and manufacturing, and massively expanded access to markets.<sup>9</sup>

This industrial revolution brought new opportunities to businesspeople to undertake productive ventures, such as building and operating roads, bridges, railroads, or factories, that had the potential to continue in operation for decades. In the early 1800s, a group of businesspeople who wanted to undertake a long-term joint business venture had three choices about how they could organize their enterprise.<sup>10</sup> They could form a general partnership, in which the participants would jointly own and manage the assets of the business and share responsibility for the liabilities of the business. They could form an unincorporated joint stock company, which was a special type of partnership that used trust law to separate the assets of the enterprise from the personal

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EXPANSION IN AMERICAN FINANCIAL MARKETS, 1780-1850, at 159-61 (2002).

9. With the exception of the U.S. postal system, most of the transportation, communications, and manufacturing infrastructure put in place during the first six decades of the nineteenth century was not financed or managed by federal or state government, but rather was accomplished by private businesspeople. See SIDNEY RATNER ET AL., THE EVOLUTION OF THE AMERICAN ECONOMY, chs. 5, 7 (1979).

10. A single individual could operate a business as an individual proprietorship, but for purposes of this Article I will consider only organizational forms that involve more than one person.

assets of the partners (or “members” as they were sometimes called). This made it possible to raise capital from passive partners. Or they could attempt to form a chartered corporation.<sup>11</sup> A partnership could be formed by a handshake or by a relatively simple contract binding the partners together for purposes of engaging in the business activity. The formation of a joint stock company required a more complex contract in which a trust was created; the resources contributed by investors were put into the trust; and trustees were assigned to manage the trust for the benefit of the investors. Investors were then given tradable claims on any distributions from the trust. Still, these contracts could be drawn up among private individuals and no involvement of the government was required. To form a corporation, however, businesspeople were required to ask their state legislatures to pass a special act granting the business organizers a charter to create a separate legal entity to hold the assets to be used in the enterprise.

Why were businesspeople willing to go to the trouble and expense of seeking a special act of the legislature if they could easily use the other two organizational forms? Why were organizers of corporations willing to yield property rights over the assets used in production to a separate legal entity, rather than retaining a direct pro-rata claim on the assets, as they would in a partnership or joint-stock company? To understand the answers, it is helpful to think about the contracting problems facing organizers of large complex businesses such as those that entrepreneurs first began assembling and operating in the early- to mid-nineteenth century and that continue to dominate commercial activity today.

In previous work of my own and with Professor Lynn Stout, I have described the problem of assembling and coordinating the use of complex inputs for long-term or continuous production as a “team production” problem.<sup>12</sup> “Team production,” as the phrase is used by economists, refers to production that requires various inputs of differing types from two or more individuals, and for which the output is not easily separable into pieces or portions that are attributable to the various inputs individually.<sup>13</sup> When inputs

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11. A fourth organizational form, often referred to as a “Massachusetts business trust,” was sometimes used. This was an unincorporated organization that was very similar to the unincorporated joint stock company, except that the passive investors had limited liability, and the trust could remain in existence only as long as certain specified members were alive. See NORMAN D. LATTIN ET AL., *CORPORATIONS: CASES AND MATERIALS* 62-65 (1968). I thank Arthur Jacobson for calling my attention to this form. See, e.g., Arthur Jacobson, *The Private Use of Public Authority: Sovereignty and Associations in Common Law*, 29 BUFF. L. REV. 600 (1980) (describing the development of various forms of Anglo-American business associations, including trusts and joint-stock companies). Because of its similarity to the joint stock company form, and because neither joint stock companies nor business trusts are used much today, I will not include a separate discussion of the Massachusetts business trust in this Article.

12. See Blair, *supra* note 5; Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

13. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic*

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are complex, difficult to specify in advance, and at least somewhat specific to the enterprise, and when outputs are “nonseparable” and risky, it is virtually impossible to draft complete contracts that will adequately govern the relationships among the participants in the joint production process over an extended period of time. Any contract that specifies the division of output in advance introduces perverse incentives into the relationship.<sup>14</sup> Any contract that fails to specify the division of the output, however, is likely to lead to costly “rent-seeking” behavior among the participants over time, as the joint surplus is realized.

The three types of organizational structures mentioned above are all based not on detailed contracts among participants, but rather on agreements among participants about process rules for governing how decisions will be made among the participants over the course of the venture. Under the rules of partnership that applied in the early 1800s, businesspeople could form a partnership simply by agreeing to act as partners in undertaking a certain business activity and to share the profits and liabilities associated with the business.<sup>15</sup> Partnership assets were considered to be the joint property of the partners, and contracts entered into by any partner with outside parties in connection with the business were legally binding on all partners. Unless the partnership agreement specified otherwise, the agreement was assumed to be at-will. This meant that any partner could terminate the relationship at any time, and for any reason, thereby forcing the other partners to either liquidate the assets of the business or buy out the share of the departing partner. An exception to this default rule would be made if the partners had explicitly agreed to continue in the relationship for a certain period of time, or until certain conditions were met (such as the completion of a particular discrete project or venture). In such a case, any partner could still exit the partnership at will and force dissolution, but the exiting partner might be required to pay damages. A partnership would automatically be dissolved if a partner died, became insane, or entered into bankruptcy proceedings.<sup>16</sup>

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*Organization*, 62 AM. ECON. REV. 777 (1972).

14. Alchian & Demsetz, *supra* note 13; Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982); Blair & Stout, *supra* note 12.

15. See 3 JAMES KENT, *COMMENTARIES ON AMERICAN LAW* 1, at 1-13 (Da Capo Press 1971) (1826) (laying out the basic features of partnership law, which, according to Kent, had “attained the precision of a regular branch of science” by the time of the writing of his treatise); Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 429 (1987) (noting that “partnerships are often informally organized, carelessly managed, less than prosperous, and, when viewed individually, relatively inconsequential.”). Simple general partnerships can still be formed on a handshake or oral agreement. See, e.g., *Bailey v. Broder*, 1998 WL 13827 (S.D.N.Y.) (on whether the oral agreements entered into by plaintiff and defendant constituted a “partnership” under New York Partnership Law). See also ROBERT HAMILTON & JONATHAN MACEY, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 154 (8th ed. 2003) (discussing “inadvertent partnerships”).

16. 3 KENT, *supra* note 15, at 28 (noting that partnerships were assumed to be “at will” unless

Each partner in a business venture organized as a partnership, therefore, had tremendous power over the other partners. Any partner could enter into contracts that bound the other partners. That partner could incur debts for which the other partners could be held liable. Or he could threaten to withdraw, forcing dissolution of the business, if he did not get what he wanted out of the partnership. And each time a partner withdrew, or died, or had to exit the partnership for some other reason, the partnership had to be reorganized to keep the business going.<sup>17</sup>

While partners had considerable power to protect themselves against unfair expropriation of the benefits of team production by other partners, the set of relationships embodied by the partnership were vulnerable to disruption by disputes among partners, as well as the death or even just bad luck of one or more partners. This complicated the relationships not only among the partners, but also between the partnership and its suppliers and customers, who surely understood that the partnership was highly vulnerable to dissolution. Thus, while partnerships provided a potential solution to the “team production” problem, they could be difficult to manage over an extended period of time.<sup>18</sup> Participants in a large network of business relationships in which mutual success depends on numerous individuals making team-specific investments over a sustained period of time require more assurance of continuity and financial stability.

Understanding the vulnerability of the partnership form, businesspeople began using a variation on the partnership form called a “joint stock company.” As early as the seventeenth century, joint stock companies were used in Europe to undertake trade missions.<sup>19</sup> In the earliest joint stock companies,<sup>20</sup> a group of merchants would pool their “stocks” (the goods they had for trade) and collectively hire a ship to undertake a trade mission. The charters that these

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otherwise stated in the partnership agreement); WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 139 (8th ed. 2002) (noting that “under partnership law, it is easy for a partner to terminate his or her involvement with the firm”); EDWARD H. WARREN, *CORPORATE ADVANTAGES WITHOUT INCORPORATION* 18 (1929) (“Even if the partnership is not at will, the weight of authority in this country is that any partner may dissolve it at any time.”).

17. Even in contemporary times, casebook authors Robert W. Hamilton and Jonathan R. Macey note that “a general partnership is . . . fragile.” HAMILTON & MACEY, *supra* note 15, at 11.

18. Business historian Alfred Chandler tells us that traditional business partnerships in the early nineteenth century were generally “short-lived.” ALFRED CHANDLER, *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 8 (1977). Nonetheless, a few major corporations, such as DuPont, Carnegie Steel, and Baldwin Locomotive Works, managed to operate as partnerships over several decades in the nineteenth century, not converting to corporate form until early in the twentieth century. See Blair, *supra* note 5, at 59-64, for a discussion of why these ventures were able to function effectively as partnerships for so long.

19. Henry Hansmann et al., *Legal Entities, Asset Partitioning, and the Evolution of Organizations* (Feb. 2002) (working paper, copy on file with author).

20. The British East India Company was chartered in 1600; the Dutch East India Company was chartered in 1602. See Hansmann et al., *supra* note 19, at 43.

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groups had been granted by their respective kings gave them monopolies over the rights to trade, as well as the rights to establish colonies, in certain parts of the world.<sup>21</sup> The companies' ships embarked on trade missions, and upon their return, the stock of goods acquired in trade would be divided among the merchants and the "company" essentially dissolved, to be reformed under the same charter for the next trade mission. Eventually, some chartered companies decided to stop distributing the proceeds at the end of each trade mission and instead commit their initial capital for an extended period. In 1623, the Dutch East India Co. was granted the right of perpetual existence. Under this new arrangement, the company members were no longer entitled to repayment at the end of each voyage, since some funds or stocks were always retained for the next trade mission. Instead, member merchants could, with the approval of other members, sell their "shares" in the company, much the way members of the New York Stock Exchange today can sell their "seats" or membership in the exchange. In 1654, the British East India Company also adopted a rule of perpetual existence, accompanied by full transferability of shares.<sup>22</sup>

During the late seventeenth and eighteenth centuries in the United States, entrepreneurs pursuing other kinds of business, especially banking and insurance, formed similar organizations. Many of these organizations sought charters from the states to give them special privileges, such as the right to issue currency. By the late eighteenth century, however, entrepreneurs pursuing business ventures that did not require any special monopoly or franchise from the state were increasingly using unchartered joint stock companies for such businesses as land speculation and settlement,<sup>23</sup> harvesting and selling natural resources such as coal,<sup>24</sup> small manufacturing (especially of textiles),<sup>25</sup> and building canals and roads.<sup>26</sup>

Legally, unchartered joint stock companies were partnerships in which partners agreed to place the assets used in the business into a trust controlled by

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21. The charters also gave them extended life; however, they did not legally partition the assets by creating a separate legal entity to own the property. At any point in time, the assets of these companies consisted of the "joint stocks" of the merchants who were members of the company at that time.

22. Hansmann et al., *supra* note 19, at 44.

23. SHAW LIVERMORE, *EARLY AMERICAN LAND COMPANIES: THEIR INFLUENCE ON CORPORATE DEVELOPMENT* 73 (Octahon Books 1968) (1939).

24. In an earlier article, I trace the history of the Lehigh Coal Mine Company and the Lehigh Navigation Company in the early nineteenth century. Blair, *supra* note 5, at 399-404, 416-20. Both were unincorporated joint stock companies. *Id.* at 399, 416. In the 1820s, the two companies merged and were granted a charter as the Lehigh Coal and Navigation Company by the Pennsylvania legislature. *Id.* at 420.

25. W. BAGNALL, *TEXTILE INDUSTRIES OF THE UNITED STATES* (1893); RONALD E. SEAVOY, *THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855* (1982).

26. Hugh L. Sowards & James S. Mofsky, *Factors Affecting the Development of Corporation Law*, 23 U. MIAMI L. REV. 476 (1969), note that there is no record of how many unchartered joint stock companies may have been formed in the late-eighteenth and early-nineteenth centuries, precisely because such organizations were not granted charters, nor were they otherwise registered.

a group of trustees, in exchange for transferable claims on distributions from that trust.<sup>27</sup> In this way, the promoters were able to achieve some degree of commitment of resources to the business venture (i.e., assets in the trust remained in the trust, even as individual investors sold their "shares" to other investors). This form also made it possible for some investors to be passive, since control rights over the assets were vested in the trustees of the trust. This, to some extent, separated the role of control from the role of investment in the business and made it possible to raise capital from a larger number of investors.

But the commitment of resources was only partial. Because the courts regarded unchartered joint stock companies as a species of partnership, members were regarded as holding pro-rata direct interests in the property of the partnership. Although the organizers of a joint stock company could agree among themselves to commit funds to the partnership trust indefinitely, these agreements apparently were not binding on the members' heirs.<sup>28</sup> So, if a joint stock company member died, the heirs could compel dissolution, just as heirs of partners in an ordinary general partnership could compel dissolution upon the death of the partner.

Moreover, the joint stock company form did not completely separate the role of investing from the role of controlling the company. Because courts at the time regarded joint stock companies as a species of partnership, they generally held that the members selected the trustees and could therefore withdraw authority from the trustees at any time. Hence, members were considered to have legal control over the enterprise, and could therefore be held personally liable for debts of the business just as individual partners could be held personally liable for debts of an ordinary general partnership.

Apparently these problems were not considered trivial. In a pamphlet published in 1823 by seven businesspeople attempting to organize the

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27. In England, the Bubble Act of 1720, passed in the wake of a financial collapse and associated market scandals, made it illegal to trade in shares of unchartered joint stock companies. This greatly slowed the development of this organizational form in England for more than a century, until the Bubble Act was repealed in 1825. See Ron Harris, *The Bubble Act: Its Passage and Its Effects on Business Organizations*, 54 J. ECON. HIST. 610 (1994). During that period, the English Parliament granted charters for joint stock companies very reluctantly, which also slowed the development of the chartered corporate form. England did not clear up the confusion and pass a general incorporation act that clearly permitted businesspeople to organize themselves into companies and receive a charter simply by registering until the passage of the English Companies Act of 1844 made incorporation more widely available. See Bishop C. Hunt, *The Joint-Stock Company in England, 1830-1844*, 43 J. POL. ECON. 331 (1935); Paul G. Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873 (2000).

28. Paddy Ireland, *Capitalism without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality*, 17 LEGAL HIST. 41, 44 n.13 (1996) (citing WILLIAM WATSON, A TREATISE OF THE LAW OF PARTNERSHIP 3-5 (2d ed. 1807)) traces the history of court cases in England, demonstrating that, prior to about 1837, English courts consistently found that shareholders in joint stock companies, whether incorporated or not, had a direct property interest in the assets of the firm. In the United States, it appears that courts followed this line of reasoning for unincorporated joint stock companies, but not for chartered corporations, which, as I explain in the next section, were always understood under American law to be separate legal entities.

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Schuylkill Coal Company and seeking a charter from the state legislature in Pennsylvania, the organizers listed the following reasons why they needed a charter:

1. To have the real estate of the Company, consisting of the coal lands which they hold, and such limited additional quantity as they may be allowed to acquire, with the necessary and appropriate improvements for the working of the mines, exempted from the laws of succession or inheritance, which govern the cases of natural persons or individuals. 2d. That the Company should be exempted from the ordinary laws of partnership, so far as they subject the estates of the several individuals who compose the Company to all the liabilities of the Association. 3d. To be recognized in law by a corporate name, and to be perpetuated, notwithstanding the demise or change of the members who may at any given time compose the Company.<sup>29</sup>

The pamphlet goes on to stress the particular problem that would arise if a member of an unincorporated joint stock company were to die:

If one of the partners die, his undivided interest will descend by inheritance, or pass by devise to his heirs, who may consist of numerous children, in infancy, or numerous collateral relations, widely spread, and difficult of recognition. The operations of the Company must, on this event, immediately cease, and the joint estate be sold for division, or be otherwise divided between the survivors and the heirs of the deceased member, according to the decree of a proper legal tribunal, perhaps after a tedious suit, involving intricate questions of partnership claims, accounts, and settlements.<sup>30</sup>

The promoters of the Schuylkill Coal Company were clearly aware of the possibility of using trust law to try to protect the assets of the enterprise. But they were not confident that organization as an unincorporated joint stock company, or the use of the business trust, would provide adequate protection:

Some of these difficulties may indeed be avoided by complicated trusts, covenants, and stipulations; but these, plain men of business cannot themselves frame, nor without difficulty understand; and when framed under the advice of the best legal abilities, they are subject nevertheless, to various constructions, and end but too frequently in vexatious and injurious controversies, which prudent men will anxiously avoid.<sup>31</sup>

The organizers of the Schuylkill Coal Company obviously believed, and the legal record supports the idea, that if the enterprise were organized under a corporate charter granted by the legislature, these problems could be solved.

### *B. How the Corporate Form Helped Lock in the Capital*

The earliest incorporated entities in the United States were either chartered trading companies that had received their charter from the English king before the Revolution, or they were eleemosynary institutions, municipalities, towns,

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29. MANUEL EYRE ET AL., REMARKS AND OBSERVATIONS SHOWING THE JUSTICE AND POLICY OF INCORPORATING "THE SCHUYLKILL COAL COMPANY" (1823) (pamphlet in the collection of the Hagley Library).

30. *Id.* at 1.

31. *Id.* at 2.

settlements, or chartered banks or insurance companies. Occasionally, corporations were chartered to carry out some public works project, such as building a road, bridge, or canal, or providing a supply of water to some municipality.<sup>32</sup> As late as 1826, James Kent, in his *Commentaries on American Law*, observed that English law recognized two broad classes of corporations: "ecclesiastical" or "lay."<sup>33</sup> Ecclesiastical corporations were religious societies that incorporated in order to provide a mechanism for holding property over time, as individual members came and went. Lay corporations, Kent noted, "are again subdivided into eleemosynary and civil." Eleemosynary institutions included hospitals, colleges and universities, or other institutions organized to provide charitable services to the indigent. Civil corporations, on the other hand, were further parsed into "either public or private."<sup>34</sup> By public corporations, Kent meant entities that exist for "public political purposes such as counties, cities, towns, and villages."<sup>35</sup>

Only the final subdivision of "private" corporations included business corporations. Of Kent's categories, private corporations were the only ones that might engage in strictly commercial activity, although in the late eighteenth century even corporations in this category were expected to provide some needed service.<sup>36</sup> Clearly, in all of these categories, the primary reason why the state provided a charter incorporating the entity was to create a mechanism of holding property for some public, charitable, educational, or religious use, so that such property would not be owned by the individuals who at any point in time might be managing the organization or charged with making decisions about the use of the property. Since the property held by an incorporated entity was not owned by individual persons, it could not be passed to the heirs of such persons, but continued to be the property of the institution, even as its "managers" (mayors, bishops, or presidents, for example) came and went. The concept of separate legal personhood was developed with respect to these non-business types of corporations, and it is from this legal development that the law governing business corporations in the United States apparently evolved.

After the American Revolution, the new American states began, tentatively at first, granting corporate charters to business promoters, to establish banks, to

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32. See LIVERMORE, *supra* note 23, at 9-36 (describing "precedent forms of association"); see also VOTAW, *supra* note 7, at 19 (noting that "the concept of *persona ficta* did not begin with commercial associations but with religious, educational, and municipal associations").

33. 2 KENT, *supra* note 15, at p. 221-22.

34. *Id.* at 222.

35. *Id.*

36. State courts apparently regarded it as an inappropriate use of legislative power for the legislature to grant corporate status for purposes that were not regarded as in the public interest. See, e.g., Curries Admin. v. Mutual Assurance Soc'y, 14 Va. (4 Hen. & M.) 315, 347-48 (1809) (arguing that "it may often be convenient for a set of associated individuals to have the privileges of a corporation bestowed upon them; but if their object is merely private or selfish; if it is detrimental to, or not promotive of, the public good, they have no adequate claim upon the legislature for privilege").

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build turnpikes, or to provide other needed services. Due to the special public purpose of the businesses that were granted corporate status, it was important that the business property be held separately from the personal property of the individual business promoters, and that it not be subject to being subdivided or otherwise broken up. Ronald Seavoy, for example, notes that “the new classes of incorporated businesses were usually fairly large-scale and they often had a high risk factor.”<sup>37</sup> Incorporating a business, he added, “helped protect the collective ownership of real property [and] facilitated the mobilization of capital.”<sup>38</sup>

Although state courts would later struggle with the implications of entity status for business corporations in certain situations, and waver back and forth about the extent to which business corporations should be understood as being like partnerships or different from partnerships, the separateness of the incorporated entity from its members or participants was rarely at issue. The whole point of the charter was separateness. In fact, courts eventually took the position that they might “pierce the veil” of the separate entity in order to reach through to the individual persons associated together in the entity only if “the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime.”<sup>39</sup>

I regard legal separateness as the singular accomplishment of corporate law, the characteristic that provided the benefit business organizers so eagerly sought. In prior work with Professor Stout, I have argued that an important feature of the corporate form that helps to solve the “team production” problem is that control rights are delegated to a board of directors.<sup>40</sup> Delegation of control helps ensure that none of the participants in the enterprise can exercise too much control over factors that affect the outcome for the other participants. This makes it easier for all of the participants in the enterprise to make credible commitments to cooperate with each other. In a recent, separate article, I argue that another critical feature of the corporate form that made it the preferred way of organizing large, complex businesses in the nineteenth century was that a corporation was regarded as a separate legal entity with potentially perpetual life, and was considered the legal owner of the assets used in the business.<sup>41</sup> Holding the property in corporate form, rather than in a partnership or a joint stock company, made it easier to commit resources to long-lived, specialized business enterprises.<sup>42</sup>

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37. SEAVOY (1982), *supra* note 25, at 4.

38. *Id.*

39. See *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (C.C.E.D. Wis. 1905, as cited in STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL 1-7 (1991)).

40. Blair & Stout, *supra* note 12.

41. Blair, *supra* note 5, at 390-91.

42. *Id.* at 393.

In connection with the separate legal status of corporations, early corporate charters and general incorporation statutes made several provisions that facilitated the locking-in of capital committed to the corporate enterprise. First, as already noted, neither shareholders nor their heirs could compel dissolution of the enterprise. Second, early corporate charters provided that organizers designate a "par value" for each share of stock issued. The initial shares in the company might be issued to subscribers for a fraction of par value, and the corporation would begin its business with the money raised from these initial installments. But when this approach was used, charters always provided that the corporation could return to the subscribers at any time in the future and require them to pay the rest of the promised commitment.<sup>43</sup> Thus, from the time of the earliest corporations, financial investors who wanted to participate in a business organized as a corporation were required to make substantial financial commitments, and these commitments were considered to be part of the corporation's permanent capital.

Once committed, the capital paid into a corporation by its initial investors could be very difficult to recover. Early charters and statutes typically specified that shareholders or "members" could not withdraw their capital unless the enterprise were to be formally dissolved.

Charters often provided that investors could receive dividends out of operating profits, but not out of the permanent capital of the corporation.<sup>44</sup> Moreover, shareholders did not have a legal right to receive any dividend at all unless such a dividend was declared by directors. Also, early case law emphasized that the resources that had been invested in corporations no longer belonged to the shareholders, but rather remained the property of the corporation unless and until paid out in the form of dividends.<sup>45</sup>

The final feature of corporate law in the nineteenth century that supports

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43. See EDWIN M. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860: WITH SPECIAL REFERENCE TO MASSACHUSETTS 74 (1954). In fact, prior to the nineteenth century, corporate charters commonly did not specify a par value for their shares, and in such cases there was no legal limit to the assessments that could be made against shareholders. See Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 13 (1945) ("As first organized, therefore, corporations could replenish their coffers by drawing without limit on the resources of all their members."). Thus, the idea of corporations as separate legal persons for purposes of holding property preceded the idea of limited liability. Limited liability began to be a characteristic of some corporate charters in the 1810s, but the state of California did not provide for limited liability for business corporations until well into the twentieth century. See LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 191 (1985) (noting that limited liability was not universally available in the nineteenth century); Mark Weinstein, *Share Price Changes and the Arrival of Limited Liability in California*, 32 J. LEG. STUD. 1, 2 (2003) ("[T]he last major jurisdiction to adopt limited liability [was] California which did not adopt limited liability for corporations until 1931.").

44. CHARLES R. T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 567 (3rd ed. 1999).

45. See, e.g., Brightwell v. Mallory, 18 Tenn. (1 Yer.) 196, 197-98 (1836) (noting that "the money in the [corporation] is the property of the institution, and to the ownership of which the stockholder has no more claim than a person has who is not at all connected with the [corporation]").

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the idea that the corporate form facilitated the lock-in of capital investments is the “trust fund” doctrine. The modern trust fund doctrine holds that, in an insolvent corporation, the directors have fiduciary duties running to creditors because corporate assets are held in trust to satisfy creditors first. This doctrine was articulated clearly in an 1824 case,<sup>46</sup> in which Justice Story wrote:

It appears to me very clear upon general principles, as well as the legislative intention that the capital stock . . . is to be deemed a pledge or trust fund for the payment of the debts contracted by [the corporation]. The public, as well as the legislature, have always supposed this to be a fund appropriated for such a purpose. The individual stockholders are not liable for the debts of the [corporation] in their private capacities. The charter relieves them from personal responsibility, and substitutes the capital stock in its stead. Credit is universally given to this fund [sic] by the public, and as the only means of repayment. During the existence of the corporation it is the sole property of the corporation, and can be applied only according to its charter, that is, as a fund for the payment of its debts. . . . If the stock may, the next day after it is paid in, be withdrawn by the stockholders without payment of the debts of the corporation, why is its amount so studiously provided for, and its payment by the stockholders so diligently required?<sup>47</sup>

Thus, the corporate form made it possible for investors in shares, as well as creditors, employees, and suppliers, to enter into long-term relationships with a firm with a greater assurance that the pool of assets would remain in the business to keep the business going forward.

### *C. Why I.M. Singer & Co. Decided to Incorporate*

The story of the rise of the Singer Manufacturing Company provides an example in which the corporate form was used not to raise financial capital, nor to achieve the benefits of limited liability, but rather to lock in existing capital and to provide a mechanism for settling any subsequent disputes among the leading participants in the firm, thereby supporting the development of an extensive marketing organization.

The Singer Manufacturing Company had its start in 1851, when Isaac Merritt Singer got a patent on a machine that would make a continuous series of stitches. Singer had formed partnerships with a number of different people who provided workshop space, equipment, and financial capital while he worked on his machine design. But once he had his patent, he got out of those various partnerships and formed a new partnership with Edward Clark, a lawyer who had pushed through Singer’s patent application.<sup>48</sup>

During the next ten years, the market for sewing machines grew, slowly at

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46. *Wood v. Dummer*, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944). This case concerns a bank, but its reasoning has been widely applied to business corporations of all types.

47. *Id.* at 436.

48. RUTH BRANDON, A CAPITALIST ROMANCE: SINGER AND THE SEWING MACHINE 82 (1977). Much of the details about Singer, his business, and his relationship with Clark are taken from Brandon’s account.

first, as Singer and several other sewing machine manufacturing firms tried to convince the male breadwinners of households that it was worth spending what amounted to a very substantial amount of money relative to typical household net worth on a device that, from their point of view, had no purpose other than to make women's work easier and faster. Moreover, the various sewing machine manufacturers were continually suing each other over patent infringement claims. Indeed, Singer's design, while containing novel components, was based partly on a prior machine patented by Elias Howe in 1846. The patent wars among Howe, Singer, and the other manufacturers absorbed most of the partnership profits, and virtually all of Clark's time and energy, during the years from 1851 to 1856.<sup>49</sup> In the fall of that year, the three leading manufacturers, together with Elias Howe, who among them held dozens of patents on sewing machines and their various improvements—including all of the most important patents—agreed to form the first “patent pool.” The parties contributed all of their relevant patents to a single pool, and agreed that, for a fee of \$20 per sewing machine sold, they could all use each others' patents.<sup>50</sup>

With the patent wars settled, I.M. Singer & Co. manufactured and sold 2,564 machines in 1856, and by 1860 production and sales reached 13,000 machines. Singer and Clark were rapidly becoming very wealthy people, and, although still organized as a conventional general partnership, were beginning to build a substantial manufacturing, distribution, and sales organization. They had established sales offices in many major U.S. cities, as well as in Paris, Glasgow, and Rio de Janeiro, and were thinking about establishing manufacturing operations overseas as well. Singer and Clark, despite not particularly liking or trusting each other, had managed to establish a reasonably successful working relationship and had begun building substantial intangible assets in their brand and unique marketing organization.

Meanwhile, however, Singer was thoroughly enjoying his new wealth, and was living an unusually flamboyant life. In 1860, a series of incidents brought public attention to the fact that Singer had domestic relationships with, and numerous children by, at least four different women, only one of whom was legally his wife. To escape the wrath of the woman with whom he had been living the longest and most openly, who called herself Mrs. Isaac Singer (although he and she had never legally married), and with whom he had

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49. *Id.* at 89 (describing reports that newspapers of the era carried about the latest developments in the “Sewing Machine Wars”). This example of a partnership deciding to incorporate was previously developed in Blair, *supra* note 5.

50. *Id.* at 98. The first \$5 of this fee was to go to Howe, who held a key early patent and had won a series of court battles defending his claim. Another part of this fee was set aside for fighting future patent infringement battles against any other manufacturers who might attempt to use the devices covered by patents in the pool, and the rest would be divided among the three manufacturing firms in the pool.

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fathered eight children, Singer fled to England.<sup>51</sup>

Apart from the unseemliness and notoriety of this lifestyle (which might have had a negative impact on the ability of the firm to market Singer machines to “respectable” households), why did this matter to Clark? The problem, Clark could easily foresee, was that if the firm were still organized as a partnership at the point at which Singer died, the valuable business which the two of them had built over the previous years would be destroyed in the legal battles over claims to Singer’s estate. Singer’s heirs, however many of them there might be, would undoubtedly all attempt to claim some share of the business, and it would probably require years of court battles to establish who was to get what. Clark feared that without liquidating much of the firm, he would not be able to come up with enough cash to prevent catastrophe by buying out Singer’s share from the heirs.

The solution to this problem, Clark also realized, was to incorporate the business, and Clark hoped as part of the bargain to ease Singer out of active management. By 1860, most states had passed generalized incorporation statutes, and the corporate form was being used widely enough that Clark would have been aware of its advantages. Once incorporated, the business assets would no longer be the joint property of Clark and Singer, but would belong to the corporation. Equity shares would be issued to Clark and Singer, each of which would provide a pro-rata claim on any distributions from the business. But any such distribution would be at the discretion of the board of directors of the company, and could not be compelled by either former partner, nor by the executor of the estate, nor would it likely be compelled by any court of law handling the proceedings. Heirs could be given equity shares in the business out of Singer’s estate, and they could thereby become passive investors in the business. All this could happen without disturbing or breaking up the assets and governance structure of the business.

The company by this time had no need to raise additional capital (it was generating cash faster than it could reinvest it), nor were there any particular concerns about limiting the liability of shareholders: the firm had little or no debt (except perhaps small amounts of trade credit from materials suppliers), and class-action lawsuits for fingers injured by sewing machine thread guides and pressure feet had not yet been invented. The most important function that incorporation served was to ensure that the substantial organizational capital that had been accumulated by the firm could not be torn apart, nor could the firm’s reputation be easily destroyed, as a result of the messy personal affairs of one of the partners.

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51. This woman was Mary Ann Sponsler, who had been Singer’s most frequent and public companion for nearly twenty years, despite the fact that Singer had never been legally divorced from Catherine Haley Singer, with whom he had fathered two children. *Id.* at 162-63.

According to Singer's biographer, it took more than three years for Clark to get Singer to agree to incorporation of the business. But in August of 1863, I.M. Singer & Co. was dissolved, and the business was reorganized as the Singer Manufacturing Company. The firm by then had twenty-two patents and capital assets of \$550,000. Within four years after incorporation, it had established manufacturing and sales operations overseas, becoming the first American firm to produce and market extensively in Europe.<sup>52</sup> According to Chandler,<sup>53</sup> Singer was also the first manufacturing company to establish a sales force of its own salaried employees, rather than rely on sales agents. The Singer organization that developed in the 1860s and 1870s included retail branches in virtually every community in the United States with a population of at least 5,000 (as well as in many communities in Europe and South America). Each branch office included, at a minimum, a general salesman, an instructor (often a female employee hired to teach other women how to use the machines), a mechanic (to assure customers that machines could be promptly repaired if they broke down), and a bookkeeper.<sup>54</sup>

One other detail of the transition of I.M. Singer & Co. to the Singer Manufacturing Company, provided by Singer's biographer Ruth Brandon, suggests that the governance structure established in the newly organized corporation was designed to serve a mediating function, as the team production theory suggests, rather than to establish agents to act on behalf of shareholders, as the standard principal-agent theory of the corporation argues. Brandon says that:

Singer had only agreed to the end of the partnership [in which he knew he would lose his ability to make extraordinary demands on the other participants] under certain conditions, the principal one being that neither of the partners would be president of the new company while the other was alive, and that both would 'retire from active participation in the management of the business.' In other words . . . if Singer was to become a non-executive director, then so must Clark. If he [Clark] was so determined to dissociate Singer from the business, this was the price he had to pay.<sup>55</sup>

The agreement they ultimately reached was that Singer and Clark would each take 40 percent of the shares of the new company in exchange for their interests in the partnership, with the rest to be subscribed to by four senior officers of the firm (who were each required to buy 175 shares at \$200 per share), and twelve other employees of the company who were offered the opportunity to buy shares. A young manager, Mr. Inslee Hopper, was named president. The initial board of trustees would include Singer, Clark, Hopper,

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52. Robert B. Davies, "Peacefully Working to Conquer the World 1969": *The Singer Manufacturing Company in Foreign Markets, 1854-1889*, 43 BUS. HIST. REV. 299, 299 (1969).

53. CHANDLER, *supra* note 18, at 403.

54. *Id.*

55. BRANDON, *supra* note 48, at 179.

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George Ross McKenzie (who had been a trusted agent of the firm for a number of years), William F. Proctor, and Alexander F. Sterling.

While Singer did retire from active involvement in the company after that, Clark did not, and after Singer died in 1875,<sup>56</sup> Clark became president in 1876.<sup>57</sup> Chandler credits Clark and McKenzie with building an integrated organizational structure that became a model for many other large manufacturing and distribution companies in the late nineteenth and early twentieth centuries.

### II. IS INCORPORATION STILL ABOUT LOCKING IN CAPITAL?

Contemporary businesspeople have a much broader array of organizational forms to choose from than Clark and Singer had. In addition to general partnerships and corporations,<sup>58</sup> entrepreneurs today can organize their business affairs through limited partnerships (LPs), limited liability partnerships (LLPs), limited liability limited partnerships (LLLPS), and limited liability companies (LLCs). They can choose between closely held corporations and widely held corporations whose shares trade on public markets. And they can also choose more complex structures such as joint ventures or organizations in which one or more members or shareholders are other organizations. Within each of these categories, the laws governing their use are generally “enabling,” meaning that the organizers can use the standard form provided by the law, or customize their form by writing specific provisions into the partnership agreement, limited partnership certificate, articles of organization, operating agreements, corporate charter, or bylaws (depending on the basic form they choose).

#### *A. General Partnerships*

Under the terms of the Uniform Partnership Act (1914) (“UPA”), on which many state laws are based, a partnership is “an association of two or more persons to carry on as co-owners of a business for profit.”<sup>59</sup> Under the Revised Uniform Partnership Act (1997) (“RUPA”), a partnership is “an association of two or more persons to carry on as co-owners a business for profit formed under Section 202, predecessor law, or comparable law of another jurisdiction.”<sup>60</sup> In states that have adopted this more recent version of partnership law, a partnership is legally an entity separate from any of its

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56. *Id.* at 193.

57. CHANDLER, *supra* note 18, at 403.

58. The use of joint stock companies died out as the corporate form became readily available to business organizers.

59. Uniform Partnership Act (1914) [hereinafter UPA] § 6(1).

60. Revised Uniform Partnership Act (1997) [hereinafter RUPA] § 101(6).)

members,<sup>61</sup> which implies, among other things, that the partnership may continue as the same entity even if some partners dissociate or new partners join. This, in turn, means that property can be held and contracts entered into in the name of the partnership, and that these arrangements do not have to be revised every time a new member joins or an existing member departs. Nonetheless, partners in a general partnership still bear full joint and several liability for partnership obligations.

Under either UPA or RUPA, it is still true today that partnership relationships are assumed to be "at will" unless otherwise specified in the partnership agreement.<sup>62</sup> The effect of this default rule is that a general partner can choose to "dissociate" from a partnership at any time, merely by announcing his or her decision to stop conducting business as a partner with the other partners in the firm. Under UPA, if one partner dissociates, the partnership must formally be dissolved. The remaining partners may continue the business of the firm if they buy out the interest of the dissociating partner, but the continuing business is organized legally as a new and distinct partnership. Under RUPA, a partner's departure does not necessarily compel the remaining partners to reorganize as a new partnership in order to continue the business.

If the partnership agreement includes a provision that the partners agree to continue in partnership for a specific period of time, or until the completion of some specific venture, or if such a commitment is implied by other agreements the partners entered into (such as a lease agreement with a specified term), then the decision of a partner to dissociate can be construed as a breach of contract, or "wrongful dissociation." In such a case, the partner may still dissociate, and courts will not compel a dissociating partner to continue in the partnership. Moreover, continuing partners may still be required to buy out the share of the departing partner. But the dissociating partner may be compelled to pay damages for any harm caused to the partnership by her dissociation. Such damages will be subtracted from (and may even exceed) the value of the partner's share of partnership assets owed to the departing partner.<sup>63</sup> Thus, it is

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61. RUPA § 201(a). UPA was ambiguous about whether partnerships created under the act were separate legal entities. Being a separate "entity" means that a partnership formed under RUPA may continue to exist even as individual partners come and go; it also ensures "affirmative asset partitioning" (to use the phrase chosen by Hansmann et al., *supra* note 19), meaning that the assets of the partnership are protected from creditors and heirs of the partners.

62. A majority of states have adopted some variation on RUPA, which provides in § 601(1) that "[a] partner is dissociated from a partnership upon the occurrence of any of the following events: (1) the partnership's having notice of the partner's express will to withdraw as a partner [upon the date of notice] or on a later date specified by the partner."

63. Robert Hillman claims that the threat that damages will be imposed on a dissociating partner discourages dissociation and helps to stabilize the partnership, making it less "fragile." Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 1-88 (1982).

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almost as difficult today as it was in the nineteenth century to lock invested capital into a general partnership.

Businesspeople acting together in a general partnership carry the burden of full, joint and several liability for debts incurred by the partnership for partnership business as well as tort claims against the partnership.

### *B. Limited Partnerships*

The limited partnership (LP) form was developed in France in the early nineteenth century, but was not widely adopted in U.S. states until the late nineteenth century. Unlike general partnerships, limited partnerships may only be formed by filing a certificate of limited partnership with the relevant state authorities.<sup>64</sup> Under the limited partnership form, partners are divided into two classes: general partners and limited partners. General partners contribute assets and have general management responsibilities for the enterprise, just as partners in a general partnership do. General partners also have full, joint and several liability for partnership debts and tort claims against the partnership. Limited partners, however, may invest assets in the partnership but not participate in the management of the enterprise. If they do not participate in management, limited partners will enjoy “limited liability,” meaning that they may not be held accountable for partnership debts or tort claims beyond the amount that they contributed in acquiring their limited partnership shares.<sup>65</sup>

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64. RULPA (1976/1985) § 201(a); ULPA (2001) § 201(a). Robert Hamilton observes that “the idea that some persons should be able to contribute capital to an enterprise and share in its profits but not be responsible for its debts or losses developed comparatively recently. . . . there is no general common law of limited partnerships as there is a common law of general partnerships, and limited partnerships are not a default form of business.” ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS: UNINCORPORATED BUSINESSES AND CLOSELY HELD CORPORATIONS 102 (1997).

65. RULPA provides:  
Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he [or she] is also a general partner or, in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner’s conduct, that the limited partner is a general partner.

RULPA § 303 (a).

§ 303 (d) provides that “[a] limited partner who knowingly permits his [or her] name to be used in the name of the limited partnership [except under few specified circumstances] is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.” RULPA also provides that:

An obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

RULPA § 303.

The Comment to § 303 of the 2001 ULPA observes that “[I]n a world with LLPs, LLCs, and, most importantly, LLLPs, the control rule [articulated in § 303(a) of RULPA ] has become an anachronism.”<sup>1</sup>

Limited partnership shares are sometimes tradable.<sup>66</sup> Like shareholders in a corporation, limited partners may not withdraw their investments in the venture at will, but must generally wait until the time specified in the partnership agreement for the dissolution and winding up of the partnership. If the limited partner does not want to wait that long, however, under the Revised Uniform Limited Partnership Act ("RULPA") (1976/1985), Sec. 603, the limited partner may withdraw "upon not less than six months' prior written notice to each general partner. . . ." General partners, under RULPA, Sec. 602, however, may withdraw from a limited partnership "at any time by giving written notice to the other partners," but if the withdrawal violates a specific term of the partnership agreement, the partnership may recover damages from the departing partner. In other words, the law has taken the position that for limited partners to have the protection of limited liability, as well as the benefits of liquidity that come from having the shares be tradable, they must accept some restrictions relative to general partners on their ability to withdraw their share of assets from the firm.

Under the Uniform Limited Partnership Act ("ULPA") (2001) (which has not yet been widely adopted), partners (limited or general) may dissociate at will by giving notice to the partnership.<sup>67</sup> However, Sec. 505 of ULPA provides that "a person does not have a right to receive a distribution on account of dissociation" from a limited partnership. So the law of limited partnerships has always made it somewhat easier, relative to other partnership forms, for business organizers to lock in the capital initially contributed to the enterprise by the limited partners. If and when states adopt ULPA, the law of limited partnership will move further in the direction of locking in of capital contributions to a degree comparable to the corporate form.

### *C. Limited Liability Partnerships and Limited Liability Limited Partnerships*

During the last decade of the twentieth century, a number of states passed

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discuss LLPs, LLCs, and LLLPs *infra* Parts II.C and II.D.

66. The default rule under both RULPA and ULPA is that a partnership interest in a Limited Partnership is transferable or assignable, although unless the partnership agreement provides otherwise, the assignable interests include only the financial interests and not any governance or management participation rights. See RULPA § 702; ULPA § 702. If the partnership agreement so provides, limited partnership interests may sometimes even trade widely, on exchanges, so long as the appropriate securities regulations are met to make financial information about the securities available to the trading public. See, e.g., ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP (1988) §§ 2.13(e), 12.14 (discussing application of securities laws to partnerships). This arrangement is common with limited partnerships that have a corporation as the sole general partner—an organizational form that became popular in the 1970s as a tax shelter vehicle. See Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 78-87 (1997). Large limited partnerships with a corporate general partner and widely traded limited partnership interests are called "master limited partnerships." See Donna D. Adler, *Master Limited Partnerships*, 40 U. FLA. L. REV. 755 (1988).

67. See ULPA § 601(b)(1) (dissociation as a limited partner); ULPA § 603(1) (dissociation as a general partner).

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some form of LLP statute. These statutes make it possible for members of businesses ventures that are otherwise equivalent to general partnerships to be protected from personal liability for obligations of the firm that exceed the assets of the firm, simply by filing a set of forms with the appropriate state regulatory authorities.<sup>68</sup> Partners in LLPs, however, are still liable for claims arising from their own misconduct.<sup>69</sup> The LLP form of organization has become particularly popular among professional partnerships, but so far, the extent and protection provided by the liability shield has not been tested.<sup>70</sup>

Since LLPs are otherwise like general partnerships, the same rules apply to LLPs as apply to general partnerships regarding the ability of partners in an LLP to dissociate and withdraw their capital contribution. Most large professional partnerships today establish a fund to be used to buy out retiring or otherwise departing partners. Thus, these organizations provide almost no lock-in of capital.

According to Susan Fortney,<sup>71</sup> the LLP form may, in fact, encourage not only capital flight, but also human resource flight. Fortney explains:

The exodus of Andersen partners and practice groups [in the wake of Arthur Andersen's exposure to liability for their role in the collapse of Enron] is another negative consequence of the LLP structure. Andersen's U.S. payroll has dwindled from 28,000 to 1,000 and its worldwide staff of approximately 85,000 has been similarly decimated<sup>72</sup>.... Rather than jumping ship, Andersen partners might have been more committed to rebuild the firm had they believed they were personally on the hook for Enron. Why remain with a crippled firm and have your future accounts tapped when you have no personal responsibility?<sup>73</sup>

Just as LLPs are otherwise identical to general partnerships except for the liability shield, LLLPs are limited partnerships that have adopted a liability shield for their general partners by filing appropriate documents with relevant state authorities. Hence, just as limited partnerships provide for at least some temporary lock-in of capital contributed by limited partners,<sup>74</sup> LLLPs also provide some degree of lock-in. And, as noted, ULPA would provide more complete lock-in than the previous law because limited partners may not withdraw their contributions until the date set in the partnership agreement for

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68. RUPA § 1001.

69. Hamilton & Macey, *supra* note 15, at 11.

70. *Id.* Hamilton and Macey note that the litigation underway against Arthur Andersen LLP arising from the auditing work it did for Enron may set precedents for the degree of protection provided to partners not involved in any wrongdoing or malpractice. See also Jonathan D. Glater, *Suits Against Andersen May Test Partners' Risks*, N. Y. TIMES, Feb. 12, 2002 (late ed.); Susan Saab Fortney, *High Drama and Hindsight: The LLP Shield, Post-Andersen*, 12 BUS. L. TODAY 47 (2003) (discussing the benefits and problems associated with the use of the LLP form by professional firms).

71. Fortney, *supra* note 70, at 47.

72. *Id.* at 48 (citing Lee Hackstader, *Andersen Hit with Maximum Penalty: Judge Fines Firm \$500,000, Puts It on Probation*, WASH. POST, Oct. 17, 2002).

73. Fortney, *supra* note 700, at 49.

74. Capital contributed by general partners is locked in only in states that have adopted ULPA (2001).

termination or some earlier date determined by the general partners.<sup>75</sup>

As a general rule, the limited partnership form, or the LLLP form today, is used only for ventures that are expected to have a termination date, as opposed to long-term ongoing ventures with an indefinite life. Hamilton & Macey note that in contemporary times, only three types of business ventures commonly use the limited partnership form. These are leveraged buyout firms, venture capital firms, and family limited partnerships.<sup>76</sup> Family limited partnerships are tax shelter vehicles in which the choice of organizational form is driven solely by tax rules. Leveraged buyout firms and venture capital firms are typically organized as LLPs or LLCs (see *infra* Part II.D) which, in turn, operate as the general partners in a series of limited partnerships. The organizing firm raises money from limited partners in tranches, with each tranche committed for a certain period of time and organized as a separate LP (or LLLP). So investors enter the partnership knowing that, as of a certain future date, the venture will be terminated, and whatever assets remain in the LP at termination date will be distributed.

#### D. Limited Liability Companies

LLCs are a late-twentieth-century innovation, developed primarily to take advantage of the differential tax treatment between partnerships and corporations. The first limited liability company statute was passed in Wyoming in 1977.<sup>77</sup> The statute permitted businesspeople to organize themselves into an entity that had some features of partnership status and some features of corporate status. In particular, all members had limited liability (like corporate equity holders), but the entity was otherwise organized like a partnership. In 1988, the promoters of this organizational form won a favorable ruling from the Internal Revenue Service, allowing for partnership taxation for LLCs.<sup>78</sup> Responding, then, to widespread demand from businesspeople to use such a form, other states quickly adopted similar statutes, so that since 1995, all fifty states have had LLC statutes.<sup>79</sup>

These statutes vary in certain significant details, however, because states did not want to wait until a uniform LLC statute was drafted. Although most of the statutes provide wide latitude for organizers to adopt whatever financing and organizational structure they want, the IRS initially insisted that the

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75. ULPA § 601(a) ("A person does not have a right to dissociate as a limited partner before the termination of the limited partnership."); ULPA § 504 ("A partner does not have a right to any distribution before the dissolution and winding up of the limited partnership unless the limited partnership decides to make an interim distribution.").

76. HAMILTON & MACEY, *supra* note 15, at 191.

77. *Id.* at 199 (citing Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L. J. 1459, 1563-64 (1998)).

78. See HAMILTON & MACEY, *supra* note 15, at 199.

79. *Id.*

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resulting entities not incorporate more than two of the features that the IRS regards as “corporate” characteristics if they were to qualify for “pass-through” partnership taxation. These characteristics are: (1) continuity of life; (2) free transferability of interests; (3) centralization of management; and (4) limited liability. Since an important object of LLCs was limited liability, and organizers generally wanted to centralize management, in practice this meant that LLCs could not have continuity of life or free transferability of interests.<sup>80</sup> In 1997, however, the IRS adopted new rules that allow organizers of business entities such as LLCs, LLLPs, and S-Corporations simply to “check the box” to choose whether to be taxed as partnerships (in which income is attributed to members on a pro-rata basis each year, and taxed at the member’s tax rates) or as entities (entity profits are taxed at the corporate tax rate before being distributed to members, and then taxed again as income to the members when paid out). Since the IRS adopted “check-the-box” tax treatment, it became immaterial for tax purposes what organizational form and structure these business ventures adopted.

In 1996, the National Conference of Commissioners on Uniform State Laws promulgated a Uniform Limited Liability Company Act (“ULLCA”), but to date, LLC statutes still vary considerably from one state to another.<sup>81</sup> Hence, it is hard to generalize completely about the ability of business organizers to lock in capital contributions using the LLC form. ULLCA, however, provides that members who initially contribute less than the stated contribution required for each unit of membership are liable for the full amount,<sup>82</sup> and that distributions from the LLC are limited by solvency constraints on the entity, similar to the constraints on distributions in many corporate statutes.<sup>83</sup> It also

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80. *Id.* at 202.

81. Early adopting states, including Colorado, Virginia, and Nevada, required that LLCs lack continuity of life. *Id.*

82. ULLCA § 402.

83. The ULLCA provides:

A distribution may not be made if: (1) the limited liability company would not be able to pay its debts as they become due in the ordinary course of business; or (2) the company’s total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those receiving the distribution.

ULLCA § 406(a). The RMBCA provides that no distribution may be made to shareholders if: after giving it effect: (1) the corporation would not be able to pay its debts as they become due in the usual course of business; or (2) the corporation’s total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

RMBCA Subch. D § 640(c). By contrast, the DGCL provides that dividends can only be paid out of capital “surplus” as determined by the board of directors under the terms of DGCL §154, or DGCL § 244 (which provide alternative ways directors may determine the capital stock of the company and the surplus). DGCL § 170 (a).

provides as a default rule, however, that LLC members may dissociate from the LLC at will.<sup>84</sup> As in the default rules for general partnerships under the RUPA, ULLCA provides that the firm may continue to conduct business as the same entity despite the dissociation of one or several members so long as a specified percentage of the remaining members agree to continue the business of the company.<sup>85</sup> If the LLC is not dissolved as a result of the dissociation of one or several members, then the LLC must buy out the interests of the dissociating members.<sup>86</sup> If the dissociation by the members violates a term of the operating agreement or is otherwise considered wrongful, the continuing firm must still buy out the dissociating members' interests, but the dissociating members must pay any damages resulting from their premature or wrongful dissociation.<sup>87</sup>

Hence, it appears that the default rules for LLCs provide about the same potential for locking in capital as is provided in the default rules for general partnerships and LLPs—that is, not much.

#### *E. Corporations*

As the IRS has observed, the distinguishing characteristics of the corporate form have historically included continuity of life, free transferability of interests, centralization of management, and limited liability.<sup>88</sup> Now that limited liability and centralized management can easily be achieved through a wide range of organizational forms, the IRS's list of unique features of the corporate form is reduced to continuity of life and free transferability of shares (and even these features can be arranged contractually in partnership-type firms). I would add to this list the fact that equity investors in corporations generally have no power, on their own initiative, to insist that the corporation buy back their shares or distribute corporate assets to shareholders.<sup>89</sup> The only other organizational form that possesses this characteristic is the limited partnership (and its limited liability counterpart), in which the limited partners

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84. See ULLCA § 601(1).

85. ULLCA § 801(b)(3).

86. ULLCA § 701.

87. ULLCA § 602.

88. HAMILTON & MACEY, *supra* note 15, at 202.

89. Under case law dating back to 1868, shareholders have not had the legal right to receive any dividend at all unless it was declared by directors. *See, e.g.*, Minot v. Mallory, 99 Mass. 101, 111 (Mass. 1868) ("The money in the hands of directors may be income to the corporation; but it is not so to a stockholder till a dividend is made . . ."). Delaware law requires corporate directors to determine what proportion of receipts from stock issuances or other assets represents "paid-in capital" and what proportion is "surplus" (DGCL § 154; DGCL § 244). Dividends may only be paid out of surplus, or if there is no surplus, out of net profits for the most recent two fiscal years, but any decision to pay dividends is solely the prerogative of directors (DGCL § 170). And, according to MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 375 (1987), U.S. courts have never in the last century ordered a management-controlled, publicly-traded corporation to increase its dividends. Corporations may, of course, issue redeemable shares, but common stock is generally not redeemable at the option of the shareholder.

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may be subject to fairly strict limits on their ability to compel the firm to buy out their interests. But limited partnerships are typically established for some term, at the end of which limited partners will be bought out, or the firm wound up and dissolved.<sup>90</sup> Corporations are generally not subject to any given term, so shareholders may never have their interest in the firm bought out or retired by the corporation. Moreover, any decision to pay dividends is solely the prerogative of a board of directors<sup>91</sup> (subject to certain legal constraints designed to protect corporate creditors) whose members need not, necessarily, be shareholders.<sup>92</sup>

Thus, the corporate form of organization, more than any other form, facilitates the locking-in of invested capital for an extended—even indefinite—period of time. It also places control rights over the assets of the firm in the hands of a board of directors.<sup>93</sup> Although in principle, directors are elected by shareholders (hence a majority of shareholders acting together might be able to elect a slate of directors who promise to pay certain dividends or buy back shares, or even to dissolve the company), in practice it is difficult and costly for shareholders to elect directors other than those nominated by existing directors. As a result, boards of directors tend to be self-perpetuating bodies. This ability to lock in capital can contribute to or exacerbate the so-called “oppression” of minority shareholders in closely-held corporations.<sup>94</sup> But in corporations where

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90. Limited partnerships were commonly used in the 1970s as a vehicle for holding oil and gas producing properties because the profits from producing and selling the oil and gas—a depleting resource—could be paid out directly to the partners without being taxed first as corporate income. Mesa Petroleum Co., for example, pioneered the use of limited partnerships in this way, setting up limited partnerships to hold the depleting assets, and spinning off limited partnership interests to its shareholders as dividends. It did this because it did not believe that it could reinvest cash flows from oil and gas production profitably. Thus, as the oil and gas deposits in the properties held by the LP were played out, the LP would eventually be wound up and dissolved. See, e.g., Laurie P. Cohen, *Mesa Petroleum Plans a Switch to Partnership*, WALL ST. J. (West Coast Edition), Aug. 27, 1985, at 3.

91. DGCL § 170; RMBCA § 6.40. See, e.g., Berwald v. Mission Development Co., 185 A.2d 480 (Del. 1962) (finding that a decision to pay a dividend was protected by the business judgment rule unless it was designed to serve the selfish interests of a controlling party).

92. Again, corporations may issue shares that have a priority claim to dividends, if and when dividends are issued. DGCL § 151(a); RMBCA § 6.01(c). In such a case, holders of the “preferred” shares can insist, according to rights granted them in the stock certificate or articles of incorporation, that prescribed dividends be paid to preferred shareholders before dividends are paid to common shareholders. DGCL § 151(c). But the distribution of dividends to preferred shares remains optional, and ordinary common shares generally cannot command any dividends.

93. In Blair, *supra* note 5, I argue that the ability to lock in capital was one of the important features of the corporate form that made it attractive to business organizers in the nineteenth century. I further argue that investors were willing, in fact eager, to invest via this form despite their loss of control rights because they apparently believed that, over time, they could achieve a higher rate of return by investing in a vehicle that was more financially stable, and could provide security to other corporate participants. In Blair & Stout, *supra* note 12, we argue that shareholders are willing to yield control rights over the assets they contribute to corporate enterprises because yielding control to boards of directors apparently produces attractive (risk-adjusted) returns over time, relative to investing in enterprises in which they could maintain more control.

94. To address this problem, most states have enacted so-called “close corporation” statutes (such as DGCL Subchapter XIV, which permits shareholders to form agreements that restrict the discretion of directors (DGCL § 350), or eliminate the need for directors altogether (DGCL § 351; RMBCA § 7.32),

common shares are widely held and traded on exchanges or over the counter, any shareholder who wants to withdraw from the corporation may do so by selling his or her shares to some other shareholder. The investor may withdraw, even while the invested capital stays locked into the enterprise.

#### *F. Implications of the Choice of Organizational Form*

Until the last decade of the twentieth century, entrepreneurs and business organizers who wanted the protection of limited liability had very few choices about how to organize their businesses, since only the corporate form provided limited liability for the managers and active investors of a firm. But use of the corporate form required investors to yield control over the assets they contribute to the corporation's board of directors.<sup>95</sup> Organizers could contract around this requirement, to some extent, by using charter provisions or bylaws that gave shareholders the right to vote on or even propose a broader range of actions than the statutes provide. But unless they met the strict requirements for a close corporation<sup>96</sup> equity investors in corporations were, and still are, basically restricted from initiating or compelling actions to pay dividends or make other distributions.<sup>97</sup>

In the year 2004, however, with the ready availability of the LLC, LLP, and LLLP forms in virtually every state, entrepreneurs and business organizers can have the benefits of limited liability without the constraints of corporate status. Meanwhile, the corporate form and, to a lesser extent, the limited partnership form, are the only forms through which organizers can effectively lock in the

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and gives shareholders control over decisions to dissolve the corporation (DGCL Subch. XIV § 355).

95. See RMBCA § 8.01(b) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitations set forth in the articles of incorporation . . ."); DGCL § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . .").

96. Under DGCL Subch. XIV§ 342(1), close corporations may have no more than 30 stockholders, under § 342(2) the transferability of shares is restricted, and under § 342(3) the firm may not make any public offerings of securities. Under RMBCA § 7.32, corporations may be governed by shareholders (under a shareholders agreement) and the board of directors either eliminated or greatly restricted in its powers if the corporation does not have securities traded on an exchange or over the counter, and if the shares of the corporation provide adequate notice of the existence of the shareholders' agreement. Shareholder agreements are valid for no longer than 10 years unless the agreement specifically provides otherwise.

97. Under RMBCA § 6.40, directors are authorized to make distributions to shareholders subject to constraints designed to protect creditors. § 12.02(b) provides that any sale or distribution of assets that requires shareholder approval must be initiated by directors. Under § 12.01, many sales or distributions can be carried out by directors without shareholder approval. Under § 14.02(b)(1), directors must initiate and recommend to shareholders for their approval any dissolution, unless directors have a conflict of interest with respect to such transaction. Delaware law is similar. DGCL § 170 provides that directors may declare and pay dividends subject to certain solvency tests. Under DGCL § 271, directors have initiation rights for sales of assets, and under § 275, directors must initiate any dissolution. *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919), is the classic case in which a shareholder successfully sued to compel a corporation to pay dividends, but Ford Motor Company was closely held at the time.

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capital contributions of equity investors for indefinite periods of time. And even in businesses organized as limited partnerships, organizers may, in the partnership agreement, give limited partners the right to dissociate at will and be paid their share of the assets, or propose and vote on dissolution or sales of assets or other payouts to partners.<sup>98</sup> In corporations whose shares trade widely, however, default rules provide that shareholders may vote on dissolutions or sales of assets, but they may not propose such actions.<sup>99</sup> Statutory and case law makes it clear, also, that directors control any decision to pay dividends.<sup>100</sup>

While these provisions of corporate law make it possible to lock in capital, and may occasionally lead to abuses by directors and managers, they do not lock in particular investors, since individual investors can sell their shares to

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98. Such a right is implied by RULPA § 303(b)(6) (clarifying that a limited partner does not become liable for partnership liabilities by taking certain enumerated governance-related actions). Such actions include:

proposing, approving, or disapproving, by voting or otherwise, one or more of the following matters: (i) the dissolution and winding up of the limited partnership; (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership; . . . (v) the admission or removal of a general partner.

*Id.* Under ULPA § 7, limited partners are broadly protected from liability regardless of governance activities they may engage in, presumably including the acts of proposing or approving dissolutions, and sales of substantially all the assets.

99. Throughout much of the twentieth century, it was very clear that corporate law required that directors be decision makers for corporations, and that shareholders were not permitted to establish voting agreements that had the effect of “sterilizing the board.” See, e.g., *McQuade v. Stoneham*, 263 N.Y. 323, 328 (1934) (“[s]tockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office . . .”); *Manson v. Curtis*, 223 N.Y. 313, 322-23 (1918) (“All powers directly conferred by statute, or impliedly granted, of necessity, must be exercised by the directors who are constituted by the law as the agency for the doing of corporate acts. In the management of the affairs of the corporation, they are dependent solely upon their own knowledge of its business and their own judgment as to what its interests require.”); *Continental Securities Co. v. Belmont*, 206 N.Y. 7 (1912) (“As a general rule, shareholders cannot act in relation to the ordinary business of a corporation . . . They are not by statute in any state given general power of initiative in corporate affairs.”) But exceptions were carved out for close corporations. See, e.g., *Clark v. Dodge*, 269 N.Y. 410, 416 (1936) (“[W]here the questioned agreements were entered into by all the stockholders of small corporations about to be organized, the fact that the agreements conflicted to some extent with the statutory duty of the directors to manage the corporate affairs was thought not to render the agreement illegal . . .”) (citing *Lorillard v. Clyde*, 86 N.Y. 384 (1881); *Drucklieb v. Sam H. Harris*, 209 N.Y. 211 (1913)). In the late in the twentieth century, a number of close corporation statutes were added to state corporate statutes. See, e.g., MBCA § 7.32 (authorizing shareholders to eliminate the board of directors and directly run corporations that qualify as “close corporations”); DGCL § 341 (defining a subset of Delaware corporate law applicable to close corporations); DGCL § 342 (defining close corporations); DGCL § 350 (allowing shareholder agreements that restrict the discretion of directors in close corporations); DGCL § 351 (providing that the board of directors may be eliminated in a close corporation, and the affairs of the firm run directly by shareholders). See also *Ribstein, supra* note 67, at 14 (observing that “though corporate statutes provide that management by the board can be qualified to some extent by contrary provisions in the articles of incorporation, such provisions do not clarify how far such restrictions may go. The existence of some limitation is supported by the fact that corporate statutes explicitly permit reduction or elimination of board functions only in special provisions applying to closely held corporations.” [footnotes omitted]).

100. RMBCA § 640(a); DGCL § 170(a); see also *Knapp v. Bankers Securities Corp.*, 230 F.2d 717, 720 (3d Cir. 1956) (noting that “[i]t is an elementary principle of corporation law that the declaration of dividends out of net profits rests in the discretion of the board of directors” except in situations in which directors act fraudulently or arbitrarily in refusing to declare a dividend out of surpluses).

other investors. Apparently, the benefits of this “lock-in” feature of corporate law are perceived as outweighing the problems, because, if the lock-in feature of the corporate form were regarded as oppressive or problematic to investors, investors could choose to invest in other organizational forms. Since we continue to see widespread use of the publicly traded corporate form by business organizers, and eager investment in businesses organized in this form by sophisticated investors, it seems reasonable to assume that the benefits outweigh the disadvantages.<sup>101</sup> Furthermore, in light of the easy availability of alternatives that provide centralized control, tradable claims, and limited liability, it seems appropriate to regard the choice by business organizers to use the publicly-traded corporate form as a clear and unequivocal choice to use an organizational form that locks in capital, and restricts the rights of equity investors to exercise control over how the capital is used and when or whether equity holders are paid back any of the funds invested in the corporation. The choice of corporate form, in other words, should be regarded as a choice by organizers to “pre-commit” to locking in their capital investment and yield control to directors.<sup>102</sup> Professor Stout and I have argued elsewhere that it might be advantageous to shareholders in the long run to pre-commit to yielding power to directors.<sup>103</sup> Here, I argue further that to have teeth, the yielding of decision rights about the use of corporate assets must be accompanied by a yielding of the right to decide whether and when assets will be distributed back out to shareholders.

### III. THE LOCK-IN CHOICE AND ITS IMPLICATIONS FOR CORPORATE GOVERNANCE REFORM

In the debates about various corporate governance reforms over the years, the idea that shareholders should be given more power and control rights relative to directors and management is based on the premise that the principal-agent problem is the most important governance problem to be addressed in contemporary corporations.<sup>104</sup> This premise has been widely accepted by

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101. In a forthcoming article, Larry E. Ribstein argues that the corporate form is inflexible and not efficient, but continues to be used because “corporate inflexibility and the concession theory serve both politicians’ interests by making it easier to regulate business, and managers’ interests by protecting their power.” Larry E. Ribstein, *Why Corporations?*, 2004 BERKELEY BUS. L.J. (forthcoming fall issue) (copy of July 2003 draft on file with author).

102. Kahan and Rock similarly argue that corporate charter provisions together with statutory requirements of corporate law that give corporate directors substantial control over decisions about whether and how to sell a company can be understood as a “pre-commitment whereby shareholders, by binding themselves *ex ante*, may be able to improve their collective position *ex post*.” Kahan & Rock, *supra* note 1, at 2.

103. Blair & Stout (1999), *supra* note 12, at 305.

104. In a recent article, Lucian Bebchuk argues for greater shareholder powers to initiate and approve major corporate transactions, simply asserting as a matter of fact that “[g]ranting such power would address important agency problems that have long afflicted publicly traded companies, considerably improving corporate governance.” Bebchuk, *supra* note 2, at 1. For at least two decades,

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corporate legal scholars, and is often assumed, almost without discussion, in the debate about takeover policy.<sup>105</sup>

Without denying that there are agency problems in the management and governance of large corporations, Professor Stout and I have argued that the widely-traded corporate form (in which the role of contributing financing is separated structurally and legally from the role of controlling the business, and with the latter role vested in a board of directors) may serve as a solution to a more fundamental organizational problem: the problem of contracting in team production contexts.<sup>106</sup> The argument, in short, is that the participants in a corporate “team” can more easily commit to cooperate with each other and work together toward mutually beneficial goals that enhance the productivity of the enterprise if they yield ownership and control rights over inputs to, and outputs from, the corporate enterprise. Ownership of corporate assets and outputs goes to the separate legal entity created by corporate law. Control belongs to a board of directors that is legally independent of shareholders, managers, employees, and all other corporate participants. To the extent that the corporate form serves this function, reform proposals that are designed to address agency problems by enhancing shareholder monitoring or control over management must be tempered by the need to protect the integrity of the basic structural solution to the team production problem provided by the corporate form.

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Bebchuk has advocated the idea that corporate boards and management (he typically treats boards and managers as if they were the same) need to be reined in by the “market for corporate control.” See, e.g., Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982). The work of a team of researchers at Harvard Business School and the Wharton School at the University of Pennsylvania is indicative of just how deeply this mentality has permeated corporate scholarship. Paul Gompers, Joy Ishii, and Andrew Metrick have collected data on corporate governance arrangements in hundreds of companies, categorizing each arrangement by whether it tends to enhance “shareholder democracy” or lead to management “dictatorship.” See Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003). It is interesting to note how few of the scholars who have engaged in the debate about corporate governance have chosen to use rhetorically neutral language in their scholarship rather than conclusory language and labels, such as calling proposals to enhance shareholder power “efficient,” “better,” “democratic,” or “corporate governance improvements,” while labeling director strengthening proposals as “entrenching” or “dictatorial.”

105. See, e.g., Frank Easterbrook & Daniel Fischel, *The Proper Role of A Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (same); Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982) (arguing that shark repellent amendments should be held invalid even if they are approved by a vote of shareholders); Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) (assuming that takeovers are about reducing agency costs and improving corporate performance, and arguing that directors should be passive in response to a takeover offer). Cf. Barry D. Baysinger & Henry N. Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 8, 1257 (1985) (accepting that agency costs are a significant potential problem, but arguing that existing corporate law and governance arrangements “emerged in a market environment that permitted free contracting among interested parties” and that therefore it is safe to assume that these arrangements do an adequate job of reining in agency costs); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987) (accepting the agency problem premise and endorsing antitakeover charter amendments if they are approved by shareholders, but opposing statutory antitakeover rules).

106. Blair & Stout, *supra* note 12.

In this Part, I propose in particular that corporate governance reform proposals be distinguished according to whether their purpose and effect is to strengthen the independence and information available to boards, to enhance shareholder "voice," or to make it easier for shareholders as a group to "exit."<sup>107</sup> If the purpose and effect of a corporate governance reform proposal is to make it easier for shareholders to "exit," by, say, requiring boards to submit takeover offers to a shareholder vote, or permitting shareholders to propose and mandate (by election) distributions, dissolution or asset sales, I argue in this Article that such a proposal is at odds with the "lock-in" function of corporate law. Since business organizers would find it difficult to achieve effective lock-in using other currently available organizational forms, to eliminate or weaken the lock-in potential of the corporate law choice by statutorily requiring corporations to give shareholders such powers would take away an important organizational option that business organizers and investors currently have. This option has been eagerly sought out and used by business organizers in the United States for more than 150 years and, superficially at least, appears to be associated with substantial economic innovation and growth. Thus, it seems unwise to change the law in ways that would eliminate this option.

On the other hand, if the purpose and effect of a corporate governance reform proposal is to enhance the monitoring capabilities of corporate boards, or to facilitate shareholder "voice," such proposals are not obviously at odds with the lock-in function of the corporate form, and may well reduce agency costs without unduly subverting the role the corporate form serves in addressing the team production problem. In the next Part, I review various corporate governance proposals, categorized by whether they make exit easier for shareholders, facilitate shareholder voice, or strengthen boards of directors. Then, in the final Part, I speculate about the implications of my arguments for the process of finding the right balance between director control and accountability.

#### IV. BRIEF REVIEW OF CORPORATE GOVERNANCE REFORM PROPOSALS

Corporate governance questions moved into the public policy spotlight during the early 1980s, when the corporate sector suddenly faced a wave of hostile tender offers.<sup>108</sup> Takeover offers often triggered controversial defensive responses by corporate managers and directors,<sup>109</sup> and the resulting debate

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107. The concepts of "exit" and "voice" as responses to problems in organizations are borrowed from ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1972).

108. THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE (Margaret M. Blair ed., Brookings 1993) provides an analysis of some of the policy issues at stake in the takeover debates.

109. Corporate managers and boards, together with their legal advisors, have developed and

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produced a wave of legal scholarship on the questions of whether takeovers were good or bad for the economy, whether directors and officers should be allowed to resist a hostile offer, and if they do, what tactics were legitimate, both legally and from the perspective of public policy.<sup>110</sup> Some businesspeople and a few legal practitioners and management professors protested that the sudden and pervasive threat of hostile takeover was contributing to unhealthy pressures on businesses from the financial markets to focus on short-term performance at the expense of long-term performance.<sup>111</sup> But the legal and finance faculties of leading universities largely accepted the premise that hostile takeovers were the market's way of correcting bad management—the fulfillment of Henry Manne's argument that the “market for corporate control” would prevent managers from straying too far from their job of maximizing value for shareholders.<sup>112</sup>

### *A. Some Prominent Proposals Designed to Weaken Takeover Protection*

The dominant academic response to the takeover wars of the 1980s, then,

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attempted to use a wide variety of tactics for warding off or preventing takeovers. In 1985, for example, Mesa Petroleum launched an attempt to take over Unocal Corp., offering \$54 per share for the first 50 percent of outstanding shares, and announcing that once it held a controlling interest, it would buy out the remaining shares with “highly subordinated securities,” nominally worth \$54 per share, but whose market value was much less. Unocal responded by making a discriminatory exchange offer, providing that, if Mesa succeeded in buying the 64,000,000 shares it sought, “the remaining Unocal shareholders could exchange all of their remaining shares for debt securities worth \$72 per share that would be senior to Mesa’s junk bond financing.” See Hamilton & Macey, *supra* note 15, at 1228. Unocal’s tactic was deemed legitimate by the Delaware Supreme Court in light of the coercive threat represented by the Mesa offer in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). Other firms adopted so-called “staggered boards,” in which directors serve three-year terms, with only one third of directors standing for re-election at each annual meeting, and the so-called “poison pill” or “shareholder rights plan,” by which shareholders are given rights to buy new securities issued at dilutive prices if a hostile bidder acquires more than some triggering percentage (such as 20 percent) of outstanding shares. The rights could be redeemed for a nominal amount by the target’s board of directors if directors were satisfied with the bid. Rights plans were approved as a legitimate takeover defense in *Moran v. Household Int'l., Inc.*, 500 A.2d 1346 (Del. 1985).

110. Lipton, *supra* note 3, at 1037-39, provides a chronology of the main arguments in favor of takeovers and of limiting director discretion to resist them. Lipton is generally credited with inventing the “poison pill” defense.

111. See, e.g., Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, 58 HARV. BUS. REV. 67 (1980) (arguing that U.S. corporations suffered from “competitive myopia” which they blamed on a tendency for managers to rely too heavily on “short-term financial measurements like return on investment for evaluating performance.”). See generally MADE IN AMERICA: REGAINING THE PRODUCTIVE EDGE (Michael L. Dertouzos et al. eds., 1989) (noting that business executives describe their own behavior in response to financial market pressures as attempting to “maximiz[e] their short-term profit in the belief that the market would penalize them for taking the long view”); TWENTIETH CENTURY FUND, REPORT OF THE TASK FORCE ON MARKET SPECULATION AND CORPORATE GOVERNANCE (1992) (characterizing financial markets as prone to “high-volume, speculative trading and short-lived bubbles and crashes,” which the report asserted were “the essence of ‘short-termism.’”); Lipton, *supra* note 3 (defending efforts by corporate managers and directors to fight off takeovers that, in the opinion of directors, would impair the ability of the corporation to perform well in the long run).

112. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

has been a continuing stream of reform proposals that would encourage takeovers and weaken the ability of corporate officers and directors to fight off unwanted takeovers. The following is not a comprehensive list, but a sampling of prominent proposals to weaken the ability of corporate directors to resist takeovers:

- \* Corporate managers should be required to remain passive in the face of a takeover bid, and the decision about whether to accept the tender offer should rest with the shareholders alone.<sup>113</sup>
- \* Directors should not be allowed to frustrate takeover bids but should advise shareholders as to the fairness of the bid, and seek competing bids.<sup>114</sup>
- \* Shareholders should be able to adopt bylaws that would allow them to control the use of poison pills in takeover battles.<sup>115</sup>
- \* Shareholders should be entitled to opt into a body of federal takeover law that would require the board to remove a pill if a majority of outstanding shares vote in favor of a takeover bid.<sup>116</sup>

One puzzle about the intensity and ongoing nature of the debate over takeovers and their defenses is that the underlying premise, that takeovers are the financial market's way of correcting poor management, is rarely challenged. In the early 1980s, scholars produced a large body of evidence that target company share prices rise when a tender offer is announced.<sup>117</sup> To finance scholars, steeped in the belief in efficient capital markets, a rise in the price of the target company stock that is not offset by a decline in the price of some other asset could only be interpreted to mean that the proposed takeover must enhance productivity.<sup>118</sup> But this price-increasing effect could alternatively be explained by the fact that tender offers are nearly always made at a price that represents a substantial premium over the previous price of the stock in order to get existing shareholders to sell. It should hardly be surprising, then, that the trading price of the target stock rises as the market incorporates some estimated probability that the bidder will eventually pay the higher

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113. EASTERBROOK & FISCHEL, *supra* note 2.

114. Gilson, *supra* note 105; Bebchuk, *supra* note 2.

115. Jeffrey N. Gordon, *Just Say Never? Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDozo L. REV. 511 (1997); Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)* (Columbia Law School, The Center for Law and Economics, Working Paper No. 177, June 2000). A ruling from the Oklahoma court in *International Brotherhood of Teamsters Gen. Fund v. Fleming Cos.*, 975 P.2d 907 (Okla. 1999), found that shareholders have the authority under current law in that state to propose a resolution requiring shareholder approval of poison pills.

116. Bebchuk & Ferrel, *supra* note 2.

117. See Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983), for a summary of early evidence on the benefits for shareholders of both target firms and acquiring firms.

118. See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

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offered price.<sup>119</sup> Furthermore, the fact that the acquiring company's shares do not all immediately fall by an amount sufficient to offset the gains to the target shareholders can be explained by the fact that the market may not be able to tell initially whether the acquiring company will be able to improve the performance of the target company.<sup>120</sup>

The real test comes in the months and years after a takeover, and there is substantial evidence indicating that acquiring companies typically lose money on corporate acquisitions.<sup>121</sup> Meanwhile, there is little or no evidence that takeover targets are poorly performing companies,<sup>122</sup> or that their performance improves after the takeover.<sup>123</sup> Moreover, there is no robust evidence that takeover defenses, such as staggered boards and poison pills, actually impair the performance of companies that have them,<sup>124</sup> nor that they are effective at

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119. See Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990).

120. Bouwman, Fuller, and Nain find substantial evidence that the market's initial judgment about whether an acquisition will add value to the firm over time are systematically wrong. Christa Bouwman et al., *The Performance of Stock-Price Driven Acquisitions* (May 2, 2002) (working paper) (on file with author). See also Ming Dong et al., *Does Investor Misvaluation Drive the Takeover Market?* (Sept. 27, 2003) (unpublished manuscript, on file with author) (finding that misvaluation of bidders and targets influences the means of payment chosen, the mode of acquisition, the premiums paid, target hostility to the offer, the likelihood of offer success, and bidder and target announcement period returns).

121. See M. Scherer, *Corporate Takeovers: The Efficiency Arguments*, 2 J. ECON. PERSP. 69 (1988) (summarizing evidence that acquiring firms experience long-term negative abnormal returns after takeovers and operating performance of acquired companies does not improve after takeovers). See also Anup Agrawal & Jeffrey F. Jaffe, *The Post-Merger Performance Puzzle*, Jan. 5, 1999, 7-9, 11-39 (summarizing numerous studies by financial economists and concluding that there is "strong evidence of abnormal underperformance [of acquiring companies] following mergers"), available at <http://papers.ssrn.com/sol3/cfm>.

122. Anup Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Under-Perform? Evidence from Operating and Stock Returns*, 38 J. FIN. QUANT. ANAL. 721 (2003) (finding little evidence that target firms were performing poorly before acquisition, using either operating or stock returns, and concluding that the conventional view that targets perform poorly is not supported by the data).

123. See Scherer, *supra* note 121.

124. Bebchuk, Coates, and Subramanian find that corporations with "effective staggered boards" (ESBs) were more likely to remain independent if they became a target of a hostile takeover, and that, as a result, shareholder returns were 8 to 10 percent lower for target companies that had an ESB. Bebchuk et al., *infra* note 127. But see Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845 (2002) (noting that the Bebchuk, Coates, and Subramanian study does not take into account the potentially greater value that corporations might have been able to create by having an ESB before they became targets). See also John Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 2 (2002) (finding that "two decades of research on poison pills and other takeover defenses does not support the belief—common among legal academics—that defenses reduce firm value"). A body of research by Gompers, Ishii, and Metrick, however, suggests that corporate governance arrangements may come in clusters and that when firms are ranked according to a "governance index" that scores firms on how many of twenty-four different governance arrangements the firms have in place, the highest ranking firms (those with the weakest shareholder rights) performed significantly less well during the 1990s than those with the lowest ranking (strongest shareholder rights). Notably, the authors do not find a negative coefficient on their governance index in regression results. Rather, they compare the performance of firms in one tail of the distribution of firms ranked by the index to firms in the other tail of the distribution. Results based on comparisons of outliers are inherently less likely to be robust. The governance arrangements scored by this data cannot be easily categorized by whether they enhance (or weaken) shareholder voice, or shareholder exit, or support (or undermine) director independence and

preventing takeovers.<sup>125</sup> One possible explanation for the absence of clear empirical support for the efficacy of takeovers is that the threat of takeovers actually has a mixed effect on corporate performance.<sup>126</sup> On one hand, takeovers may in some cases discourage wasteful managerial empire-building, but on the other hand, the vulnerability of companies to unwanted takeovers may make it more difficult for corporate managers to foster long-term cooperation and commitment to the corporate enterprise by “team members” other than shareholders.<sup>127</sup>

Nonetheless, the debate goes on, and takeover advocates continue to generate reform proposals that would weaken the power of directors to fight off takeover offers that, in the directors’ judgment, would not be in the long-run best interest of the target company.

#### *B. Proposals That Would Enhance Shareholders’ Exit Options or Give Them More Direct Control over Corporate Assets*

One of the most relentless proponents of the view that agency costs are a severe problem for the corporate sector, and that takeover defenses increase agency costs by entrenching managers, has recently proposed a very aggressive set of corporate governance reforms that would greatly strengthen shareholders’ control over corporate assets, even beyond the takeover context.<sup>128</sup> Bebchuk classifies his proposals into three categories, according to how they influence one of three kinds of decisions made within corporations: “(i) ‘rules-of-the-game’ decisions to amend the corporate charter or change the company’s state of incorporation; (ii) ‘game-ending’ decisions to merge, sell all assets, or dissolve; and (iii) ‘scaling-down’ decisions to contract the size of the

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access to information.

125. See Sanjai Bhagat & Richard Jefferis, Jr., *The Econometrics of Corporate Governance Studies* (abstract of SANJAI BHAGAT & RICHARD JEFFERIS, JR., THE ECONOMETRICS OF CORPORATE GOVERNANCE STUDIES (2002)) (finding that “antitakeover measures are not effective in preventing takeovers, nor are they effective in enhancing management’s job-tenure”), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=306375](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=306375).

126. See, e.g., Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819 (2002).

127. This may explain why young companies that are just going into the publicly-traded financial markets for equity capital often have both staggered boards and poison pills, the takeover protection combination that Bebchuk, Coates, and Subramanian claim is the most effective at preventing an unwanted takeover. See Lucian Bebchuk et al., *The Anti-Takeover Power of Classified Boards: Theory, Evidence and Policy*, 54 STAN. L. REV. 887 (2002). See also Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J. L. ECON. & ORG. 82 (2001) (finding that a majority of firms that go public through IPOs have adopted both staggered boards and poison pills); Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857 (Oct. 2002) (same); Stout, *supra* note 124 (arguing that available studies of anti-takeover protections generally focus on their impact on firm valuation after a takeover offer has been made, but fail to measure how they affect firm value prior to the takeover bid).

128. Bebchuk, *supra* note 2.

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company's assets by ordering a cash or in-kind distribution.”<sup>129</sup> I regard his “rules-of-the-game” proposals as proposals that give shareholders a more effective voice, so I consider them in the next section, and here consider only his “game-ending” and “scaling-down” proposals.<sup>130</sup>

### 1) Scaling-down proposals:<sup>131</sup>

- \* Shareholders should have the power to initiate and approve distributions, in cash or in other corporate assets.<sup>132</sup>

- \* Shareholders should have the power to order the distribution of new debt securities to shareholders, compelling management to liquidate assets in order to satisfy the claims of the new securities.<sup>133</sup>

### 2) Game-ending proposals:<sup>134</sup>

- \* Shareholders should have the power to initiate mergers and/or consolidations with other companies.<sup>135</sup>

- \* Shareholders should have the power to initiate a sale of all the assets of a company to a certain buyer<sup>136</sup> (or even to auction the assets to the highest bidder<sup>137</sup>).

- \* Shareholders should have the power to initiate the dissolution of the company.<sup>138</sup>

Bebchuk’s case for these proposals is based on an argument that apparently assumes that whatever is better for shareholders at any point in time is “better” in some larger social sense.<sup>139</sup> Or he may believe that giving shareholders more power is “better” because it is more consistent with his apparent view of shareholders as “owners” of corporations,<sup>140</sup> and, therefore, serving their

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129. *Id.* at 1.

130. Bebchuk himself implicitly concedes that these are the most radical of his governance reform proposals, observing that his “proposed [shareholder] intervention power wins support most easily when applied to rule-of-the-game decisions and meets most resistance when applied to scaling-down decisions.” See Bebchuk, *supra* note 2, at 4.

131. *Id.* at 36.

132. *Id.* at 36.

133. *Id.* at 37.

134. *Id.* at 31.

135. *Id.*

136. *Id.*

137. *Id.* at 33.

138. *Id.* at 31.

139. Bebchuk continually argues that focusing on shareholders’ interests represents an “improvement” over current arrangements, without being explicit about the standard by which he measures the quality or effect of such arrangements. See, e.g., *id.* (noting with respect to giving shareholders the right to initiate reincorporation in other states that the result would be that “states will have incentives to focus on shareholders’ interests. The resulting improvement in the quality of state corporate law rules will considerably improve the arrangements governing publicly traded companies” (emphasis added)).

140. Bebchuk carefully avoids explicitly referring to shareholders as the “owners” of corporations, a view which has long been rejected by contractarian legal scholars. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 37 (1991) (“Notice that a contractual approach [to corporate law] does not draw a sharp line between employees and contributors

interests honors their property rights.<sup>141</sup>

Perhaps Bebchuk would not claim that shareholders are the “owners” of corporations, but he nonetheless considers their situation to be analogous to that of partners in a partnership, except that shareholders lack the degree of influence and control rights over corporations that partners have in partnerships. But if this is Bebchuk’s analogy, this line of reasoning suggests its own response: If equity investors in corporations had wanted the same rights of control over corporate assets as partners in a partnership have over partnership assets, then they should have invested in partnership-type organizations rather than in corporations.<sup>142</sup>

As discussed above, unlike shareholders, partners are considered “co-owners” with direct interests in partnership assets, and as such have considerable leeway to influence the use of partnership assets, to withdraw their share of the partnership assets, and to compel dissolution of the partnership. Since those options are available to investors through the partnership organizational form (and can be modified to the precise specifications of any given group of investors through the details of the partnership agreement), then restructuring *corporate* law so that shareholders have similar options by legislative requirement would effectively deny investors the opportunity to commit their assets to ventures that they think might be more effective if capital is locked in. Bebchuk’s proposals would reduce the range of investment opportunities now available to investors by eliminating one of the most important factors that distinguishes corporations from partnerships.

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of capital.”); Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 863, n. 22 (1997) (“Because shareholders are simply one of the inputs bound together by the web of voluntary agreements, ownership should not be a particularly meaningful concept in nexus-of-contracts theory.”). But he repeatedly analogizes the corporate governance problem to the problem of getting a building manager to serve the interests of an absentee landlord. See Bebchuk (2003), *supra* note 2, at 18, 53. And at one point he asserts, regarding decisions about the allocation of corporate resources, that “it is their [shareholders’] money that is on the line.” *Id.* at 51.

141. Bebchuk does not explicate a theory of property rights in corporations that explains why all the benefits of corporate activity should flow to shareholders.

142. Ribstein, *supra* note 66, proposes exactly this: that investors should consider reorganizing firms using partnership law rather than corporation law, on the grounds that investors would then have more control over the use of firm assets, and the firm would be less subject to government regulation. But, of course, passive investors in limited partnerships may have even less ability to withdraw their contribution or influence management to make distributions than shareholders have, especially if the limited partnership shares are publicly traded. Perhaps Bebchuk just believes, for aesthetic or distributional reasons, that shareholders should have the benefits of direct ownership of corporate assets (control rights and claims on economic value created using the assets), but none of the responsibilities of direct ownership of corporate assets (liability and lack of liquidity). As an economist, I find the incentives implied by such an allocation of rights and responsibilities to be a bit troubling.

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### C. Proposals That Give Shareholders More Information and More Effective Voice

The corporate scandals of the last few years have made it clear that agency problems in corporations can be severe, but even granting that agency costs can be a problem, it is hard to see how Bebchuk's "scaling-down" proposals or "game-ending" proposals would have helped to prevent the frauds that happened at Enron or WorldCom, or the insider dealing at Tyco, or even the errors in business judgment that might have been behind Time Warner's merger with AOL. The financial markets appeared to love all of those companies right up until their problems were revealed, and by then it was too late to prevent them.

Financial investors, however, may not be able to make optimal investment decisions because they are likely to suffer from limited and/or distorted information about the performance of companies in their portfolios.<sup>143</sup> Presumably it was bad information and distorted perceptions, rather than stupidity, that led financial investors to invest so much cash in internet and telecom companies in the late 1990s, resulting in the financial market boom of that period, and the subsequent bust since 2000.<sup>144</sup> Hence, corporate governance proposals that are aimed at enhancing investor information, and even giving investors more effective voice, might "improve" corporate governance (in the sense of increasing the wealth-creating potential of corporations) by reducing agency costs and facilitating the allocation of capital toward truly promising investments, while not undermining the features of corporate governance that help to solve the team production problem. A sampling of the reforms that have been proposed (or enacted) are:

1) Enhancing the quality of information:

- \* Enhance oversight of the accounting profession through a new, publicly-chartered oversight board.<sup>145</sup>
- \* Enhance the rules for auditor independence.<sup>146</sup>
- \* Require CEOs and CFOs to take personal responsibility for the accuracy of reports filed with the Securities and Exchange Commission.<sup>147</sup>

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143. All the more reason that they should not have scaling-down, or game-ending authority.

144. See ROBERT SHILLER, IRRATIONAL EXUBERANCE (2000) (reviewing evidence that financial markets often overreact to new information).

145. Sarbanes-Oxley Act § 101(d) (providing for the establishment of the Public Company Accounting Standards Board).

146. *Id.* § 201(a) (prohibiting auditor provision of certain non-audit services to audit clients; § 202 (requiring audit committee pre-approval of audit and permissible non-audit services); § 203 (requiring audit partner rotation); § 204 (requiring auditor to report to audit committee regarding critical accounting practices and other matters); § 206 (providing for the SEC to develop rules regarding auditor conflicts of interest)).

147. *Id.* § 302(a) (requiring CEOs and CFOs to certify disclosures in quarterly and annual reports; § 906 (requiring CEO and CFO certification of disclosures in periodic reports containing financial

\* Enhance disclosure requirements regarding off-balance sheet arrangements and contractual obligations.<sup>148</sup>

\* Reduce the time allowed for companies to report insider transactions.<sup>149</sup>

These reforms have, of course, all been made law by the enactment of the Sarbanes-Oxley Act of 2002. Without analyzing the merits of these reforms (which would be beyond the scope of this Article), we can safely assume that all of them are intended to improve the quality and reliability of information that shareholders have about the corporations in which they are investing. Better information will help shareholders decide whether to buy or sell shares, causing the market price to more accurately reflect the true underlying value of the shares. But better information does not affect the degree of control that corporate directors have over corporate decisions or allocation of corporate assets. Hence, these are the kinds of reforms that could reduce agency costs in ways that are consistent with the “team production” and “locking-in of capital” functions of corporate law.

## 2) “Rules-of-the-game” proposals:

\* Shareholders should have the right to vote on all equity-based compensation plans.<sup>150</sup>

\* Shareholders should have the right to nominate directors.<sup>151</sup>

\* Shareholders should have the power to initiate charter amendments as well as bylaw amendments.<sup>152</sup>

\* Shareholders should have the power to initiate actions to reincorporate in another state under different statutory rules.<sup>153</sup>

These proposals all clearly shift power and influence away from directors and toward shareholders, and so I regard them with caution. But they do so in ways that are not *necessarily* inconsistent with the ability of directors to retain

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statements). Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 942, n.93 observes that the new certification requirements “adds to pre-existing signature requirements without changing these pre-existing requirements.” Cunningham suggests that the point may be “to heighten executive attention to the stakes.” *Id.* at 942.

148. Sarbanes-Oxley Act § 401(a) (requiring disclosure of off-balance sheet arrangements and contractual obligations).

149. *Id.* § 403 (requiring accelerated reporting, electronic filing and website posting of information on insider transactions).

150. NYSE, New York Stock Exchange Corporate Accountability and Listing Standards Committee June 6, 2002, at 17, available at [http://www.nyse.com/pdfs/corp\\_govreport.pdf](http://www.nyse.com/pdfs/corp_govreport.pdf) (last visited Feb. 24, 2004); NYSE, Form 19b-4 Proposed Rule Change by New York Stock Exchange, Inc. June 20, 2003, at 5, available at <http://www.nyse.com/pdfs/2002-46am2.pdf> (last visited Feb. 24, 2004) [hereinafter NYSE Proposed Rule Change]; NASDAQ Summary of NASDAQ Corporate Governance Proposals As of September 10, 2003, at 1, available at [http://www.nasdaq.com/about/Corp\\_Gov\\_Summary.pdf](http://www.nasdaq.com/about/Corp_Gov_Summary.pdf) (last visited Feb. 24, 2004).

151. Press Release, Securities and Exchange Commission, *SEC Proposes to Increase Proxy Access by Shareholders* (Oct. 8, 2003), available at <http://www.sec.gov/news/press/2003-133.htm> (last visited Feb. 24, 2004).

152. Bebchuk, *supra* note 2, at 4.

153. Bebchuk, *supra* note 2, at 30-31.

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ultimate control over “scaling-down” and “game-ending” decisions, which are the types of decisions that, if left to shareholders, would have the greatest potential for undermining the team-production-fostering role of the corporate form. If shareholders were permitted to nominate directors, propose charter amendments, and initiate reincorporations in other states, it would be interesting to see whether they would use these rights to improve their access to information and ability to monitor performance, or whether they would use these additional powers to attempt to extract immediate benefits for shareholders at the expense of other stakeholders or at the expense of the long-run wealth-creating potential of the corporation.

The funds managers at large institutional investors may understand that, to a great degree, the performance of their portfolios is ultimately tied to the performance of the economy as a whole. Although it might benefit individual shareholders from time to time to engage in scaling-down or game-ending strategies that extract wealth at the expense of the long-run performance of a particular firm, it does not serve the interests of shareholders as a class to have weak directors and managers who are unable to elicit the enthusiastic cooperation of other corporate stakeholders in the wealth-creating enterprise of the firm. Thus, to the extent that the large-block shareholders in U.S. companies are widely diversified institutional investors, they might use these new powers in moderation, and would not undermine the strength of boards or compel the premature distribution of corporate assets.

This line of argument does not apply to the game-ending and scaling-down decisions, because the short-term benefits that are available from extracting assets from a corporation can sometimes be attractive enough to motivate individual investors to acquire concentrated holdings and form coalitions with other undiversified and short-term-oriented investors to strip assets out of a corporation.<sup>154</sup> This could occur despite the fact that a widely-diversified institutional investor, with a very long time horizon (such as an indexed

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154. For example, in April 1995, investors led by Kirk Kerkorian formed an alliance with former Chrysler Corp. chairman Lee Iacocca to make a bid to acquire Chrysler Corp. Kerkorian claimed that his intention was to get Chrysler to use its cash surplus to pay out dividends and buy back stock to increase the share price. Iacocca disavowed any interest in running the company, and Kerkorian explained that Iacocca was involved because he knew a great deal about the auto industry and because he recognized the opportunity to pull assets out of Chrysler in a way that they thought would increase the value captured by shareholders. Kerkorian publicly praised the Chrysler management team and promised that he had no intention of replacing them. Kerkorian and Iacocca did not win the support of enough institutional investors to allow their bid to succeed, however. See, e.g., Charles Stein, *Investor Seeks \$22B Takeover of Chrysler*, BOSTON GLOBE, Apr. 13, 1995, § 1, at 1; Bill Barnhart, *Chrysler Bid Pairs Two Old Allies*, CHICAGO TRIBUNE, Apr. 13, 1995, § 3, at 1. See also Shinichi Hirota & Kohei Kawamura, What Makes Autonomous Management Do Well? Corporate Governance Without External Controls (ECGI—Finance Working Paper No. 10/2003) (finding that it is optimal for shareholders to be passive and leave the firm to management control in situations where workers are employed on a long-term basis and the effort of young workers depends on managerial decision-making; employees in such situations will keep the pressure on managers to perform, providing a substitute for shareholder control), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=379100](http://papers.ssrn.com/paper.taf?abstract_id=379100).

pension fund) would not find that the advantage to be gained from pulling assets out of one corporation outweighed the costs in lost credibility of the capital lock-in bargain that would affect its whole portfolio of investments.

#### *D. Proposals That Strengthen the Role and Effectiveness of Boards*

The team production approach to understanding corporate law emphasizes the role of strong independent boards of directors in maintaining the right balance among the competing claims and interests in corporations. By contrast, the principal-agent approach to understanding corporate law often conflates the roles of directors and managers. In Bechuk's article on empowering shareholders, for example, he never even acknowledges that boards of directors might be distinct from managers institutionally, legally, and in terms of the personalities involved. Hence, he acknowledges no role for boards of directors to help address the principal-agent problem by monitoring managers to be sure that they are not self-dealing, and that their actions are directed toward long-run wealth creation by the corporation rather than get-rich-quick schemes by management itself. If the role of boards of directors is properly understood, then it seems clear that any reforms that enhance the independence of boards, that provide them with better information, or that help them to work better and smarter, are likely to enhance both the team production-fostering and the agency cost-reducing functions. A sampling of proposals that I believe have the potential to generate this effect include:

- \* Boards of directors should consist of a majority of independent directors.<sup>155</sup>
- \* Boards should have audit, nominating, and governance committees consisting entirely of independent directors.<sup>156</sup>
- \* Directors and committee members should be required to meet without management,<sup>157</sup> and their responsibilities should be enhanced to include reviewing more closely the goals, objectives, and performance of management, and evaluating compensation in light of these.<sup>158</sup>

Although reforms such as these are not inconsistent with the role of boards in addressing the team production problem, they would not necessarily improve the performance of boards, nor of companies, by themselves. What is also

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155. NYSE Proposed Rule Change, *supra* note 150, at 6; *see also* NASDAQ, *supra* note 150, at 1 (proposing that NASDAQ listing rules should require a majority of independent directors on boards).

156. NYSE Proposed Rule Change, *supra* note 150, at 9-11; *see also* NASDAQ, *supra* note 150, at 2-3 (proposing that audit committee members be independent, and approval be by independent directors of nominations and executive compensation).

157. NYSE Proposed Rule Change, *supra* note 150, at 10; *see also* NASDAQ, *supra* note 150, at 2 (proposing that executive sessions of independent directors must be convened regularly).

158. NYSE Proposed Rule Change, *supra* note 150, at 8. NASDAQ proposals suggest independent compensation committees but do not specify duties in the same way that NYSE proposed rule changes do.

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needed is education and acculturation of directors so that they better understand, buy into, and have the tools they need to fulfill their roles.

### V. FINDING THE RIGHT BALANCE BETWEEN REDUCING AGENCY COSTS AND FOSTERING TEAM PRODUCTION

The problem of choosing appropriate organizational forms and rules arises whenever people agree to work together to accomplish complex and long-term goals. If people could foresee all contingencies, and if they were all completely cooperative and trustworthy, almost any organizational form would work, because no one would try to take advantage of private information or unforeseen events. But, as Oliver Williamson noted long ago, people are “boundedly rational” and behave opportunistically.<sup>159</sup> Thus, productive activity that involves many people is susceptible to being co-opted or diverted to serve the interests of one or more participants at the expense of the others. It is therefore impossible to write complete contracts that will elicit best efforts and cooperation by all participants in the enterprise. Productive organizations, or firms, provide an alternative solution to this problem by establishing a set of gap-filling rules about who gets to decide what as the enterprise proceeds. Corporations in particular come with a set of default rules that, under U.S. law in the twenty-first century, differ from the rules of legal organizational forms based on partnership in four principal ways: They provide continuity and possibly perpetuity of existence; they provide for control by a board of directors; they provide free transferability of interests; and they provide a mechanism for locking in the capital used in the enterprise without locking in the investors. Although the default rules for partnership do not provide these features, it is possible to structure partnership forms contractually to provide the first three of these features too. Conversely, it is possible to include charter provisions in corporate charters that eliminate or restrict these features. But the basic corporate form provides for all four features, and using the basic form is the simplest way to create a business organization that has these features.

Hence, under current corporate law, it is possible for investors to form an organization, invest capital in that organization, turn control over to an independent board of directors, and pre-commit not to withdraw their invested capital prematurely, or capriciously, or in ways that harm other participants in the enterprise. Such a pre-commitment may be important in order for a corporation to attract complex, intangible, and firm-specific inputs from other participants in the enterprise, such as managers and skilled employees. If corporate law were “reformed” in ways that conferred upon shareholders in corporations the rights to compel directors to pay out dividends, make other

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159. See, e.g., OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 45-47 (1995) (identifying “opportunism” and “bounded rationality” as among his basic behavioral assumptions).

distributions, sell assets, or liquidate and dissolve the company, such “reforms” would eliminate investors’ ability to choose a form that essentially prevents them from taking advantage of the other participants—or at least, makes it more difficult for them to do so. By reducing options currently available to business organizers, such a “reform” would probably reduce overall welfare. In light of more than 150 years’ worth of experience with wealth creation through the corporate form, it seems to me that the burden of proof is on those who would propose such changes in corporate law to show that the economic welfare is reduced, and society is harmed by the fact that business organizers have the ability to choose an organizational form that locks in capital and yields control rights to directors.