

Book Review

Corporate Anatomy Lessons

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The Anatomy of Corporate Law: A Comparative and Functional Approach. By Reinier Kraakman* et al. New York: Oxford University Press, 2004. Pp. 260. \$85.00.

INTRODUCTION

Every ten years or so, a book is published that sets the terms of discussion in corporate law scholarship for the years that follow. In 1976, Melvin Eisenberg published *The Structure of the Corporation*,¹ a work that redefined how scholars and policymakers thought about the role of the board of directors. Eisenberg's model of the "monitoring board"—a board that oversees the managers of a company instead of attempting to

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1. MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1976). The first in a line of classic corporate law books, and still by far the most influential book ever written on American corporate law, was ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932), which identified the growing separation between ownership and control in America's largest corporations. The most influential book in the intervening years was a collection of essays, *THE CORPORATION IN MODERN SOCIETY* (Edward S. Mason ed., 1959).

run the business directly—continues to define our expectations of a properly functioning board. Next came *The Economic Structure of Corporate Law* by Frank Easterbrook and Daniel Fischel, which reworked a series of their classic articles from the 1980s.² Writing from a law-and-economics perspective, Easterbrook and Fischel contended that the principal task of corporate law is to limit the conflict of interest—or “agency costs”—between managers and shareholders, and that American corporate law facilitates this goal by providing a menu of default rules the parties can alter by contract if they so choose. The most recent addition to this pantheon was Mark Roe’s 1994 book, *Strong Managers, Weak Owners*, which challenged the traditional assumption that the emergence of America’s widely held corporations was dictated entirely by economics.³ In *Strong Managers, Weak Owners*, Roe noted that, unlike American corporations, where shareholders are scattered and rarely play a prominent role, German and Japanese firms are often monitored by large shareholders such as banks and insurance companies. He attributed the difference as much to politics—the traditional American hostility to concentrated financial power—as to economics.

The book that will lay the groundwork for the corporate law debates of the coming decade is *The Anatomy of Corporate Law*.⁴ Written by seven of the world’s leading corporate law scholars—Henry Hansmann, Reinier Kraakman, and Ed Rock of the United States; Paul Davies of England; Gérard Hertig of Switzerland; Klaus Hopt of Germany; and Hideki Kanda of Japan—*The Anatomy of Corporate Law* attempts to identify the underlying structure of corporate law and to provide a framework for understanding the wide range of approaches that different countries take to corporate regulation. “What is the *common structure* of the law of business corporations . . . across different national jurisdictions?” the authors ask at the outset.⁵

It is hard to overstate the significance—and, as we shall see, the success—of this project. Traditional comparative corporate law scholarship has tended to explore the differences among jurisdictions in intricate detail. The authors of *The Anatomy of Corporate Law* insist that

2. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

3. MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

4. REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* (2004).

5. *Id.* at 1.

these local variations are only that—variations on a single, common theme. Throughout the book, they take a functional approach, emphasizing the extent to which countries that seem to have very different legal rules nevertheless tend to develop roughly similar solutions to the characteristic problems of corporate law.

The central issue for corporate law in every jurisdiction, they argue, is how to mediate three kinds of agency conflicts: between managers and shareholders, between majority and minority shareholders, and between the firm and third parties. To understand how different countries address these competing claims, the authors develop a typology of ten different strategies. The authors divide these strategies across two vectors: first by operational criteria, categorizing each strategy broadly as either a “regulatory” or a “governance” approach; then by temporal criteria, separating strategies that operate *ex ante* from others that come into play *ex post*.⁶ Having developed their schema, the authors then apply it to related party transactions, control transactions, investor protection, and a variety of other key corporate law issues.

The great virtue of *The Anatomy of Corporate Law* is that its typology of strategies provides a simple, user-friendly way to compare the corporate law regimes of a wide range of different countries. Although scholars will surely debate both the authors’ typology and their claim that several basic agency cost problems lie at the heart of every corporate law system, the essential framework is likely to withstand even the most relentless scrutiny.⁷ Almost as remarkable as the typology itself is the clarity and elegance of the analysis—especially given that the book is the work of seven different scholars. The authors develop and apply their typology in well under three hundred pages, a succinctness that would fill the editors of that other anatomical guide, *Gray’s Anatomy*,⁸ with envy.

6. For readers who are already counting the parts of the typology, I should note that there are two regulatory strategies and three governance strategies, each of which has both an *ex ante* and an *ex post* version. This gives the typology its total of ten parts.

7. At a seminar at the London School of Economics in June 2003 that focused on the book in anticipation of its publication, and for which I began thinking about the issues discussed in this Review, the invited guests (roughly forty academics and top corporate lawyers) spent much of the day trying to poke holes in the authors’ typology and its emphasis on agency costs—but without success.

8. *Gray’s Anatomy*, the best-known general purpose medical handbook, comes in at roughly six times the length of *The Anatomy of Corporate Law*. See GRAY’S ANATOMY (Peter L. Williams et al. eds., Churchill Livingstone 37th ed. 1989).

To say so much in so brief a compass, the authors obviously had to exercise ruthless editorial judgment on what to include and what to omit. After describing their typology and exploring several of their applications, I spend much of this Review focusing on issues and perspectives that the authors left out. At a general level, the book's most important limitation is that it does not take its functionalist approach far enough. Functional analysis, as the legal realists understood that term, encompasses not only legal rules, but also norms, history, and social context. Although the authors are careful not to limit themselves to the "law on the books," *The Anatomy of Corporate Law* focuses heavily on legal regulation, and tends to give short shrift to these other factors. This gives the book a somewhat ahistorical quality, and makes it seem less "functional" than one might expect. To borrow an analogy from the world of art, it is as if the typology is drawn from casts of ancient sculptures, rather than drawn from life.⁹

The Review also argues that the book leaves out several crucial facets of corporate law. The most important omission is the bankruptcy or insolvency regime. In recent years, it has become increasingly apparent that bankruptcy—or corporate reorganization—is best seen as a component of corporate law. Indeed, I argue that it is impossible to understand other corporate law issues without appreciating the role that bankruptcy plays in shaping the incentives of managers and other constituencies even while the corporation is financially healthy.

The authors also omit any sustained discussion of corporate groups—that is, the parent-subsidary arrangements that characterize nearly every large corporation. Although the authors refer to the extensive regulations of corporate groups in Germany and elsewhere, they have little to say about these regulations and do not offer any analysis of the factors that influence a company's decision whether to set up a new business as a division within an existing corporation or to locate the business in a separate corporation.

Finally, the authors do not fully consider the distinctive challenges of corporate governance in emerging countries. Although they suggest that the book's ten-part typology is relevant to any country, the authors' analysis focuses on five notably developed jurisdictions—the United

9. "The beginner can at the very outset," the American artist Thomas Eakins said in defense of his teaching philosophy in 1881, "get more from the living model in a given time than from study of the antique in twice that period." 1 LLOYD GOODRICH, THOMAS EAKINS 174 (1982) (internal quotation marks omitted).

States, the United Kingdom, Germany, France, and Japan. In the developing and transition nations whose corporate law has been a particular concern in recent years, by contrast, it is important to move beyond the typology in order to account for problems such as limited judicial enforcement.

Part I of the Review describes the authors' typology and explores some of the insights that emerge when they apply it to issues such as self-interested transactions and the market for corporate control. Part II considers the limits of the authors' functionalist approach and argues that *The Anatomy of Corporate Law* should be seen as a prequel to, rather than an extension of, important recent debates over the political determinants of different corporate law regimes and the likelihood that corporate law is converging around the world. Parts III-V then discuss bankruptcy, corporate groups, and the special issues raised by corporate governance in emerging nations. I offer the last three Parts as a kind of friendly amendment (though an amendment that articulates my own—perhaps at times conflicting—vision of corporate law) to the book. These Parts can be seen as a plea that the authors add chapters on bankruptcy and corporate groups to their book in the future, and that they highlight the distinctive concerns of developing nations in its epilogue. These additions are all it would take to make the anatomy complete.

I. THE BASIC ANATOMY OF CORPORATE LAW

The audacious goal of *The Anatomy of Corporate Law* is, in the authors' words, "to offer a *common language* and a general *analytic framework* with which to understand the purposes that can potentially be served by corporate law, and with which to compare and evaluate the efficacy of different legal regimes in serving those purposes."¹⁰ This objective does not distill to a claim that the business corporations of every country are, once we scratch beneath the surface a bit, identical. Nor do the authors claim that the laws governing corporations are heading in this direction, converging toward a single framework (although several of the authors have made essentially this claim elsewhere, and the book presents evidence of convergence in the five

10. KRAAKMAN ET AL., *supra* note 4, at 4.

jurisdictions on which it focuses).¹¹ The point, instead, is that “corporations have a fundamentally similar set of legal characteristics—and face a fundamentally similar set of legal problems—in all jurisdictions.”¹² The underlying template and the problems are the same; the way they are addressed may be quite different.

After describing the basic attributes of the corporation in the first chapter, the authors develop their typology—their common language and general analytic framework—in chapter 2; they then spend the remainder of the book applying it to a series of corporate law issues. To lay the groundwork for the remainder of this Review, this Part adopts the same strategy. I describe the authors’ account of the attributes of the firm, and summarize their ten-part typology and the agency problems to which it responds. I then highlight some of the insights the book offers into the key dilemmas of corporate law.

A. *Tweaking the Traditional Attributes of the Corporation*

In the beginning is the corporation itself. *The Anatomy of Corporate Law* does not dwell on the reasons that businesses choose to incorporate rather than use another enterprise form. The authors take it as a given that the vast majority of large businesses are likely to be organized as corporations or in an equivalent form, and that most small firms that are held by more than two owners also adopt the corporate form.

What this means in practice, the authors argue, is that most substantial firms have five basic characteristics in common: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. The initial list of attributes is to some extent familiar turf for anyone who has read a corporate law treatise or taken a law school class on corporations in the

11. The strong view of convergence is defended in Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001). Another one of the authors, Gérard Hertig, has taken a more cautious view, emphasizing the complexity of the analysis and the need to take differences in actual enforcement into account. Gérard Hertig, *Convergence of Substantive Law and Convergence of Enforcement: A Comparison*, in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon & Mark J. Roe, eds., forthcoming 2004). Although Kraakman emphasizes in the preface to *The Anatomy of Corporate Law* that the authors “do not articulate a political economy of legal convergence in corporate law,” he also hastens to add that the “book as a whole offers persuasive evidence of convergence across our major jurisdictions.” KRAAKMAN ET AL., *supra* note 4, at vii.

12. KRAAKMAN ET AL., *supra* note 4, at 1.

last thirty or forty years. And its role is simply to serve as a springboard for the authors' most important innovation—the typology they will develop and apply throughout the book. But even here, there are hints of a new perspective. Rather than recycling the traditional five-factor description of the corporation, the authors reshape both the attributes and the overall account.¹³

The two attributes that track the standard account most closely are limited liability and transferability. Limited liability—which means that the shareholders of a corporation generally do not have any liability beyond the capital they have contributed to the corporation in return for their shares—is the attribute most laypeople associate with the corporate form. Transferability refers to the fact that, so long as there are no contractual restrictions, shareholders have the right to transfer their shares, and this shift in ownership does not interfere with the existence or operation of the corporation.

In the standard account, the authors' fourth attribute, “delegated management under a board structure,” would be labeled “centralized management.” Because corporations have limited liability and the corporation does not dissolve if a shareholder dies or sells her shares, the corporate form facilitated a division of labor between investors and managers. In the United States, this division emerged most strikingly in the nineteenth-century railroads, as chronicled by Alfred Chandler and others.¹⁴ By rechristening this attribute, *The Anatomy of Corporate Law* underscores the significance of the board of directors as an intermediary between shareholders and managers.¹⁵ Shareholders ordinarily have the right to elect directors, but it is the directors who choose and oversee the managers. Thus, as the phrase “delegated management under a board

13. The traditional list of corporate attributes includes: limited liability, free transferability of ownership interests, continuity of existence or “perpetual life,” centralized management, and entity status. See, e.g., MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 100 (8th ed. unabr. 2000) (listing and describing these five attributes).

14. See, e.g., ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977) (describing the emergence of middle managers and a hierarchical structure in American business).

15. “Manager” is a somewhat slippery term in the corporate world. In the conventional definition, which I adopt here, managers are the executives who run the corporation on a day-to-day basis. The firm’s highest-level executives, such as the chief executive officer (CEO) and the chief financial officer (CFO), often serve on the board as well and are referred to as “inside directors” in that capacity. Thus, there is often an overlap between a company’s managers and its directors.

structure” suggests, the directors are the crucial link between shareholders and the decisionmaking authority that shareholders implicitly delegate to the day-to-day managers.

The authors have created “investor ownership,” the fifth characteristic in their initial list of attributes, out of whole cloth. In the traditional recitation, the fifth attribute would be continuity of interest or “perpetual” life—the fact that, so long as they keep making money and paying their debts, corporations are eternal. Why omit perpetual life? Presumably, the authors concluded that the permanence of the corporate form is already captured in the concept of legal personality, and thus that continuity of interest wouldn’t be missed (save, perhaps, by a few corporate law scholars who have a deep attachment to the traditional incantation). One cannot help but imagine that Henry Hansmann (who not coincidentally is one of the coauthors of the initial chapter) was the one who dropped perpetual life and slipped “investor ownership” into the mix. Hansmann is the author of an extremely important book on the choice among different enterprise forms.¹⁶ The emphasis on investor ownership is designed to highlight the fact that the shareholders of a corporation enjoy both the right to control the firm and the right to receive the firm’s net earnings. In other enterprise forms, either or both of these rights may be missing.¹⁷

I have saved the first attribute, legal personality, for last because it has received by far the most attention in the recent literature and will figure prominently in my analysis later in the Review. In the late nineteenth and early twentieth century, the nature of corporate personality was hotly debated by European, and then American, corporate scholars. The principal question was whether corporations are “real” entities, with a philosophically separate existence, or whether they are simply aggregations of shareholders or artificial entities that owe their powers entirely to the state.¹⁸ From a twenty-first-century vantage point, the debate is excruciating; it is the corporate law equivalent of the

16. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996).

17. In a limited partnership, for instance, the limited partners have the right to receive the partnership’s net earnings but cannot take part in the control of the partnership. *See, e.g.*, EISENBERG, *supra* note 13, at 480-90.

18. For an excellent analysis of the debate as it played out in the United States, see MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 68 (1992). Horwitz argues that the “natural entity” view figured prominently in the legitimization of large-scale corporate enterprise in the late nineteenth century.

medieval quarrels over how many angels can dance on the head of a pin. Indeed, the debate is often viewed as having ended when the pragmatist philosopher John Dewey published an article in this journal arguing that the various views collapsed into each other, and each could be used to support any outcome on a particular issue.¹⁹ Certainly, we should be careful not to understate the significance of the opposing views. In the United States, the persistence of the natural entity theory has contributed to the legal treatment of corporations as “persons” that are entitled to constitutional protections such as free speech rights—as well as subject to criminal liability for their acts. But most corporate law scholars simply took corporate personality for granted for decades after the philosophical debate petered out.

In the past five years, two of the authors of *The Anatomy of Corporate Law*, Hansmann and Kraakman, have put corporate personhood back on the scholarly radar screen by arguing (on economic rather than philosophical grounds) that corporate personality is the single most important attribute of the corporate form. The key attribute of corporate personhood, in their view, lies in two protections that they refer to collectively as “affirmative asset partitioning.”²⁰ The first protection is priority status for creditors of the corporation. Corporate law underscores the separate existence of the corporation by giving corporate creditors first dibs on its assets; only after they have been paid are creditors of the corporation’s shareholders entitled to share in the assets. In effect, this treatment segregates the company’s assets and as a result enables creditors to monitor more effectively. The second component of corporate personhood, liquidation protection, assures that individual shareholders “cannot withdraw their share of firm assets at will, thus forcing partial or complete liquidation of the firm, nor can the personal creditors of [a shareholder] foreclose on the [shareholder’s] share of firm assets.”²¹ Liquidation protection diminishes the risk that a company’s going-concern value will be destroyed as the result of financial grabs by shareholders or their creditors.

19. John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655 (1926).

20. Hansmann and Kraakman develop their theory in Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000), and Henry Hansmann, Reinier Kraakman & Richard Squire, *Legal Entities, Asset Partitioning, and the Evolution of Organizations* (Sept. 2003) (unpublished manuscript, on file with author).

21. KRAAKMAN ET AL., *supra* note 4, at 7.

What makes affirmative asset partitioning especially important is that the parties could not realistically create it themselves. All of the other attributes theoretically could be replicated through contractual provisions (just as the attributes can be, and often are, altered or eliminated by contract). But it would be nearly impossible to achieve affirmative asset partitioning by contract, due to the huge number of actual and potential parties involved (which would include every creditor of every current or future shareholder of the enterprise).²² As a result, it is here that the corporate form, as supplied by the state, plays its most important role.

Although the description of corporate personhood in *The Anatomy of Corporate Law* is drawn directly from Hansmann and Kraakman's work, it plays little role in the analysis of the book. The authors quickly leave this and the other attributes of the corporation behind. They take the existence of the firm and its boundaries as a given throughout the book, and focus on the relationships among the principal parties within an established firm. As we shall see, it is unfortunate that the corporate boundary issues leave almost no further trace on the analysis; the choice of boundaries, as it turns out, is an essential part of the anatomy of corporate law.²³

B. *The Typology at the Heart of Corporate Law*

1. *The Three-Headed Problem of Agency Costs*

Having dispensed with corporate law's initial function, establishing and defining the parameters of the corporate form, the authors go on to develop the typology that governs the remainder of the book. This entire typology is based on a startlingly simple claim: The authors argue that the chief end of corporate governance is to control the inevitable conflicts of interest that arise among the principal constituencies of the corporation—nothing more, nothing less. These conflicts fall into three general categories: conflicts between the corporation's shareholders and

22. See Hansmann & Kraakman, *supra* note 20, at 410-12, 429. John Armour and Michael Whincop argue that another important role of corporate law is to establish the authority structure that governs the relationships among various constituencies of the firm. John Armour & Michael J. Whincop, *The Proprietary Structure of Corporate Law* (Aug. 2001) (unpublished manuscript, on file with author).

23. See *infra* Part IV (reintroducing asset partitioning to analyze boundary issues and corporate groups).

its managers; between controlling shareholders and minority shareholders; and between the corporation and contracting parties such as creditors, employees, and customers.

As is customary in the corporate governance literature, the authors refer to these conflicts as “agency” or “principal-agent” problems. These kinds of problems, they note, “arise[] whenever the welfare of one party, termed the ‘principal,’ depends on actions taken by another party, termed the ‘agent.’”²⁴ In layperson’s terms, whenever one party acts on behalf of another, there is a risk that he will pursue his own interests rather than those of the other party.

For American readers, the most familiar of these problems is the first: the potential conflict between shareholders and the company’s managers and directors. Although the directors (and through them, the managers) are representatives of the shareholders (and sometimes of other constituencies as well), they may pay more attention to protecting their jobs, benefits, or the privileges of running the business than to the best interests of the shareholders and the company. The problem can be particularly acute if—as has traditionally been the case in the United States, and more recently the United Kingdom as well—shareholdings are diffuse.²⁵

If, by contrast, some of the shareholders hold significant blocks of stock—as is often the case in continental Europe and Japan—the authors’ second category of potential conflict arises: Blockholders may use their influence to direct benefits to themselves at the expense of the company’s other, scattered shareholders. These blockholders, who may be members of a controlling family or a financial institution such as a bank, may contract with the company on attractive terms or use the company’s assets as their own.

The authors’ final category of conflict arises out of the fact that the company (at the behest of its owners or managers) may exploit one or more of the other constituencies with whom it contracts by shifting

24. KRAAKMAN ET AL., *supra* note 4, at 21.

25. Identifying this problem, which they referred to as the separation of ownership from control, was the central insight of Berle and Means’s landmark book *The Modern Corporation and Private Property*. BERLE & MEANS, *supra* note 1. In recent decades, institutional shareholders such as mutual and pension funds have become major stockholders in most large U.S. corporations, and they hold even larger stakes in U.K. companies. *See, e.g.*, Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994).

excessive risk to its creditors, mistreating its employees, or deceiving the consumers who buy its products.

The authors' claim that addressing these three agency problems is the single overriding objective of corporate law is certain to generate fierce debate. As noted earlier, at a full-day seminar celebrating the book in June 2003, a group of commentators and participants repeatedly questioned whether this is the proper lens through which to view corporate governance.²⁶ Although the participants agreed that relationships among the various constituencies are the central issue in corporate law, there was far less consensus on whether the agency cost notion is the best way to analyze these relationships. Two of the counterproposals will give the flavor of the initial debate. One commentator, Jonathan Rickford, suggested that the real issue in corporate governance is not so much agency problems as control rights—that is, the proper allocation of powers among the various constituencies of the corporation. The issue, he argued, consists of questions such as what issues should be within the shareholders' prerogative, how authority should be divided between the corporation's managers and its board (or boards) of directors, and how much influence employees should have over corporate decisionmaking. Although the authors acknowledged the importance of control rights—and the roles that both law and private contract play in allocating corporate power—they argued that the underlying goal of such an allocation is to minimize agency costs. Manager control is often overridden, for instance, in contexts such as takeovers, where managers have a particularly strong incentive to favor their own interests at the expense of shareholders and the firm.

A second debate centered on the term “agency” itself. Rather than principal-agent relations, several participants insisted, the relationships among the constituencies of the corporation are promissory in nature. Managers and employees are subject to employment contracts, and creditors and customers have their own contractual relations with the company. Most of these relationships do not fit the traditional agency paradigm of a principal transferring control over the res of a trust to an agent, the trustee, who acts on the principal's behalf. In response, the authors emphasized that the conception of “agency” employed by *The Anatomy of Corporate Law* is the economists' more general conception

26. See *supra* note 7.

of principal-agent relations (a usage that is now standard in the corporate law literature as well, as noted above), rather than the traditional, doctrinal legal definition. One of the authors, Paul Davies, also pointed out that many corporate relationships are more dependency-based than truly promissory in nature—that is, the promisor-promisee paradigm is too narrow to capture many aspects of corporate law, such as directors' fiduciary duties to shareholders or the corporation's environmental obligations.

Each of these issues can be expected to resurface as scholars grapple with the insights of the book, and there will be additional debates as well—for example, given that agency cost analysis tends to be economic in its focus, future commentators are likely to argue that *The Anatomy of Corporate Law* does not place enough emphasis on social or moral concerns. Yet the book's analysis does not preclude these considerations, and its authors make a powerful argument that the choices made in any given jurisdiction will have predictable economic consequences, consequences that are best seen in agency cost terms.

By the end of the London seminar, the authors' claim that agency costs lie at the heart of corporate law had withstood even the most aggressive pummeling. I strongly suspect this will be the case in the broader corporate governance literature as well. At least for the developed economies that are the authors' principal focus, agency conflicts are precisely the right starting point.²⁷

2. *The Ten-Category Typology of Corporate Governance*

It is here that the anatomy lessons truly begin. *The Anatomy of Corporate Law* divides all of corporate law into a total of ten different strategies for protecting principals from expropriation by corporate double agents.²⁸ These strategies fall into two general categories, four of which the authors refer to as “regulatory strategies,” and six that are characterized as “governance strategies.” Let me begin by describing the

27. For a discussion of the very different issues raised in the context of developing economies, see Part V.

28. Given that there are three different kinds of agency problems, the identities of the principal and agent will vary in the three contexts. Shareholders are the principal, and managers the agents, in the first type of agency problem; minority shareholders are the principal, and controlling shareholders the agent, in the second; and various third parties are the principal, and the corporation (or its owners) the agent, in the last.

two general categories, then turn to the strategies within each category. A table of the entire schema is included below.²⁹

TABLE 1. STRATEGIES FOR PROTECTING PRINCIPALS

	Regulatory Strategies		Governance Strategies		
	Agent Constraints	Affiliation Terms	Appointment Rights	Decision Rights	Agent Incentives
Ex Ante	Rules	Entry	Selection	Initiation	Trusteeship
Ex Post	Standards	Exit	Removal	Veto	Reward

Regulatory strategies have a prescriptive quality. They impose direct performance requirements on the agent, and they set the terms for forming or dissolving the principal's relationship with the company. Governance strategies, by contrast, focus more on the ongoing principal-agent relationship; the goal of these strategies is to "protect principals indirectly, either by enhancing their power or by molding the incentives of their agents."³⁰ Provisions restricting the right of a manager or controlling shareholder to enter into contracts with the corporation are an example of the "regulatory" approach, whereas shareholders' authority to vote on directors and certain major transactions is a governance strategy.

Within each of the major categories, the authors refine the strategies further by making a series of additional distinctions. Start with the regulatory strategies. The authors identify two types of regulatory strategies, which they characterize as "agent constraints" and "affiliation terms." By "agent constraints," the authors have in mind provisions that define the parameters of permissible agent conduct. Dividend restrictions are an illustration of an agent constraint, since they limit the ability of the

29. The schema is outlined in KRAAKMAN ET AL., *supra* note 4, at 23-28. Because the authors' overview is succinct, I will not refer to specific page numbers for the ten strategies in the description that follows.

30. *Id.* at 23.

company (the agent) to disburse dividends, in order to protect a principal (here, the creditors) who could be hurt by excessive dividends. Whereas agent constraints focus on the agent's midstream conduct, "affiliation terms" dictate the terms on which the principal (that is, shareholders) begin or end their relationship with the agent. Perhaps the most familiar affiliation term is the set of mandatory disclosure requirements that provide information to investors who are deciding whether or not to buy a company's stock.

As a final refinement of the regulatory strategies discussion, the authors distinguish between agent constraints and affiliation terms that operate *ex ante*, and those that come into play *ex post*. The authors refer to *ex ante* agent constraints, such as the dividend restrictions mentioned in the previous paragraph, as "rules," and to *ex post* agent constraints, such as judicial scrutiny of whether the managers have fulfilled their fiduciary duties, as "standards." With affiliation terms, *ex ante* terms govern the parties' entry into an agency relationship and are called, appropriately enough, "entry" terms; "exit" terms regulate termination of the relationship. Mandatory disclosure obligations are a common entry term, and appraisal rights—which permit shareholders to insist that the company buy back their shares under certain circumstances—focus on exit terms.

Lawmakers thus have a total of four regulatory strategies in their arsenal: two agent constraints (rules and standards) and two affiliation terms (entry and exit).

Turn now to the governance strategies. Here, the authors identify three different strategies, which they call "appointment rights," "decision rights," and "agent incentives." An appointment right is the principal's right to appoint or remove the relevant agent. The most familiar illustration of this strategy is shareholders' right to vote on the corporation's directors. Decision rights give the principal similar powers with respect to particular transactions, as when shareholders have the right to approve or reject a proposed merger or amendment of the company's charter. Agent incentives are strategies that are designed either to minimize the self-interest of the decisionmaking agent (as with a requirement that only disinterested directors vote on a transaction involving one of the other directors) or, alternatively, to align the agent's incentives with those of the principal, thus harnessing the agent's self-interest (as when managers are given performance-based compensation).

Each of the three governance strategies also comes in either an ex ante or an ex post variety. The authors refer to ex ante appointment rights as “selection” rights; an example of these is the right of shareholders to vote on the company’s directors. The authors refer to the ex post version as “removal” rights; an example of these is ousting a director, which sometimes requires a showing of cause and sometimes does not. With decision rights, the ex ante strategy is the right of “initiation,” while ex post decision rights are referred to as a “veto” power. Thus, shareholders are generally given the authority to initiate a few transactions, such as bylaw changes in the United States, and shareholders have the authority to veto (or approve, if they so choose) major transactions such as mergers or sales of most or all of the corporation’s assets. Finally, the authors divide agent incentives into ex ante “trusteeship” strategies and ex post “reward” strategies. They point to disinterestedness requirements and nonlegal constraints on agent performance such as conscience and professional pride as examples of the trusteeship strategy. High-powered incentives such as performance-based pay, on the other hand, operate as “rewards.”

Added together, there are a total of six strategies on the governance side of the ledger: a pair of appointment rights strategies (selection and removal), a pair of decision rights approaches (initiation and veto), and a final pair of agent incentives (trusteeship and reward).

That’s it. Much as linguists have long sought to identify the deep structure of language, the authors of *The Anatomy of Corporate Law* offer their ten-part schema as a complete map of corporate law. These ten strategies are the tools that lawmakers use to keep the three different kinds of agency problems in check. Although I argue in Parts III-V for a broader application of the anatomical framework, the schema itself elegantly captures the full range of corporate law strategies. Nothing is missing.

C. *The Typology in Action*

Having defined the attributes of a corporation and developed their ten-part typology of legal strategies in the first chapter, the authors of *The Anatomy of Corporate Law* proceed to apply it to a series of key corporate law issues in chapters 3 through 8, before summarizing their findings and conclusions in chapter 9. To complete this overview of the

book, let me briefly describe the major substantive chapters and some of the insights of each.

In chapter 3, the authors provide an overview of the strategies in action, exploring some of the ways in which they are actually implemented. The authors point out, for instance, that each of their five principal jurisdictions—the United States, the United Kingdom, Germany, France, and Japan—gives shareholders a broad right of appointment,³¹ and that U.S. corporations tend to rely more heavily on the reward strategy (by paying managers in stock and stock options) than corporations elsewhere.³² Examining conflicts between controlling and minority shareholders, they note that cumulative voting is the most common appointment rights strategy used to protect minority shareholders.³³ With regard to the agency problem between the company and nonshareholder constituencies, the authors focus most extensively on the decision whether to give employees representation on a company's board of directors (a selection strategy). The fact that this strategy is rare except where mandated by law—as in Germany and the Netherlands—suggests, they argue, that the costs of employee representation (such as divisiveness on the board) exceed its benefits.³⁴

Chapter 4 addresses creditor protection measures such as minimum capital and dividend rules. After noting some of the standard justifications for creditor protections, the authors focus on the use of entry requirements (in particular, mandatory disclosure) and the two agent constraints—rules and standards. The United States imposes the most extensive disclosure requirements for large corporations, whereas Japan and European countries are stricter with small corporations.³⁵ The authors find striking differences in the use of legal capital rules such as the requirement that corporations maintain a minimum amount of capital. Minimum capital rules have gone the way of the dodo in the United

31. *Id.* at 44-46.

32. *Id.* at 51.

33. *Id.* at 54-55. With cumulative voting, each shareholder is given a number of votes equal to the number of shares she owns, multiplied by the total number of directors who will be elected. Rather than voting on each directorial slot individually, as is done with traditional voting, shareholders can spread their votes over as few or as many candidates as they like. Because it enables minority shareholders to stack their votes on a small number of candidates, cumulative voting increases the likelihood that they can elect at least one of the directors. For discussion, see, for example, Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).

34. KRAAKMAN ET AL., *supra* note 4, at 64.

35. *Id.* at 79, 81.

States, but figure prominently in continental Europe.³⁶ The authors speculate that the prominence of these requirements in continental Europe may stem from the fact that these are civil law systems (which rely more on strict rules and less on judicial discretion) and that banks are central to corporate governance in these countries. Although the differences in the formal rules of the five principal jurisdictions are stark, the authors conclude that this starkness is somewhat misleading. In practice, the disclosure rules function relatively similarly across jurisdictions, for instance, and the authors suggest that Europe's legal capital rules may be eroding somewhat.³⁷

In chapter 5, the authors take up related-party transactions, which they define to include self-dealing transactions between the company and one of its managers, compensation issues, the usurpation of corporate opportunities, and insider trading. The most common strategies for addressing these issues, they argue, include trusteeship strategies such as approval by disinterested directors, shareholder decision rights such as the right to approve or veto a transaction, and ex post judicial review (the "standards" form of agent constraint). Disclosure requirements figure less prominently in continental Europe than in the United States and the United Kingdom, a difference the authors attribute to the ownership structure of European firms. Because they tend to have large, well-informed shareholders, disclosure may be less important in these countries than would be the case if shareholders were more diffuse.³⁸

Chapter 6 explores the treatment of significant corporate actions such as mergers, assets sales, stock repurchases, and the issuance of debt. The authors argue that regulatory intervention is likely in each of the principal jurisdictions when at least one, and ordinarily all, of the following three conditions are met: (1) There is a large amount of money at stake; (2) the issue in question is similar to shareholders' initial decision whether to invest, and thus is one that shareholders are competent to assess for themselves; and (3) self-interest is likely to cloud the managers' decisionmaking perspective.³⁹ Although the regulatory

36. *Id.* at 84. For a scathing criticism of the legal capital rules used by many European countries, see Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 (2001). Although chapter 4 points out that the rules can be costly, the authors are not as skeptical as Enriques and Macey of their value.

37. KRAAKMAN ET AL., *supra* note 4, at 98-99.

38. *Id.* at 129.

39. *Id.* at 131.

strategies vary, shareholder decision rights play a particularly prominent role,⁴⁰ and they are coupled in the United States and the United Kingdom with reliance on judicially enforced fairness standards.⁴¹ Shareholders are given the right to veto large mergers, even when they hold shares in the acquirer rather than the target, the authors argue, because all three prerequisites are met.⁴² None of the principal jurisdictions requires shareholder approval of a management decision to issue a large amount of debt, on the other hand, because the decision does not dovetail with shareholders' expertise and because managers' borrowing decisions are not systematically tainted by self-interest.⁴³

Chapter 7 offers a penetrating analysis of jurisdictions' very different treatment of another issue, takeover regulation. The key regulatory issue with takeovers, the authors argue, is "the allocation of *decision rights* on the offer, more particularly, the division of decision rights as between the target shareholders and target board."⁴⁴ The authors distinguish between the U.K. model, which limits managers' ability to interfere with a takeover offer, and the U.S. model, which gives the board of directors broader authority to determine whether or not an offer will make its way to the shareholders.⁴⁵ Although the other principal jurisdictions fall somewhere in between, most lean toward the U.K. model, which emphasizes shareholder decisionmaking and takes a dimmer view of directors' faithfulness to shareholders' interests.⁴⁶ The authors also point out that affiliation rules such as mandatory disclosure are particularly important in the management buyout context, because inside bidders have less incentive than a competitive bidder to produce information about the company.

In chapter 8, which addresses "issuers and investor protection," the authors focus on mandatory disclosure rules. Thus, unlike the preceding chapters, which apply the ten-part schema to particular sets of corporate law issues, this last major chapter homes in on a single governance strategy: the use of mandatory disclosure as an "entry" requirement.

40. *Id.* at 133-34.

41. *Id.* at 135.

42. *Id.* at 134.

43. *Id.* at 152-53.

44. *Id.* at 163.

45. *Id.* at 164. Managerial agency costs are constrained under this model by fiduciary duty and reward strategies. *Id.* at 168.

46. *See id.* at 170 (noting the prevalence of the U.K. model); *id.* at 189 (discussing the effects of the two models).

After rehearsing the arguments for why mandatory disclosure is necessary—that is, why companies are unlikely to provide enough information to investors unless they are required to do so⁴⁷—the authors note that the level of disclosure that is required often varies with the sophistication of the likely investor. Although roughly the same disclosure approaches are used in all five principal jurisdictions, the comprehensiveness of the required disclosure varies, with the most extensive disclosure obligations coming in the most developed markets (the United States and the United Kingdom).⁴⁸ *Anatomy's* authors are agnostic on the reason for this. They suggest that perhaps developed markets need to protect a large number of relatively small, unsophisticated investors in their midst, or perhaps interest groups such as lawyers and securities analysts, which benefit from intrusive regulation, are responsible for the higher level of enforcement.⁴⁹

Chapter 9 wraps up the book (and puts a bow on it, as it were) by briefly summarizing the authors' findings and suggesting eleven avenues for future research. Scholars should “explore further the fundamental issue of how far corporate law successfully complements or supplements market institutions” such as credit-rating agencies, for instance;⁵⁰ they should “investigate the trade-offs in regulatory strategies”;⁵¹ and they should examine differences (such as the choice between mandatory and default rules) in “regulatory technique.”⁵² Although the framework is designed to “transcend[] particular jurisdictions,”⁵³ the authors' principal focus is on developed economies. “An eleventh and final area of research,” they conclude, is “to examine to what extent and with which

47. The issue of whether mandatory disclosure rules are necessary was the subject of extensive debate in the 1980s and early 1990s. The classic works were those of John C. Coffee, Jr., and Easterbrook and Fischel. See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) (contending that analysts have inadequate incentives to ferret out all relevant information and that companies would engage in underdisclosure absent mandatory disclosure obligations); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) (arguing that companies would have an incentive to disclose even in the absence of mandatory rules).

48. KRAAKMAN ET AL., *supra* note 4, at 212-13.

49. *Id.* at 213-14.

50. *Id.* at 222 (emphasis omitted).

51. *Id.* at 223 (emphasis omitted).

52. *Id.* at 224. These are the first, second, and fourth avenues for future research, respectively.

53. *Id.* at 225.

amendments our analytical framework can be used to deal with emerging jurisdictions issues.”⁵⁴

D. *A Few Concluding Words*

In a book written by seven different authors, who teamed up in shifting combinations to write the individual chapters,⁵⁵ there is an obvious risk that the tone and emphasis will careen wildly from one perspective to another. Yet to a remarkable extent, *The Anatomy of Corporate Law* reads as if it were written by a single author.⁵⁶ It has the same clear, streamlined tone throughout. The authors make a compelling case that delegation and its resulting agency problems are the central governance issues in large-scale corporate enterprise. Their typology also neatly captures the range of strategies that can be found in the corporate laws of every jurisdiction, no matter how widely divergent the approaches may look at first glance. It takes no great act of imagination to predict that the book’s ten-part anatomy will soon become the lingua franca of corporate law discourse. Corporate law scholars and reformers may disagree on everything else, from the treatment of employees to the best approach to regulating corporate takeovers. But this is the language that all of them will be using.

II. THE ROAD NOT TAKEN: HISTORY, POLITICS, AND CONVERGENCE

As should be clear from the overview we have just completed, one of the great virtues of *The Anatomy of Corporate Law* is the authors’ emphasis on the function, rather than the form, of the corporate governance approaches used in different jurisdictions.⁵⁷ Comparative

54. *Id.* at 226. This eleventh avenue of further research was added in response to an earlier version of this Review. Part V can thus now be seen as a more detailed consideration of the relationship between the authors’ schema and the governance problems of developing and transition nations.

55. The principal authors of each chapter are listed at the outset of the chapter. One effect of this format is to invite readers to search for the distinctive perspectives of the individual authors, a sport in which I engage on several occasions in the discussion that follows.

56. This no doubt stems at least in part from the role Reinier Kraakman played as lead author, as reflected in his authorship of the preface and coauthorship of the first three chapters.

57. Here and throughout the Review, I use the term “corporate governance” broadly, to refer to the ten strategies as a group. Corporate governance thus includes both the governance and the regulatory strategies outlined in the authors’ schema. It also includes nonlegal influences on corporate decisionmaking, such as norms.

analysis of corporate law can quickly bog down in the intricacies of the regulations of any given country. The difficulties become still more acute if the comparatist tries to account for all of the related areas (such as employment or commercial law) that can have an important effect on corporate governance. By emphasizing the similarities among jurisdictions, *The Anatomy of Corporate Law* cuts through the Gordian knot of difference and provides a basis for comparing and critiquing the corporate governance approach of any country or countries.

But just what does the authors' functionalism include? The authors sidestep this question. Rather than defining what they mean by "functional," they

simply note that the exigencies of commercial activity and organization present practical problems that have a rough similarity in developed market economies throughout the world, that corporate law everywhere must necessarily address these problems, and that the forces of logic, competition, interest group pressure, imitation, and compatibility tend to lead different jurisdictions to choose roughly similar solutions to these problems.⁵⁸

As it plays out in the book, the authors' functionalism is limited in two important respects. First, *The Anatomy of Corporate Law* does not offer any general theory as to how the various elements of its typology fit together. The authors make a number of scattered generalizations about lawmakers' use of the ten strategies—they point out in chapter 2 that most jurisdictions rely more on standards than on rules to police intracorporate transactions, for instance,⁵⁹ and in chapter 5 they observe that disclosure figures less prominently in continental Europe than in the United States and Japan⁶⁰—but they do not provide any general rules of thumb as to when we should expect one strategy to predominate rather than another. Because they never fully integrate the ten strategies into an overarching theory, many of the book's insights seem to emerge less from the typology itself than from the authors' efforts to make sense of the welter of different rules and practices of the principal jurisdictions.⁶¹

58. KRAAKMAN ET AL., *supra* note 4, at 4.

59. *Id.* at 24.

60. *Id.* at 119-20.

61. For a fascinating recent governance survey that does develop the beginnings of a theory as to the relationship between different governance approaches, see Katharina Pistor

Second, the work's "functionalism" is further limited by its authors' decision to emphasize the common underlying structure of all corporate law, and to exclude all of the other messy factors (such as history, interest-group pressures, or economic shocks) that have contributed to the corporate governance we find in any given jurisdiction. I should hasten to add that this limitation is in many respects more a virtue than a vice of the analysis. It is this emphasis on underlying similarities that gives the book much of its power. But it is often difficult to understand just how corporate governance functions without taking factors such as history and interest groups fully into account, and the book's pared-down functionalism makes it difficult for the authors to assess and explain the areas in which their five jurisdictions seem to diverge. As we shall see, because the authors have excluded history, politics, and other factors from their conception of what "functionalism" entails, their explanations for jurisdictional divergences often have an arbitrary, ungrounded quality.

In the discussion that follows, I begin by contrasting the authors' approach with the most familiar conception of functionalism in the legal literature—the more full-blooded functional approach pioneered by the American legal realists during their revolt against legal formalism in the early twentieth century. I then explore several recent theories of corporate law that come closer to the realists' brand of functionalism, and offer more complete (though contested) explanations for the differences among corporate law approaches in different jurisdictions. Although the constrained functionalism of *The Anatomy of Corporate Law* precludes the authors from providing an alternative to, or critique of, these recent theories, *The Anatomy of Corporate Law* is not irrelevant to the current debate. I argue in the final Section of this Part that the authors' ten-strategy schema is best seen as a prequel, rather than a sequel, to the current debates. The book provides a framework for understanding the choices available to the relevant decisionmakers in any given corporate law regime.

et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791 (2002). Pistor and her colleagues argue that in common law countries, lawmakers tend to supplement flexible corporate laws (which often lead to strong manager control and weak shareholder rights) with "a strengthening of exit rights, judicial recourse, and a new regulatory regime for securities markets." *Id.* at 838.

A. *A Less-than-Functional Functionalism?*

When legal scholars announce that “we are all legal realists now,” they usually mean that everyone now assumes that judicial opinions are more than simply the scientific application of existing law to each new set of facts. Rather than turning on purely deductive analysis, judicial decisionmaking is influenced by a wide variety of social, political, and psychological factors.

In place of the Langdellian vision of law as purely deductive and scientific, the realists argued for a functional approach to legal analysis and legislative reform. The traditional approach, the realists argued, led to attempts to put everything into rigid frameworks that were as useless and artificial as they were elaborate.⁶² A more functional approach, the legal realists believed, must look beyond the simple confines of the law, and take historical, sociological, and economic factors into account as well.⁶³ The law is simply a piece of a much larger system, and only by looking at the entire system can lawmakers and scholars evaluate any given issue or develop an informed proposal for change.

The Anatomy of Corporate Law shares something of this spirit in its emphasis on the practical effects of different rules and on the structural similarities of apparently disparate regimes. But there are clues from the very outset that the authors have a much more limited brand of functionalism in mind than did the legal realists who preceded them. The book's title signals that the authors will confine their attention largely to the “law” alone, rather than consider historical or political influences or other factors. Notice, too, the hint of tension between the authors' claim that their analysis is functional, on the one hand, and, on the other, their reliance on a classificatory strategy that looks suspiciously like the taxonomies that legal realist scholars loved to make fun of.

62. For a useful analysis of the traditional Langdellian approach, see Thomas C. Grey, *Langdell's Orthodoxy*, 45 U. PITT. L. REV. 1, 11 (1983).

63. William Douglas used the derisive term “library law” to describe the Langdellian approach. Because it failed to account for “other psychological, political, economic, business, social factors,” Douglas argued, the Langdellian approach “grossly oversimplifies and distorts the nature of law.” William O. Douglas, *Education for the Law*, Address Before the American Association of Collegiate Schools of Business (Apr. 1936), in *DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS AS MEMBER AND CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION 278, 278, 280* (James Allen ed., 1940).

This does not mean that the book's functionalism is simply a sham. The authors are careful to look beyond the "law on the books," and to talk about how corporate governance actually plays out in practice. But their analysis is almost completely ahistorical and pays very little attention to the political factors that have influenced corporate governance law and norms in the five jurisdictions with which they are most concerned. A more full-blooded functionalism might enable the authors to say more about the relationship between a jurisdiction's substantive rules and the extent to which those rules are actually enforced.⁶⁴ The significance of this omission is particularly apparent at the ends of chapters 4 through 8, each of which concludes with a short section that is designed to explain the differences among jurisdictions with respect to the issues covered in the chapter. The explanatory sections have an ad hoc quality. Divergences in creditor protection are characterized as more apparent than real in chapter 4—a phenomenon the authors attempt to explain by economic factors such as the cost imposed by creditor protections.⁶⁵ Elsewhere in the book, interest-group influence is used to explain interjurisdictional differences.⁶⁶ But there is no context for assessing the validity of either of these explanations. Why, if each explanation is correct, does economics reign supreme in one area while politics calls the tune in another? Is there a way to know which interest groups are likely to have influence in any given country, and whether this influence is likely to persist?

The Anatomy of Corporate Law does not provide a basis for answering these questions. One way to summarize the virtues and limitations of the book is to distinguish between the "how" and the "why" of corporate governance. *The Anatomy of Corporate Law* is concerned with the "how" questions: How does corporate governance function? How are various jurisdictions similar and different? The question that the book does not attempt to answer is why.

64. The authors themselves note this limitation at the outset of the book. KRAAKMAN ET AL., *supra* note 4, at vi ("While we address issues of law enforcement, administration, and compliance throughout, we do not do so with the same consistency or emphasis that we bring to our comparative discussion of substantive law.").

65. *Id.* at 98-99.

66. *See, e.g., id.* at 214 (speculating that interest-group and economic explanations for disclosure regulation both have elements of plausibility).

B. *The Corporate Ownership and Governance Debates*

The ahistorical and apolitical quality of *The Anatomy of Corporate Law* is especially striking given that these issues—the “why” questions—are precisely where the action is in current corporate law and corporate finance scholarship. In the past decade, developments such as the shift toward a more shareholder-oriented approach to corporate governance in Germany and other European countries and Japan’s continuing economic travails have focused attention on governance differences among various jurisdictions, prompting a rich debate as to the reasons for those differences and whether they are likely to persist. Much of the debate has centered on the contrast between stock-ownership patterns in the United States and the United Kingdom, where large corporations are generally widely held, and patterns in Japan and Western Europe, where concentrated ownership is the norm.

Loosely speaking, one can identify three views, at times overlapping, that have emerged to explain the ownership and governance differences between jurisdictions. A brief summary and assessment of each will help to show where *The Anatomy of Corporate Law* fits, setting the stage for the adjustments I propose in the next three Parts.

The single most widely debated theory comes from a group of corporate finance scholars: Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. Based on an extensive empirical survey of corporate governance around the world, La Porta and his colleagues have published a stream of articles emphasizing differences in the underlying legal regimes.⁶⁷ Their approach has come to be known, appropriately enough, as the “law matters” thesis. In the late 1990s, they argued that ownership will remain concentrated unless the country in question provides legal protections for minority shareholders, such as a fiduciary duty requirement or voting rules that magnify the voice of small shareholders. The existence of these protections in the United States and the United Kingdom—and their absence elsewhere—explain why shareholdings are dispersed in the United States and the United Kingdom, but concentrated outside of those jurisdictions. La Porta and his colleagues have also emphasized the difference between common law

67. E.g., Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

and civil law legal systems. The process of case-by-case development in a common law system, they argue, is ideally suited to keeping pace with changes in commercial life, since judges have the flexibility to adapt existing precedent to new developments. Civil law systems, by contrast, are rigid, relying on strict rules with little judicial discretion. On this view, the emergence of dispersed ownership and market-based governance in the United States and the United Kingdom may reflect the superior adaptability of these nations' judicial systems.

Yet the studies done by La Porta and his colleagues are flawed in several respects. Because their initial corporate governance studies rely more on the "law on the books" than on how firms are governed in practice, their assessments can be misleading.⁶⁸ In addition, even if they correctly describe a country's governance characteristics, their scoring system sometimes produces dubious assessments. Their most prominent study awards a one or a zero for each of six different governance characteristics, then simply tallies up the total. But the characteristics vary significantly in their overall importance. Two countries both scoring four, for instance, may in reality provide very different levels of shareholder protection.⁶⁹

Perhaps more importantly, it appears that the "law matters" thesis may have gotten the direction of causation backwards. Although La Porta and his colleagues suggest that legal protection of minority shareholders makes liquid markets and diffuse ownership possible, in both the United States and the United Kingdom commercial norms and private arrangements seem to have paved the way both for diffuse

68. An exchange between Italian corporate law scholar Luca Enriques and one of La Porta's coauthors illustrates both this problem and the authors' awareness of the limitations of their study. During that conversation, which took place in 1996, Enriques pointed out a number of mistakes in the index created by La Porta and his coauthors. He assumed the authors would correct the index, but when the article appeared in print, none of the corrections had been made. When Enriques later brought this to the attention of one of the authors, he "replied . . . that so many lawyers had provided them with contrasting comments on what the law really was in this or that country, that they had soon decided to disregard them." Luca Enriques, *The Comparative Anatomy of Related Party Transactions: Preliminary Notes for the Discussion* 17 n.68 (June 30, 2003) (unpublished manuscript, on file with author).

69. For a similar criticism, see Pistor et al., *supra* note 61, at 805. As an example of a misleading variable, Pistor and her coauthors point out that preemptive rights, which are coded as a minority shareholder protection, can sometimes benefit large shareholders rather than dispersed minorities. *Id.* at 805 n.39.

ownership and for the laws that La Porta and his coauthors point to as evidence of shareholder protection.⁷⁰

Like their governance scorecard, La Porta and company's recent work contrasting civil and common law regimes relies on sharp dichotomies that can obfuscate as well as clarify. Even in civil law jurisdictions, for instance, judges often exercise an enormous amount of discretion.⁷¹ Despite these flaws—and perhaps in part because of them⁷²—the work by La Porta and his colleagues has transformed corporate law and corporate finance scholarship. It is the acknowledged inspiration for the rapidly expanding recent literature on the determinants of different corporate governance regimes.

A second perspective, often associated with Mark Roe, focuses directly on the relationship between politics and a nation's corporate governance.⁷³ In work published several years before the first of the studies by La Porta and his coauthors, Roe attributed the scattered ownership of America's largest corporations to populist distrust of concentrated financial power. Each time large financial institutions were poised to take substantial ownership stakes in corporate America, he argued, politicians intervened, kicking financial institutions out of the boardroom and ensuring that ownership would remain fragmented. By contrast, in both Germany and Japan—which lack this populist hostility to concentrated power—banks and other financial institutions own

70. See, e.g., John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 7-11 (2001).

71. See, e.g., Pistor et al., *supra* note 61, at 799 n.27 (“[I]n civil law countries courts have at times played a much more proactive role in shaping the contents of legal rules than the general principle that ‘judges interpret, but do not make the law’ may suggest.”).

72. The studies by La Porta and his coauthors have spawned a growing number of articles calling their treatment of various countries into question. See, e.g., Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459 (2001) (arguing that U.K. history casts doubt on the claim that legal protections are a prerequisite of dispersed share ownership); Pistor et al., *supra* note 61 (providing a historical comparison of countries that had originated corporate governance regimes with others that had imported such regimes); Julian Franks et al., *Ownership: Evolution and Regulation* (Aug. 25, 2003) (unpublished manuscript, on file with author) (providing a historical study of the emergence of diffuse ownership and minority shareholder protections in England).

73. Roe's analysis of the political determinants of American corporate governance is set out in ROE, *supra* note 3. The description of Roe's work that follows is drawn in part from the more extensive account in John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1712-13 (2002).

significant blocks of stock and play a central role in corporate enterprise.⁷⁴

In more recent work, Roe has distinguished between “left-wing” social democracies, which tend to favor employees’ interests over those of investors, and “right-wing” countries that are not so strongly worker-oriented.⁷⁵ Roe argues that, in a social democracy, managers have an incentive to pay more attention to employees’ interests than to those of shareholders. Managers may favor opaque accounting that understates the company’s profits, so that the profits can be used to protect the managers’ and employees’ interests. The employee orientation magnifies the underlying conflicts of interest between managers and shareholders, thus increasing the disadvantages of investing in a widely held company. As a result, the Berle-Means corporation is less likely to emerge in a social democracy than it is in a country that does not have a strong socialist tradition.

Roe’s political account—like the “law matters” approach and, to a lesser extent, the Rajan and Zingales theory discussed below—suffers from the inevitable limitations of an effort to fit a wide variety of approaches into a single coherent scheme. “The squirming facts,” as the poet Wallace Stevens once put it, “exceed the squamous mind.”⁷⁶ Roe’s political thesis arguably explains corporate governance in Germany, but it does not fit England, where the shift toward diffuse ownership came during a period best characterized as social democratic rule.⁷⁷

A third explanation for interjurisdictional divergence comes from recent work by Raghuram Rajan and Luigi Zingales.⁷⁸ Focusing on the

74. My colleague Friedrich Kübler advances a somewhat different account of bank influence in Germany. The hyperinflation of the early twentieth century, he argues, decimated the equity markets, leaving retained earnings and bank loans as the principal sources of financing for corporations. See, e.g., Friedrich Kübler, *The Impact of Equity Markets on Business Organization: Some Comparative Observations Regarding Differences in the Evolution of Corporate Structures*, 2 EUR. BUS. ORG. L. REV. 669 (2001).

75. Roe’s political explanation of differing ownership regimes worldwide is developed in MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003); and Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000).

76. WALLACE STEVENS, *Connoisseur of Chaos*, in THE COLLECTED POEMS OF WALLACE STEVENS 215, 215 (photo. reprint 1967) (1954).

77. See, e.g., Armour, Cheffins & Skeel, *supra* note 73, at 1716-18.

78. Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003). Rajan and Zingales have now developed their “great reversal” thesis into a book aimed at a more popular audience. See RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS:

emergence of liquid securities markets, which is closely related to the relative dispersion of share ownership, Rajan and Zingales emphasize the openness of a country's markets to outside investment. In countries where local financial institutions are especially powerful, they have often sought to stymie foreign investment during a time of crisis in order to protect their market power over companies' access to capital. If the efforts of these local interest groups succeed, the country's securities markets may atrophy, creating a "great reversal" as previously liquid securities markets are stifled. If a country's markets are sufficiently open, on the other hand, or its government is decentralized, the country may resist the pressure to erect barriers to trade and cross-border financial flows. England illustrates the latter pattern in recent decades, with the markets remaining open and equity becoming increasingly dispersed over the last half of the twentieth century. In France, by contrast, markets were relatively liquid in the early twentieth century, but have become increasingly dominated by local interests after the shock of the two world wars. In each case, Rajan and Zingales argue, it is the interaction between interest groups and external shocks that determines the liquidity or illiquidity of a nation's equity markets.

Although Rajan and Zingales's great reversal theory is in many respects the most versatile of the recent explanations, it is not clear how it fits with interest-group theories that suggest cataclysms have often undermined rather than enhanced the influence of existing interest groups.⁷⁹ It also is not clear whether one can derive policy implications from the theory, other than the general (though important) admonition to open up one's markets as much as one can.

C. *The Anatomy of Corporate Law as Prequel Rather than Sequel*

The scholarship that I have just discussed has transformed the analysis of corporate governance. Given this variety of new theses—that legal reform has shaped changes in corporate development, that politics is central, or that the openness of markets has played the pivotal role—scholars have taken a closer look at the governance patterns of countries

UNLEASHING THE POWER OF FINANCIAL MARKETS TO CREATE WEALTH AND SPREAD OPPORTUNITY (2003).

79. The theory that catastrophes can undermine previously influential interest groups (and facilitate growth as a result) is defended at length in MANCUR OLSON, *THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL RIGIDITIES* (1982).

throughout the world. More than ever before, the new corporate governance literature has brought economists, historians, political scientists, and law professors into a single, very important conversation.

Against this backdrop, the analysis of *The Anatomy of Corporate Law* seems to borrow a favorite term of the literary critic Harold Bloom, “belated”⁸⁰—as if it hailed from an era before scholars had gotten their hands dirty exploring the complicated twists and turns of corporate history or had started devising models to explain the dynamics of governance reform.⁸¹ The absence of history, interest groups, and norms is particularly striking given that the book’s authors are key players in these debates.⁸²

What role can a book like *The Anatomy of Corporate Law*, which has so little to say about the recent literature, play in the current scholarly and policy discussion? The best way to answer this question is to look at *The Anatomy of Corporate Law* more as a prequel than a sequel to the current debates. *The Anatomy of Corporate Law* does not extend or refine the current literature so much as it provides a framework for understanding it.

Anyone who has dabbled in the “law matters” literature will appreciate the importance of developing a common language and framework. The literature has tended to rely on ad hoc determinations as to what counts as, say, minority shareholder protections, and how different jurisdictions’ protections compare with one another.

80. See, e.g., HAROLD BLOOM, WALLACE STEVENS: THE POEMS OF OUR CLIMATE 51 (1976) (discussing the issue of “belatedness” in Stevens’s poems).

81. In a sense, it did: The project that gave rise to the book started some ten years ago. But this seems unlikely to be the explanation for the authors’ exclusion of history, politics, and other influences. As we have seen, and as discussed further below, the authors’ acontextual framework is precisely the contribution of the book.

82. See, e.g., CAPITAL MARKETS AND COMPANY LAW (Klaus J. Hopt & Eddy Wymeersch eds., 2003); PAUL DAVIES, GOWER AND DAVIES’ PRINCIPLES OF MODERN COMPANY LAW (7th ed. 2003) (providing the preeminent account of English corporate law doctrine and history); Hansmann & Kraakman, *supra* note 11 (arguing that corporate law is converging); Gérard Hertig & Ruben Lee, *Four Predictions About the Future of E.U. Securities Regulation*, 3 J. CORP. L. STUD. 359 (2003) (maintaining that recent E.U. efforts to integrate European securities markets will fail, but that increased harmonization and the eventual establishment of a pan-European securities regulator are inevitable); Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT’L BUS. L. 569 (1991) (arguing, based in part on political factors, that Japanese regulation focuses more on ex ante protections than does that of the United States); Edward B. Rock, *America’s Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L.Q. 367 (1996) (exploring the emergence of the political account of corporate governance).

The Anatomy of Corporate Law will not make these issues go away. But the authors' ten-part typology gives us a framework for making sense of the similarities and divergences of different governance regimes. Indeed, if we had possessed the authors' typology at the outset of the comparative turn in corporate governance scholarship, these recent debates might have had a much less helter-skelter quality.

The Anatomy of Corporate Law is likely to have a particularly profound influence on the corporate finance literature. As evidenced by the "law matters" debate, corporate governance scholarship has witnessed a remarkable confluence of different scholarly disciplines over the past decade. Even in the 1990s, legal scholars often ignored parallel scholarship in the corporate finance literature, and economists paid relatively little attention to the legal literature. To a remarkable extent, this has now changed. The days when economists' models were so abstract that legal scholars could simply dismiss them are gone, and economists increasingly look to the legal literature for an explanation of the relevant legal framework. A great virtue of *The Anatomy of Corporate Law* is that it provides a simple set of tools for understanding all of corporate governance, and thus offers precisely the kind of tractability that economists look for. Given that it is both simple and comprehensive, the authors' ten-part typology will appeal at least as much to economists as to legal scholars, and will bring the respective literatures even closer together.

In the Parts that follow, I discuss three adjustments that would make the book's analysis even more powerful and complete. Parts III and IV argue that bankruptcy and corporate groups should be added to the issues addressed in the book's substantive chapters. As we shall see, bankruptcy raises some of the sharpest agency conflicts in all of corporate law, and adding corporate groups would tie the authors' agency cost emphasis to their earlier discussion of the attributes of the corporate form. Part V briefly considers the unique problems of corporate governance in developing and transition countries.

III. THE MISSING PIECE OF THE PUZZLE: BANKRUPTCY (TOWARD A NEW CHAPTER 9)

Although the authors of *The Anatomy of Corporate Law* consider a wide variety of important corporate issues, they explicitly exclude bankruptcy from their account, lumping it together with other "bodies of

law [that are] designed to serve objectives that are largely unrelated to the core characteristics of the corporate form, and therefore do not fall within the scope of corporate law as we define it here.”⁸³ In some respects, the authors’ decision to omit bankruptcy is understandable. As their reference to other “bodies of law” suggests, bankruptcy laws are usually housed in a different statute than the nation’s corporate laws. In addition, as the authors also point out, “the problems of bankruptcy presented by corporations are often shared by other types of legal entities, and the elements of bankruptcy law that address those problems are not, in many jurisdictions, confined to entities formed as business corporations.”⁸⁴

The fact that bankruptcy law is not found in the same statutory provisions as corporate law, however, and that it extends beyond corporations, is far too slim a reed on which to base a decision to banish bankruptcy from the analysis. First, in some countries bankruptcy is included within the overall corporate governance framework; in others its omission is at least in part a historical accident. The United States is a particularly good illustration of the latter point. Large-scale corporate reorganization was developed in the nineteenth century by the same Wall Street investment banks and lawyers who underwrote a company’s stock or bonds.⁸⁵ If J.P. Morgan underwrote a railroad’s bonds, and the railroad later defaulted, Morgan would step in to quarterback the reorganization process. It was not until well into the twentieth century that bankruptcy was codified separately from corporate law, and it took a major set of New Deal reforms (which were initially framed as amendments to the securities laws) to drive a wedge between the corporate and bankruptcy bars. Until then, corporate reorganization was a seamless part of corporate governance.⁸⁶

Second, if the authors’ goal is to provide a functional account of the underlying structure of corporate law, they obviously should not be deterred by lawmakers’ decision to put bankruptcy and insolvency rules in one statute rather than another. Ten or twenty years ago, one could

83. KRAAKMAN ET AL., *supra* note 4, at 17.

84. *Id.*

85. DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 63 (2001). *See generally id.* at 48-70 (recounting the origins of corporate reorganization in America).

86. *Id.* at 113-27 (describing the enactment of the Chandler Act of 1938, which regulated corporate reorganization until the bankruptcy laws were completely overhauled in 1978, and the Act’s effect on the elite Wall Street reorganization bar).

have argued with a straight face that bankruptcy raises a separate set of issues.⁸⁷ But in an era when developing countries understand bankruptcy as essential to properly functioning securities markets, and when mergers and acquisitions have once again become central to U.S. corporate reorganization, that time has long passed.⁸⁸

Think of this Part as a plea to the authors to add an additional chapter to the next edition of *The Anatomy of Corporate Law*. In the discussion that follows, I imagine what this ninth chapter might look like. I begin by applying the authors' typology to the bankruptcy context. I then explore how corporate law and bankruptcy fit together.

A. *Bankruptcy and the Three Agency Cost Problems*

Even under U.S. law, with its emphasis on preserving normal business operations, ordinary regulatory strategies are altered in important respects when a company files for bankruptcy. In other countries, the adjustments are even more profound. By focusing on the three agency problems that *The Anatomy of Corporate Law* identifies as the heart of corporate law, we can quickly appreciate how and why this is so. In this Section, I briefly consider each of the three agency cost problems and how they play out when a company encounters financial distress.

1. *The First Agency Problem: Desperate Managers*

As a company nears insolvency, the danger that managers will become unfaithful agents of the firm looms especially large. As in an impending takeover (which the authors discuss in chapter 7) or in connection with some major corporate transactions (chapter 6), the managers of a financially troubled company face an end-game situation.

87. When I first started arguing in my own work that bankruptcy is a facet of corporate law, see, e.g., David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992), I thought that the idea might even be original, but I soon discovered that an earlier generation of scholars and bankruptcy lawyers would have been astonished to learn that anyone viewed them as separate, see, e.g., SKEEL, *supra* note 85, at 109 (describing William Douglas's work on both corporate law and corporate reorganization issues).

88. For discussions of the dramatic recent changes in corporate reorganization in the United States, see, for example, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002); and David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

There is a very good chance that they will lose their jobs unless the company's fortunes quickly turn around. As a result, managers have an incentive to take drastic actions to reverse the financial distress—actions that may be inefficiently risky and pose a danger of destroying significant value.

Dealing with these high managerial agency costs is a central theme of bankruptcy law in every developed nation. Of the ten governance strategies, the three that figure most prominently are “removal” rights (the *ex post* appointment rights strategy), and the two “agent incentives”—“trusteeship” and “reward.” As discussed in more detail in Section III.B, most countries adopt either a presumptive or a *per se* rule that managers are simply ousted in favor of a court- or creditor-appointed decisionmaker in the event of bankruptcy.⁸⁹ In the United States, managers continue to run the company even after it files for bankruptcy, and the locus of removal rights shifts to some extent. But creditors have increasingly used contractual governance levers to constrain managerial discretion and to control both the selection and removal of managers.⁹⁰

The other standard approach to addressing managerial agency costs in many bankruptcy regimes is to rely heavily on trusteeship strategies. This is particularly true when the company's managers are displaced in favor of either an administrator or a court-appointed trustee.⁹¹ This trustee is usually required to be disinterested, and she is often instructed to take all of the corporation's constituencies into account in the decisions she makes on behalf of the troubled firm. There are two important qualifications, however, to the general emphasis on disinterestedness. First, in some countries the choice of decisionmaker

89. In a few countries, such as England, managers also may be subject to liability if they continue to operate a company that is insolvent, rather than promptly initiate insolvency proceedings. *See, e.g.*, Armour, Cheffins & Skeel, *supra* note 73, at 1746-47 (discussing “wrongful trading” rules).

90. These developments are discussed in detail in Skeel, *supra* note 88.

91. Even in the United States, where this is not the case, disinterested experts play a very prominent role. For instance, the bankruptcy court is authorized to appoint an examiner to investigate the debtor's affairs, 11 U.S.C. § 1104(b) (2000), and in several of the most prominent recent cases, the reports of examiners or related experts have played a major role in shaping the reorganization process. In Enron's bankruptcy, the examiner's report served as a roadmap for federal prosecutors and private attorneys who sued the banks that had helped to facilitate its manipulation of earnings, and WorldCom has adopted nearly all of the corporate governance reforms that former SEC Chairman Richard Breeden called for in the report he filed in connection with that case. *See, e.g.*, Barnaby J. Feder, *WorldCom Report Recommends Sweeping Changes for Its Board*, N.Y. TIMES, Aug. 26, 2003, at C1; Ben White & Peter Behr, *Citigroup, J.P. Morgan Settle over Enron Deals*, WASH. POST, July 29, 2003, at A1.

(often a receiver) is or can be controlled by one or more of the corporation's creditors. If this is the case, the decisionmaker is likely to be closely monitored by creditors, and her decisions will reflect their interests, even if her compensation is not based on a "reward" strategy. Second, the reward strategy plays an increasingly important role in Chapter 11 cases in the United States, as managerial compensation is often based on how quickly the managers reorganize the firm.

In short, because bankruptcy raises serious end-game problems, managers are kept on a much shorter leash than when the company is healthy, and in most countries they are displaced in favor of an entirely new decisionmaker.

2. *Agency Issues Involving Controlling and Minority Shareholders*

Like managerial agency costs, the inside or controlling shareholder problem also figures quite prominently when a company encounters financial distress. The most obvious concern with a troubled company is that the controlling shareholders will protect themselves at the expense of minority shareholders and often other parties as well. The most exaggerated illustration of this problem occurred in Russia in the 1990s, when bankruptcy was used by insiders and the financial institutions with which they were sometimes in cahoots to transfer control to the inside shareholders. But the problem arises in nearly every bankruptcy regime in one form or another. Even in companies in the United States and the United Kingdom that tend not to have controlling shareholders, large creditors can pose analogous problems if they dominate the process to the detriment of small creditors and other constituencies.⁹²

The most common strategies for dealing with majority-minority problems are the two affiliation terms—"entry" and "exit"—together with "veto," the ex post decision right. One way to limit a majority shareholder's or large creditor's manipulation of the process is to provide extensive access to information about the company's financial condition and prospects, and to protect the terms on which investors exit. In the United States, Chapter 11 adopts this approach by giving parties in interest the right to examine the debtor and its managers, and by assuring each investor that she will receive as much in Chapter 11 as she would if

92. Indeed, creditors generally assume many of the prerogatives of shareholders in the insolvency context, and they often become the company's shareholders if the firm is reorganized. This shift in control is discussed in detail in Subsection III.A.3.

the company were liquidated.⁹³ In countries that cede control to a creditor or creditors, the extent of disclosure may be much less extensive. An obvious explanation for this difference is that major creditors will already have extensive information about the firm's finances, and other creditors will derive proportionate benefits from the sale or other disposition of the firm's assets by the controlling creditor. Although this will often be the case, there is a strong argument that extensive disclosure should be provided even in this context.⁹⁴

The other major strategy for reining in large creditors or shareholders is through the process by which decisions are approved or vetoed. Chapter 11 once again provides the most elaborate protections. All major decisions are subject to court approval, and every affected shareholder or creditor is entitled to vote on a proposed reorganization plan.⁹⁵ The bankruptcy court also has the power to disqualify votes (such as votes by a large creditor that seeks to thwart a proposal because it is a competitor of the debtor) that are not cast in good faith.⁹⁶ In other systems, proposals to sell or reorganize the company are subject to approval by a court, an administrator, or both.⁹⁷

3. *Agency Problems Between the Company and Third Parties: The Shift in Control*

Even in countries that do not focus extensively on the interests of third parties like creditors and employees while a corporation is healthy, third parties come to the forefront in the bankruptcy context. By far the

93. See, e.g., 11 U.S.C. § 1129(a)(7) (ensuring a minimum recovery for creditors); FED. R. BANKR. P. 2004 (providing rights to examination of the debtor). For an argument that § 1129(a)(7) functions very much like appraisal rights in corporate law, see Skeel, *supra* note 87, at 493-94.

94. In Sweden, for instance, which calls for a mandatory auction when a firm files for bankruptcy, creditors often arrange sales to the company's existing managers. Although this frequently reflects the fact that the current managers value the business more highly than third parties, there is also a risk that information asymmetries distort the auction process. For a discussion of the Swedish framework, see, for example, B. Espen Eckbo & Karin S. Thorburn, *Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions*, 69 J. FIN. ECON. 227 (2003); and Per Strömberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests*, 55 J. FIN. 2641, 2645-48 (2000).

95. See 11 U.S.C. § 363(b) (requiring court approval of transactions that are not in the ordinary course of business); *id.* § 1126 (defining the terms on which voting and class approval must occur).

96. See, e.g., Skeel, *supra* note 87, at 513-15.

97. See, e.g., Klaus Kamlah, *The New German Insolvency Act: Insolvenzordnung*, 70 AM. BANKR. L.J. 417, 431-32 (1996).

most important change is a sharp shift in focus from shareholders to creditors as the principal decisionmakers for the firm. From the perspective of the ten-part schema of *The Anatomy of Corporate Law*, this shift is reflected in the increased use of governance strategies that give control rights to creditors and constrain the authority of the company's shareholders and managers.

The reason for the shift in focus is that the risk that the company (and, more importantly, its owners) will divert value from its creditors is unusually high if the firm is in financial trouble. When the firm is healthy, what is good for shareholders is usually good for all of the company's constituencies, since shareholders benefit from good decisions and are hurt by poor ones.⁹⁸ But shareholders' incentives (like managers', as we have seen) are much more problematic when the company's fortunes go sour. They may encourage the company to take big gambles, for instance, or discourage the company from pursuing attractive opportunities if the benefit would go to creditors rather than shareholders themselves.⁹⁹

In creditor-oriented systems, the increase in creditor protection is especially dramatic. In England, for instance, a lender that holds a floating charge on the company's assets is entitled to appoint a receiver (a "selection right," in terms of the ten-part schema) if the company defaults.¹⁰⁰ Through the receiver, the lender effectively controls the decision as to how to resolve the financial distress. In Germany, creditors are entitled to call for a liquidation (an "initiation right") if they are unhappy with the course of a company's reorganization procedure.¹⁰¹

98. This is because shareholders are the firm's "residual owners," and thus benefit if the company pursues opportunities that have net positive present value, while eschewing those with negative present value. For an example of a more nuanced view, emphasizing shareholders' imperfect incentives even when a company is solvent, see Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999).

99. The incentive to take gambles is generally referred to as an "overinvestment" problem, and the reluctance to pursue beneficial opportunities that benefit only creditors as an "underinvestment" or debt-overhang problem. The classic treatment is Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977).

100. This right will be eliminated when the recently enacted Enterprise Act, 2002, c. 40, goes into effect. For a discussion, see Armour, Cheffins & Skeel, *supra* note 73, at 1748. Lenders who hold floating charges will continue to wield significant control, however, because they control the debtor's access to cash and because the receivers in administration cases are insolvency professionals, many of whom have close ties to the banks that hold floating charges.

101. See, e.g., Kamlah, *supra* note 97, at 426.

In Chapter 11, which is one of the least creditor-oriented bankruptcy frameworks, shareholders theoretically retain the right to elect directors in bankruptcy, but directorial elections are seldom held during a bankruptcy case, and shareholders who ask for them are successful only about half of the time.¹⁰² Creditors are entitled to ask the court to appoint a trustee (a “removal” right),¹⁰³ and directors are instructed to focus on creditors, rather than just shareholders (thus, creditors are added to the fiduciary “standard” that constrains directorial decisionmaking), once a company becomes insolvent.¹⁰⁴ The crowning event of a Chapter 11 case is the vote on a proposed reorganization plan, and here too the shift in authority is clear. Under the elaborate Chapter 11 voting system, each class of creditors and shareholders is entitled to vote (an approval or “veto” right over the plan), but, as I have argued at length elsewhere, the voting rules have the effect of giving particular leverage to the residual class of creditors—that is, the first class of creditors whose claims cannot be paid in full.¹⁰⁵

Nearly all of the creditor protections I have described thus far are found in the formal regulatory structure. Creditors also may use contractual mechanisms to shift control away from managers and shareholders after the onset of financial distress.¹⁰⁶ The single most important development in U.S. bankruptcy in the past decade, for instance, has been the use of ex post contracts to alter the allocation of control rights in Chapter 11. Debtor-in-possession (DIP) financing agreements have figured particularly prominently in this trend. These agreements are now used to force sales of assets and to keep the debtor’s

102. For a criticism of the case law, suggesting that even this number of successful requests is too high, see Skeel, *supra* note 87, at 506-09.

103. 11 U.S.C. § 1104 (2000). Although this step is rarely taken, creditors can use the threat of calling for a trustee as leverage over the company’s managers.

104. See, e.g., Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003) (analyzing fiduciary duties when a firm nears or enters insolvency).

105. Skeel, *supra* note 87, at 480-81. I do not mean to suggest that the American corporate reorganization framework is optimal. To the contrary, the Chapter 11 decisionmaking rules could be improved in a variety of ways. Shareholders could be precluded altogether from voting on directors, for instance. But the overall effect of Chapter 11 is to shift decisionmaking authority away from shareholders at a time when their decisionmaking incentives have become problematic.

106. For an excellent new analysis of the role of contracting and renegotiation in the bankruptcy context, see David C. Smith & Per Strömberg, *Maximizing the Value of Distressed Assets: Bankruptcy Law and the Efficient Reorganization of Firms* (Oct. 2003) (unpublished manuscript, on file with author).

managers on a tight leash throughout the bankruptcy proceedings.¹⁰⁷ Managerial pay is being used in much the same way: Managers are often promised a larger bonus if the company is reorganized quickly, which gives them an additional incentive not to dally in Chapter 11.¹⁰⁸

I have focused on the enhanced role that creditors play in corporate governance once bankruptcy or insolvency proceedings have been initiated. But it is important to emphasize that creditors also figure prominently in corporate governance well before this time. In the United States, for instance, DIP financing agreements are invariably negotiated prior to bankruptcy, and they are often preceded by bank-led efforts to restructure the company that, if successful, would obviate the need for bankruptcy. Lenders may insist that the company bring in a new restructuring officer, for instance, to work with the existing managers. In each of the authors' other principal jurisdictions—France, Germany, Japan, and the United Kingdom—bank lenders figure even more prominently in corporate governance. Other creditors, such as bondholders, may also have a governance role.

For several related reasons, *The Anatomy of Corporate Law* seems to underemphasize the importance of debt-based governance. First, although they consider creditor protections such as dividend restrictions and minimum capital requirements, the authors largely ignore the more active role that creditors play in corporate governance and the rules that facilitate this role.¹⁰⁹ Second, the decision to lump creditors together with other third parties in the third category of agency costs further de-emphasizes the significance of creditors. Finally, leaving bankruptcy and insolvency out of the analysis omits the context where, as we have seen, creditor influence is at its peak.

The next Section develops a more complete analysis of the overall corporate governance dynamic. First, however, we should briefly consider the other important third-party issue in bankruptcy: the treatment of employees. Although employees are not ordinarily given

107. See Armour, Cheffins & Skeel, *supra* note 73, at 1728; Skeel, *supra* note 88, at 923-26; David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. (forthcoming Apr. 2004). Douglas Baird and Robert Rasmussen have also explored these developments in some detail. See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); Baird & Rasmussen, *supra* note 88.

108. SKEEL, *supra* note 85, at 61.

109. The authors thus treat creditors as the passive recipients of various creditor protections, rather than focusing on their active role in corporate governance.

appointment rights or decision rights in bankruptcy, they often are protected by agent constraint strategies that either discourage layoffs or provide compensation for displaced workers. In Sweden, as in other European countries, the trustee is required to “take special care in ‘promoting employment,’ if this can be done ‘without appreciable loss’ to the claimants of the firm.”¹¹⁰ In other countries, by contrast, employees are protected outside of bankruptcy but have less protection in bankruptcy. In the Netherlands, for instance, some companies use the bankruptcy to effect layoffs that would be much more difficult to implement outside of bankruptcy.¹¹¹

B. *The Dynamic Relationship Between Corporate Governance and Bankruptcy*

The previous Section identified several important patterns in most countries’ treatment of the three core agency problems of corporate law in the context of bankruptcy. Managerial agency costs are generally controlled through a decisive “removal” strategy, and many countries also rely on a heightened “trusteeship” approach. Majority-minority problems can be reduced by disclosure requirements, and ex post oversight of major transactions—the “veto” strategy—also figures prominently. Creditors are protected through a variety of governance strategies, such as “removal” rights and enhanced influence over important decisions.

It would, however, be a mistake to assume that these common patterns suggest that corporate bankruptcy functions in more or less the same way in every country. To fully understand how bankruptcy (and, more generally, corporate governance as a whole) works in different jurisdictions, we need to explore the significance of two central distinctions: (1) differences in ownership structure, and (2) differences in the treatment of managers when a firm files for bankruptcy. By focusing on these two factors, we can develop a dynamic perspective on the

110. Strömberg, *supra* note 94, at 2646 (quoting Konkurslagen [Bankruptcy Act] ch. 7, § 8 (1998) (Swed.), and noting that France, the United Kingdom, Germany, and Finland have similar rules).

111. See, e.g., Reinout Vriesendorp, *Employees and Insolvency in Phase II: An Undesirable Consequence of the Dutch ‘Polder Model,’* in COMPARATIVE AND INTERNATIONAL PERSPECTIVES ON BANKRUPTCY LAW REFORM IN THE NETHERLANDS 27, 38-43 (Reinout Vriesendorp et al. eds., 2001).

relationship between corporate law and bankruptcy, a perspective that dramatically increases the explanatory power of our analysis.¹¹²

The first distinction is connected to the differences in ownership structure that have been the focus of the recent debates described in Section II.B. In jurisdictions characterized by concentrated stock ownership, firms also tend to have concentrated debt; diffuse equity, on the other hand, seems to be correlated with diffuse debt. The most obvious explanation for this pattern is agency costs. If the creditors of a firm with a controlling block of shareholders were widely scattered, the shareholders could take advantage of their superior ability to coordinate by expropriating value from the diffuse creditors.¹¹³ In this context, bank loans or other forms of concentrated debt are an important counterweight to shareholders' concentration. Because bank lending is costly, however, firms that are widely held (and thus have less need for close creditor oversight) have an incentive to issue bonds and other forms of diffuse debt.¹¹⁴

Second, the single most important distinction among different bankruptcy regimes is whether the corporation's managers are displaced at the outset of the bankruptcy process. As noted earlier, in most countries the managers are neutralized or replaced, usually by a court-appointed official.¹¹⁵ In the United States, by contrast, managers continue to run the company. (In England, the informal "London Approach" to restructuring large companies parallels Chapter 11 in intriguing respects.)¹¹⁶

112. As is no doubt apparent, this analysis moves us beyond the basic framework of *The Anatomy of Corporate Law* and will enable us to develop an overarching theory of corporate law.

113. See Armour, Cheffins & Skeel, *supra* note 73, at 1763-65. The fact that it is more difficult for the shareholders to force a large number (as opposed to a small group) of bondholders to write down their debt, due to the high negotiating costs, is a countervailing consideration in the absence of an effective bankruptcy regime. See, e.g., Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1 (1996).

114. Armour, Cheffins & Skeel, *supra* note 73, at 1765.

115. Although Germany modeled its extensive recent bankruptcy reforms on Chapter 11, for instance, those reforms retain a presumption that managers will be removed at the outset of the bankruptcy case. See, e.g., Kamlah, *supra* note 97, at 426 (explaining that managers are typically replaced by administrators).

116. In a London Approach restructuring, the banks that have participated in syndicated lending to a large corporate debtor agree to an informal standstill, then conduct an investigation of the troubled company. If they conclude that the business is viable, the banks negotiate a restructuring plan entirely outside of the formal insolvency rules. The early London Approach restructurings were spearheaded by the central bank, which prodded smaller lenders

Notice the pattern here: In jurisdictions with concentrated ownership, we tend to see concentrated debt and a manager-displacing bankruptcy regime. Diffuse equity, by contrast, is usually correlated with diffuse debt and a manager-driven bankruptcy process. Once again, agency costs seem to be an important part of the explanation. In a concentrated ownership regime, harsh, manager-displacing bankruptcy rules reinforce the leverage of the monitoring bank, since managers know that the guillotine awaits them if they resist bank intervention in the event of financial distress.¹¹⁷ With widely held firms, by contrast, similarly harsh bankruptcy rules would create disequilibrium in the governance framework. Faced with the prospect of removal in bankruptcy, managers would have a strong incentive to protect themselves from the equally harsh discipline of the takeover market either by encouraging friendly investors to buy a concentrated block of shares, or by persuading lawmakers to shut down the takeover market.¹¹⁸

Focusing on the dynamic relationship between corporate governance and bankruptcy clarifies the underlying anatomy of corporate law in several important ways. First, the analysis I have sketched out—which I have referred to elsewhere as an “evolutionary theory”¹¹⁹—enables us to make sense of the complex interrelationship of regulation, formal contract, and informal norms. By incorporating the ten-part typology into a more general theory, we can avoid the ad hoc quality that *The Anatomy of Corporate Law* has when it attempts to make sense of the differences among the governance rules of different jurisdictions.

Second, the analysis can also be used to make predictions about the likely effect of changes in regulation or in the relative strength of interest groups. Take, as an example, the Rajan and Zingales insights into the interest-group influence of local financial institutions.¹²⁰ The evolutionary account suggests that powerful financial institutions should

to effect informal reorganizations. For a detailed discussion, see John Armour & Simon Deakin, *Norms in Private Insolvency: The “London Approach” to the Resolution of Financial Distress*, 1 J. CORP. L. STUD. 21 (2001).

117. See David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1344-45 (1998).

118. Armour, Cheffins & Skeel, *supra* note 73, at 1726-27; Skeel, *supra* note 117, at 1341. In the United States, there are now more barriers to hostile takeovers than in the past, and, as we have seen, bankruptcy is characterized by greater creditor control.

119. See Skeel, *supra* note 117 (arguing that market-based corporate governance is likely to be accompanied by manager-driven bankruptcy, and bank or insider governance by manager-displacing bankruptcy).

120. See *supra* notes 78-79 and accompanying text.

be expected to translate their influence into a harsh, manager-displacing bankruptcy framework through lobbying or other means. If a jurisdiction with market-based governance were to adopt manager-displacing bankruptcy rules, by contrast, we would expect to see either successful efforts by managers to subvert the manager-displacing rules (thus altering the “selection” and “removal” appointment rights) or an increase in the concentration of firms’ stock and debt. This would equilibrate the system of corporate governance in a manner consistent with the predictions of Rajan and Zingales, but through a mechanism that lies beyond the explanatory power of their theory.

Finally, although the theory is principally descriptive in nature, it also has important normative implications. The most important of these implications involve efforts to change existing governance regimes, such as the market reforms in Russia and Eastern Europe. As we shall see in Part V, for instance, the evolutionary theory suggests that the equity markets were the wrong place to start with market reform in such countries.

IV. OF CORPORATE GROUPS AND CORPORATE BOUNDARIES (TOWARD A NEW CHAPTER 10)

The large corporations that *The Anatomy of Corporate Law* is particularly concerned about explaining are not monolithic. Most, from Daimler-Chrysler to Mitsubishi, are extensive networks of corporate (and often noncorporate) entities. Enron, to give a somewhat exaggerated recent example, included roughly two thousand different entities.¹²¹ Despite the common name, these entities often consist of a collection of separate enterprises that are linked together—under a single parent corporation, through cross-shareholdings, or in other ways.

The ancient philosophers had a vivid expression for the notion that groups sometimes seem to have a single identity on the one hand, but also to consist of a large number of autonomous people or parts on the other. They called it the problem of the “one and the many.” Suppose a flock of birds is (or are) flying in tandem. Is the flock a single entity, the philosophers asked, or should we focus instead on the individual birds?

121. See, e.g., Joseph N. DiStefano, *In Delaware, Enron Found Secrecy and Savings*, PHILA. INQUIRER, Jan. 31, 2002, at A1 (“Enron Corp. organized a sprawling network of 2,000 corporate subsidiaries in 62 countries and 23 U.S. states.”).

Or, as the philosophically inclined poet Wallace Stevens framed the issue: “Twenty men crossing a bridge, / Into a village, / Are twenty men crossing twenty bridges / Into twenty villages, / Or one man / Crossing a single bridge into a village.”¹²² (“This is an old song,” Stevens went on to say, “That will not declare itself”)¹²³

If we look at the corporate laws of the five countries that feature most prominently in *The Anatomy of Corporate Law*, there is a striking divergence of perspectives on the question of whether organizationally linked corporations should be treated as isolated entities or as a single group. In Germany, lawmakers view corporate groups as a single entity, and subject corporate groups (referred to in German as *Konzernrecht*) to an elaborate set of rules.¹²⁴ The United States, by contrast—with an obliviousness to the nature of groups that would make the philosophers wince—gives much more weight to the formal corporate boundaries and often ignores the overall corporate group; Japan, France, and the United Kingdom fall somewhere in between.¹²⁵

At various points in their study, the authors of *The Anatomy of Corporate Law* note the role of corporate groups in the countries with which the book is concerned. Chapter 4, for instance, which focuses on creditor protections, provides an elegant description of the concerns raised by corporate groups, such as the risks that “such a structure might reduce transparency by blurring divisions between the assets of group members,” and that the “group structure allows controllers to set the terms of intra-group transactions, and thus to assign (and reassign) value within the group” in ways that could “extract value from the creditors or minority shareholders of a group member.”¹²⁶ Aside from these scattered references, however, the authors have very little to say about the significance of corporate groups.¹²⁷

122. WALLACE STEVENS, *Metaphors of a Magnifico*, in THE COLLECTED POEMS OF WALLACE STEVENS, *supra* note 76, at 19, 19.

123. *Id.*

124. For a discussion of the German approach, see, for example, Herbert Wiedemann, *The German Experience with the Law of Affiliated Enterprises*, in GROUPS OF COMPANIES IN EUROPEAN LAWS: LEGAL AND ECONOMIC ANALYSES ON MULTINATIONAL ENTERPRISES 21 (Klaus J. Hopt ed., 1982).

125. See, e.g., KRAAKMAN ET AL., *supra* note 4, at 76 (describing the differences among jurisdictions’ perspectives).

126. *Id.* at 75.

127. As noted above, the authors’ most extensive treatment of corporate groups comes in chapter 4, where they discuss creditor protections. In addition, in chapter 5, they note that German law includes strict formal requirements that a subsidiary be indemnified if the

I argue in this Part that by giving short shrift to the role of corporate groups, the authors have missed an opportunity to integrate their initial analysis of the attributes of the corporation—and, in particular, the corporation's asset-partitioning function—with their ten-part typology of strategies for addressing agency problems. By adding a final chapter on the dynamics of corporate groups, the authors could have shown how the choice of corporate boundaries is itself strongly influenced by (and in turn influences) subsequent agency issues. Such a chapter would extend the analysis and at the same time bring it back to the beginning—back to the choice of entity form.

The Part begins by speculating as to why *The Anatomy of Corporate Law* has so little to say about corporate groups. I then show how the choice of corporate boundaries could be incorporated into, and would enrich, the overall analysis. My goal, of course, is to propose another new chapter for the book. After the authors added a new chapter 9 to deal with bankruptcy, the book I imagine would include one last major chapter: "Chapter 10: Of Corporate Boundaries and Corporate Groups."

* * *

Although the authors do not explain in detail why they have given such short shrift to corporate groups, they seem to have decided that the issues raised by corporate groups are not different in kind from the issues raised by a single corporate entity. There is an initial plausibility to this view (at least to an Anglo-American corporate law scholar—I suspect most German scholars would beg to differ), and I begin by showing why this is so.

The argument is this: The key issue both for a single corporate entity and within a corporate group is agency costs. Take self-dealing. A particular problem in a parent-subsidiary framework is the risk that the parent corporation (or a block of shareholders that controls the parent) will use its control to favor the parent and its shareholders at the expense of the minority.¹²⁸ The parent might enter into contracts with the

subsidiary incurs losses from a group decision that benefits the group overall at the expense of the subsidiary, but that these rules are widely ignored in practice. *Id.* at 124-26. They also point out that the French approach, which relies less on formal rules, "is favored to become the model for European harmonization." *Id.* at 126.

128. *See id.* at 124-26 (describing this concern as motivating the German and French rules).

subsidiary that are wildly unfair to the subsidiary, for instance. Although this may be an especially pressing concern for corporate groups, it is closely analogous to the concerns raised by contracts between a single corporate entity and one of its managers or controlling shareholders. Indeed, in the United States, Delaware courts apply essentially the same analysis in both contexts.¹²⁹

Whether courts truly treat issues involving corporate groups the same way as those that involve a single corporate entity is a matter of much discussion, even in the United States. Commentators have long assumed that courts are more willing to “pierce the veil” within a corporate group, for instance.¹³⁰ But this by itself would not call into question the authors’ decision to forgo separate treatment for corporate groups. Even if the outcomes differ somewhat, the fact that veil piercing is analyzed similarly in corporate groups and in other contexts would justify a decision not to treat corporate groups separately with respect to this kind of issue.

If we shift our focus, however, and look at how and why corporate groups are set up in the first place, rather than transactions entered into thereafter, the case for downplaying corporate groups looks much more problematic. Corporate groups don’t simply spring forth fully formed, like the goddess Athena from her father Zeus’s head. To the contrary, they are the product of numerous decisions. Firms must decide whether to include an entire business within a single corporation or to separate it into two or more distinct corporations, for instance; or whether to cement ties with another corporate group through cross-shareholdings. Each of these decisions is influenced in crucial respects both by agency costs—the focus of the authors’ ten-part typology—and by the attributes of the corporate form.

To appreciate how these factors help to explain corporate groups, recall that, as a historical matter, the most important benefit of the

129. See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) (applying the entire-fairness standard in a transaction involving a controlling shareholder); *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110 (Del. 1994) (relying on a similar standard in a case involving a squeeze-out acquisition by a corporate parent).

130. When courts “pierce the veil,” they hold the shareholders, parent corporation, or related subsidiaries liable for the obligations of the corporation in question, thus refusing to honor the corporate attribute of limited liability. For an empirical study of the outcomes in veil-piercing cases suggesting that parent corporations are frequently held responsible for obligations of their subsidiaries, though not quite as commonly as is often thought, see Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

corporate form was asset partitioning.¹³¹ As Hansmann and Kraakman have argued in several pieces showcasing this attribute, the corporate form facilitates creditor monitoring and thus reduces a firm's cost of credit by assuring corporate creditors that they will have priority over creditors of any of the corporation's shareholders.¹³² Monitoring efficiencies thus provide one explanation for the decision to house different parts of an enterprise in separate corporations. If (to use their illustration) the company includes both an oil business and a chain of hotels, for instance, the benefits of specialized monitoring by different creditors might be one reason to set up separate oil and hotel corporations, rather than treating them as divisions within a single business.

Monitoring efficiency is unlikely to be a complete explanation for the decision to incorporate the oil and hotel businesses separately, however. As Hansmann and Kraakman note, the parties could achieve similar monitoring benefits in other ways, such as secured finance. If one creditor lent on a secured basis to the oil business, and another to the hotels, each could serve as a specialized lender to the part of the business against which it held a priority claim.¹³³

In a recent article, George Triantis argues that the tradeoff between managerial flexibility and agency costs is another important factor in deciding how to structure a corporate group.¹³⁴ If the oil and hotel businesses are structured as divisions within a single corporate entity, managers can more easily shift capital from one business to the other as circumstances change. Because managers have better information than anyone else about the prospects of each business, this flexibility—which finance theorists refer to as a “switching option[]”—can prove very valuable.¹³⁵ But greater flexibility means greater agency costs, since managers may use the discretion to further their own interests rather than the best interests of the enterprise. They may prop up a hopeless

131. See *supra* notes 20-22 and accompanying text.

132. See, e.g., Hansmann & Kraakman, *supra* note 20, at 393; Hansmann, Kraakman & Squire, *supra* note 20, at 1.

133. Although Hansmann and Kraakman acknowledge the role of secured credit, they argue that it is at most a partial substitute for asset partitioning. See, e.g., Hansmann, Kraakman & Squire, *supra* note 20, at 4 (questioning the usefulness of secured credit where there is a “floating’ group of creditors”).

134. George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102 (2004).

135. *Id.* at 1103.

business, for instance, in order to protect their perks or their jobs.¹³⁶ Separate incorporation reduces this problem, since separate corporations are subject to higher disclosure obligations, and their transactions are subject to greater scrutiny, than is the case for divisions of a single corporation.¹³⁷ Where flexibility is particularly important, we would expect businesses to be housed in a single corporation; by contrast, separate corporations make more sense if the switching option is less valuable or managerial agency costs particularly high.

Seriously complicating the boundary decision—or at the least, our efforts to explain the corporate groups we see in practice—is the fact that the boundaries are often indirectly influenced by various kinds of noncorporate regulation. The most obvious illustration is tax. When Enron set up thousands of separate entities for its structured finance transactions, or when corporations establish separate offshore corporations to hold title to their intellectual property, the boundary decision was or is driven more by tax considerations than by corporate governance.¹³⁸ A particularly important tax concern for multinational companies is the treatment of transfer pricing. An obvious implication for understanding corporate groups is that, to the extent these regulations encourage distortions in the corporate structure, the distortions should be viewed as an important cost of such regulations.

Corporate law itself can, of course, distort these boundary decisions as well. If the German *Konzernrecht* indemnification requirements were strictly enforced, the obligation to compensate subsidiaries for any decision that redistributed value elsewhere in the group could have a chilling effect on the incorporation of separate subsidiaries. In practice, as the authors of *The Anatomy of Corporate Law* point out, the indemnification requirements seem to be largely ignored so long as the subsidiary is solvent.¹³⁹

In the United States, the recent WorldCom bankruptcy sparked a controversy over whether bankruptcy courts should “substantively

136. *Id.* at 1105.

137. *Id.* at 1125-27 (describing the higher fiduciary duty and disclosure obligations where separate subsidiaries are set up).

138. Delaware does not impose a state tax on many kinds of passive income (such as income from intellectual property rights). This benefit seems to have been a major consideration in Enron’s decision on where to set up separate business entities. *See, e.g.*, DiStefano, *supra* note 121 (characterizing the tax-free status of passive income as a generally important attraction of Delaware as a state of incorporation).

139. KRAAKMAN ET AL., *supra* note 4, at 125.

consolidate” the obligations of a corporate group whose members file for bankruptcy—that is, ignore the group’s corporate boundaries and lump the creditors of different entities together. In the past, courts have refused to consolidate the obligations of a corporate group unless the boundaries had been essentially ignored outside of bankruptcy. In WorldCom, however, the debtor argued for consolidation on administrative grounds, as a way of simplifying the restructuring process.¹⁴⁰ If WorldCom foreshadows a loosening of the restrictions on substantive consolidation, this shift would have the opposite effect from strict enforcement of the German indemnification rules: Whereas the German rules would enforce the boundaries between firms too strictly, substantive consolidation would make them too porous. In each case, the benefits of the boundaries would be undermined.

The corporation and its shareholders are not the only ones that are affected by the company’s boundary decisions. Corporate boundaries also have important implications for the agency relation between the firm and third parties. In many jurisdictions, the most important corporations are government-owned or government-controlled. A particularly vexing boundary issue in this context is whether and when to permit corporations to expand into new businesses. Because government-owned corporations often have market power in their core business, there is a danger that the firm will use an existing monopoly to subsidize its expansion into the new business, to the detriment of actual and potential creditors. One way to minimize the risk of inappropriate cross-subsidization would be to require the corporation to set up a separate subsidiary if it wished to enter into a new line of business.¹⁴¹ As with the analogous restrictions on U.S. financial services corporations,¹⁴² this

140. The decision to substantively consolidate the entities for the purposes of WorldCom’s proposed reorganization plan was challenged by a group of creditors but later settled. Many observers (including this one) suspect that the bankruptcy court would have rejected the challenge and upheld the consolidation.

141. For a more detailed defense of this proposal, see David A. Skeel, Jr., *Virtual Privatization: Governance Reforms for Government-Owned Firms*, 2 J. CORP. L. STUD. 82, 102-06 (2002).

142. Until the recent repeal of the Glass-Steagall Act, 12 U.S.C. §§ 24, 78, 377-378 (1994) (repealed 1999), banks were prohibited from engaging in both investment and commercial banking, and banks and insurance companies could not be housed in the same corporate group. These barriers have since been removed, but such businesses must still be set up as distinct subsidiaries under a single corporation. See, e.g., Adam Nguyen & Matt Watkins, Recent Legislation, *Financial Services Reform*, 37 HARV. J. ON LEGIS. 579 (2000) (describing the repeal of the Glass-Steagall Act and the new requirements to replace its regulations).

structural separation would make it much easier for regulators or other observers to track the transfers of funds from one business to the other, and thus would reduce the risk that the corporation would use profits from a monopoly business to subsidize expansion into other, more competitive areas.

The benefits of a mandatory subsidiary requirement for government-owned corporations vividly illustrate a more general point about the relationship between regulatory oversight and a firm's decision regarding how to structure the corporate group. The firm (and its investors) is concerned about the tradeoff between flexibility and managerial agency costs. The optimal choice for the firm's shareholders is not always the socially optimal choice, however. This potential conflict suggests that a third crucial factor influencing boundary decisions is the role of regulatory intervention in minimizing the risk that such decisions will impose costs on third parties that are not internalized by the corporate group engaging in corporate restructuring.

By adding corporate groups to the overall analysis of corporate law, as I have attempted to do here, we can develop a more complete theory—one that integrates the attributes of the corporation with the agency cost concerns that animate the authors' ten-part typology. This more complete theory also has the virtue of accounting for the way large corporations are actually structured in most jurisdictions. Corporations are not simply one; they are also many.

V. CORPORATE GOVERNANCE IN DEVELOPING AND TRANSITION COUNTRIES (TOWARD AN EXPANDED EPILOGUE)

The Anatomy of Corporate Law is framed largely as an analysis of corporate governance in developed economies. “[W]e focus,” Kraakman announces on the first page of the preface, “on what we understand to be corporate laws of five major commercial jurisdictions: France, Germany, Japan, the UK and the U.S.”¹⁴³ But their analysis is not limited to this context: “[A] signal achievement of this book is,” as Kraakman puts it, “the development of an analytical framework that transcends particular jurisdictions.”¹⁴⁴ Underscoring the universality of intended application is the authors' choice of touchstone jurisdictions. Few countries develop

143. KRAAKMAN ET AL., *supra* note 4, at v.

144. *Id.*

their own corporate law from scratch. Major enactments are usually borrowed from the laws of another country, and it turns out that nearly every corporate law in the world can be traced, directly or indirectly, to one or more of the five jurisdictions on which the authors focus.¹⁴⁵

The implicit universality of the framework—it is, after all, *the* anatomy of corporate law—raises an obvious question: Is it safe to assume that the typology will help us to understand how corporate law functions in every country, everywhere in the world? To answer this question, conduct a simple thought experiment. Suppose you are a corporate law professor, and you have been asked to visit a developing or transition country. You will be expected to talk to the relevant officials, market players, and community groups in order to prepare a report offering suggestions for reform. (This thought experiment is hardly far-fetched; many are the corporate law scholars who have packed their parkas or sunblock and headed to the airport to consult on corporate or market reform in the past decade or so.) If you brought only your copy of *The Anatomy of Corporate Law*—already available in paperback, one hopes, by the time you left—and spent the visit asking your interviewees which regulatory and governance strategies the country had adopted, would this tell you everything you needed to know? Would the interviews give you a complete picture of how governance functioned in the developing country?

The answer, of course, is no. If we have learned anything from the corporate governance reform projects of recent years, it is that the strategies that are used in developed countries cannot simply be transplanted into a developing country with the expectation that they will function in a comparable way. In terms of practical importance, there is no greater corporate governance issue in the world today than the question of how to improve the effectiveness of corporate governance in developing countries.

In the epilogue, the authors of *The Anatomy of Corporate Law* characterize the book as “provid[ing] a platform for a wide-ranging program of multi-disciplinary research on corporate law,” and suggest a series of “avenue[s]” for future research that scholars could pursue.¹⁴⁶ Although some of the proposed projects can be seen as relevant for

145. See, e.g., Pistor et al., *supra* note 61, at 799 (describing England, the United States, Germany, and France as “spearhead[ing] the development of corporate law”).

146. KRAAKMAN ET AL., *supra* note 4, at 222.

developing economies, the authors clearly have the United States, Western Europe, and Japan most directly in mind.

The discussion that follows suggests one final adjustment to the authors' handiwork. Call it the last and most important avenue for future research: How can we apply the lessons of this book and other recent corporate governance work to the distinctive problems of developing countries?¹⁴⁷ In the first Section, I briefly describe a few of the unexpected consequences of recent governance reforms and summarize the lessons that can be learned from them. The Section that follows sketches out several proposals for how we should think about reform.

A. *The Law of Unintended Consequences: A Brief, Selective Tour*

Over the past decade or so, starting with the collapse of the Soviet empire in 1989, corporate governance reform has been on the agenda across the globe. More often than not, reforms have had very different effects than their proponents expected. Let me start with two short examples, chosen almost at random.

The most dramatic wake-up call, at least for academic reformers, came in Russia. Starting in the early 1990s, a group of academic experts, many of them based at Harvard, were hired to consult on corporate governance and market reforms. In connection with the project, two of the leading American corporate law scholars (including one of the authors of *The Anatomy of Corporate Law*) proposed an elegant framework for Russian corporate law.¹⁴⁸ To protect minority shareholders against oppression, they called for a combination of per se rules and enhanced voting requirements. When Russia enacted a new corporate law, its lawmakers drew extensively on the framework that the academics had proposed. Despite the elegance of the proposal, however, it proved to be a complete disaster in practice—not because there was anything wrong with the new provisions, but because the formal framework was almost completely ignored. Corporate insiders ravaged

147. In the initial draft of *The Anatomy of Corporate Law*, the authors proposed ten avenues for further research. As noted earlier, they added an eleventh—"emerging jurisdictions" issues—in response to this Review. See *id.* at 226.

148. Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

Russia's newly privatized corporations, undeterred by the corporate governance framework.¹⁴⁹

Second example: Hungarian reformers dramatically revised their bankruptcy laws in the mid-1990s, drawing extensively on the U.S. bankruptcy laws. They framed the new regime as a Chapter 11-style corporate reorganization code and included a provision that authorized debtor-in-possession financing, just as in the United States. In practice, however, Hungarian firms are almost never able to obtain financing—apparently in large part because lawmakers omitted the special priority U.S. lenders are given—and the reorganization provisions are rarely used to reorganize troubled firms.¹⁵⁰ One could multiply these examples almost endlessly. India created special bankruptcy tribunals, but the experiment was arguably a complete failure.¹⁵¹ Efforts to privatize corporations in Eastern Europe have had dramatically different consequences than reformers expected.¹⁵²

* * *

What are some of the lessons we can learn from these experiences over the past decade, from the unintended consequences of reform? The first lesson is that even the most carefully crafted corporate governance framework is useless if the underlying infrastructure isn't in place. In many developing and transition countries, the judicial system is not effective enough to protect basic property rights. In this context, any corporate governance reform effort needs to take account of the limitations of the underlying enforcement system.

149. For a postmortem speculation about what went wrong, with a particular emphasis on the absence of adequate judicial enforcement, see Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000). For an empirical analysis of analogous problems with the Russian bankruptcy framework (with a focus on expropriation by alliances of managers and regional governments), see Ariane Lambert-Mogiliansky et al., *Capture of Bankruptcy: Theory and Russian Evidence* (June 18, 2003) (unpublished manuscript, on file with author).

150. See, e.g., Ekaterina Zhuravskaya, Remarks at the Bankruptcy-Corporate Governance Panel Meeting, Institute for Policy Dialogue, Columbia University (Sept. 24, 2003) (arguing that the failure to give priority to debtor-in-possession finance has been a "key to the failure of [Hungary's reorganization] procedure in practice").

151. For one analyst's opinion, see E-mail from Leora Klapper, Senior Financial Economist, World Bank (Feb. 11, 2004) (on file with author) (describing problems with the specialized courts in India, and with reforms in Sri Lanka, Romania, and other countries).

152. See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 782 (2001).

Even if judicial enforcement is adequate, governance reforms are unlikely to have a significant effect unless there is a demand for them. “We find two distinct patterns of legal change in transplant countries,”¹⁵³ Katharina Pistor and her colleagues explain in a recent study of corporate evolution in ten countries, some of which served as the source and others as the recipient of corporate law frameworks. “One is lethargy. The other is quite the opposite—erratic change.”¹⁵⁴ In the transplant jurisdictions they studied, the “countries that receive[d] foreign law [were] frequently unprepared for the changes it [brought].”¹⁵⁵ As a result, the new laws were either ignored or repeatedly altered, with little apparent effect on actual corporate governance.¹⁵⁶

Even if there is an adequate infrastructure, and even if there is a demand for a new law, reforms often have a very different effect in the new country than in the jurisdiction from which they are borrowed or adapted. As illustrated by the Hungarian experience noted above, a small change in a provision borrowed from elsewhere can lead to dramatically different results in the adopting country.

B. *Learning from the Recent Mistakes*

By itself, *The Anatomy of Corporate Law* would be a most misleading guidebook for understanding corporate governance in a developing or transition country. Because the authors’ typology is based largely on the law on the books, it is not designed to make sense of the vicissitudes of corporate law in many countries—such as the divergence between rules and practice, and the comparative irrelevance of formal rules in the absence of adequate judicial enforcement.¹⁵⁷ But if we put the

153. Pistor et al., *supra* note 61, at 840.

154. *Id.*

155. *Id.* at 841.

156. *Id.* (describing the experience in Colombia); see also Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 *ECON. TRANSITION* 325, 328 (2000) (“Past experience with legal reforms suggests that where new laws were forced upon a judicial system unfamiliar with the underlying legal tradition and were not adapted to fit the specific local context, the effectiveness of the law suffered.”).

157. Not surprisingly, existing data suggest that an increase in the enforcement of contract rights can have a dramatic effect on borrowers’ access to credit. See, e.g., Daniela Fabbri & Mario Padula, *Legal Institutions, Credit Market and Poverty in Italy* (Apr. 1, 2003) (unpublished manuscript, on file with author) (finding much greater access to credit in Italian regions where courts function more efficiently, as measured by backlogs of cases). Judicial enforcement is also linked to higher rates of bankruptcy filings. See Stijn Claessens et al., *Resolution of Corporate Distress in East Asia*, 10 *J. EUR. FIN.* 199, 200 (2003).

book in the broader context of the insights I have developed in this Review, it offers a “platform”—to use the authors’ word—both for understanding corporate governance in developing countries and for rethinking the focus of future reforms. Although the regulations and governance reforms supported by law in developed jurisdictions like the United States, the United Kingdom, Germany, France, and Japan are not available by way of the judiciary in many developing and transition nations, *The Anatomy of Corporate Law* still gives us a framework for understanding and creating strategies aimed at minimizing the agency issues inherent in the corporate form—particularly if we supplement the framework with the more robust functional analysis discussed in Part II.

One obvious implication of the absence of effective judicial enforcement is that policymakers should place less emphasis on devising elaborate corporate codes for developing and transition jurisdictions. Harnessing private solutions—governance strategies that minimize the need for court oversight—may be much more promising in this regard. Interestingly, contemporary practices in two of the most developed of all nations—the United Kingdom and the United States—could offer a useful analogy. In England, under the so-called “London Approach,” the central bank has long put informal pressure on bank lenders to restructure troubled corporate debtors outside of the formal insolvency framework.¹⁵⁸ In an emerging country that has a stable central bank but spotty judicial enforcement, a process resembling the London Approach could prove much more effective than full-blown insolvency rules. Somewhat similarly, in the United States, corporate debtors that wish to minimize their stay in bankruptcy can negotiate the terms of a restructuring outside of bankruptcy and ask the court to confirm a “prepackaged” reorganization plan. Like the London Approach, this strategy—which harkens back to the nineteenth-century railroad receiverships—sharply reduces the need for judicial involvement.¹⁵⁹

Of course, it is important to recognize that private negotiations carry their own potential risks. There is a danger that the parties represented at the bargaining table will favor themselves in the restructuring at the expense of other interested parties. This suggests both that the effectiveness of private negotiations will depend in important part on the

158. For a description of the London Approach, see *supra* note 116.

159. For a similar point, see Erik Berglöf et al., *The Formation of Legal Institutions for Bankruptcy: A Comparative Study of the Legislative History* 37 (Feb. 19, 2001) (unpublished manuscript, on file with author).

reputational stake that the principal players have in the quality of the restructuring, and that at least limited judicial oversight is necessary to protect third parties.

A second, and quite related, implication is in the context of market reform. During the wave of privatizations in Eastern Europe and Russia in the 1990s, reformers assumed that the way to develop liquid capital markets was to focus on stock.¹⁶⁰ Yet much of the analysis of this Review suggests that debt financing—either bonds or bank lending—may be a more sensible starting point than the stock market. In most countries, as in nineteenth-century America, there is likely to be an existing interest group that already has a stake in the credit markets and could serve as an underwriter for corporate bonds.¹⁶¹ Reformers could look to the underwriters, or to existing professionals in the accounting industry or the bar, to act as bond trustees to represent the interests of scattered investors. These professionals would have a reputational stake in creating a properly functioning market, since their future business would depend on investors' willingness to continue buying bonds. In addition, investors might be less skittish about investing in bonds than in stocks, both because debt has a higher priority claim against the company's assets and because bond ownership is a less dramatic step for individuals who have not previously participated in the market.¹⁶²

In some emerging markets, bank lending may be a superior source of corporate financing to that of publicly traded bonds or stocks. In part, the choice may turn on the nature of a country's principal industries. "For the less risky, capital intensive modernization investments characteristic of lower levels of economic development," as the authors of one recent study note, "bank finance may be more appropriate [than equity

160. For an extensive and important analysis of the preconditions for developing effective securities markets, see generally Black, *supra* note 152.

161. The most obvious candidate, as in nineteenth-century America, is existing or newly emerging banks. See, e.g., SKEEL, *supra* note 85, at 63-69 (describing the role of Wall Street investment banks and the Wall Street bar in the bond market and corporate reorganizations).

162. For a similar point about the relationship between equity and debt finance, see CHARLES W. CALOMIRIS, U.S. BANK DEREGULATION IN HISTORICAL PERSPECTIVE 248 (2000). Specifically, Calomiris notes that equity sometimes may "not be a feasible alternative to debt, either because the costs of resolving asymmetric information between firms and ultimate sources of funds are large . . . or because the equity holder is unable to exert control over corporate management." *Id.* Notice that the argument in the text is not inconsistent with the fact that liquid stock markets seem to be developing before bond markets in several European countries whose corporate governance has traditionally been characterized by concentrated ownership: In these countries, such as Germany and France, there is a much longer tradition of market investment.

markets].”¹⁶³ In contrast to securities markets, moreover, which may be entirely lacking, most developing and transition countries have at least an embryonic banking system to serve as a starting point.¹⁶⁴

The experience with privatization in Eastern Europe underscores the case for focusing on bond markets or bank lending rather than stock. As recounted by Erik Berglöf and Patrick Bolton, the “number of firms listed on [the Czech, Slovak, Lithuanian, and Romanian] stock exchanges increased dramatically” shortly after reforms were implemented, “but after an initial phase of high trade volumes, most stocks became and remained illiquid.”¹⁶⁵ Within a few years, stock ownership in most companies was once again highly concentrated, stock changed hands relatively infrequently, and corporate finance in the most successful jurisdictions was dominated by bank lending.¹⁶⁶

Rather than trying to create a liquid stock market from scratch, debt finance, together with manager-displacing bankruptcy, is a more plausible starting point for reform in these countries. This suggests that the most important agency cost issues may stem from the relationship between lenders and the firm, and that creditor protection should take precedence over efforts to enhance the rights of minority shareholders as the focus of future reforms.¹⁶⁷ In the bankruptcy context, efforts to reduce the information asymmetries between principal bank lenders and other creditors should take center stage, given the risk that well-positioned bank lenders may divert value from small creditors.

There is another point as well, a lesson that takes us back to the heart of *The Anatomy of Corporate Law*. The book provides a framework for understanding the issues that are inherent to the corporation, and thus common to every jurisdiction; this Review has attempted to develop the authors’ analysis into a more fully functional perspective on corporate law. But this framework cannot substitute for the hard work of

163. Pistor et al., *supra* note 156, at 327.

164. *Id.* As discussed in Section III.B, firms that borrow from banks, and thus have concentrated debt in their capital structure, are likely to have concentrated stock ownership as well. Although stock markets will often be illiquid under these circumstances, there have been at least a few exceptions to this tendency. In the late nineteenth and early twentieth century, German corporate finance seems to have been characterized by both bank finance and an active stock market. *See, e.g.*, CALOMIRIS, *supra* note 162, at 241-50 (describing the role of banks and equity, and the relative dearth of bond finance, in pre-World War I Germany).

165. Erik Berglöf & Patrick Bolton, *The Great Divide and Beyond: Financial Architecture in Transition*, J. ECON. PERSP., Winter 2002, at 77, 86.

166. *Id.* at 87.

167. *See, e.g.*, Pistor et al., *supra* note 156, at 327.

understanding the peculiar institutional dynamics of any given developing or transition jurisdiction. The framework can help reformers determine what questions to ask, but the most effective reforms are likely to be those that are sensitive to jurisdiction-specific nuances such as the institutions that are already in place.

CONCLUSION

As I noted at the outset, *The Anatomy of Corporate Law* is the most important corporate law book of the decade. This Review has offered several friendly amendments to the authors' analysis. I have argued that they should add chapters on bankruptcy and corporate groups, and expand the epilogue to consider the extent to which their framework does and does not apply to corporate governance in developing nations. But these adjustments do not detract in any way from the importance of the authors' underlying schema. The ten-part typology of *The Anatomy of Corporate Law* will provide the next generation of corporate law scholars and policymakers with a framework for understanding the characteristic dilemmas of corporate enterprise. For comparative corporate law scholarship, the future starts here.
