

# THE EVOLUTION OF CORPORATE LAW:<sup>1</sup> A CROSS-COUNTRY COMPARISON

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## 1. INTRODUCTION

The importance of law and legal institutions for economic development is widely acknowledged today. The invention of credit mechanisms to support long-distance trade has been hailed as one of the preconditions for the development of capitalism in Europe.<sup>2</sup> The corporate form is regarded as another milestone for industrialization, the creation of viable market economies, and ultimately economic prosperity.<sup>3</sup> Many former socialist countries quickly enacted new corporate codes or revived their pre-World War Two ("WWII") legislation. The failure of major privatization efforts to enhance enterprise efficiency is attributed to weaknesses in corporate governance, of which the corporate law is a crucial element.<sup>4</sup>

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<sup>2</sup> For a discussion, RONALD I. MCKINNON, MONEY AND CAPITAL IN ECONOMIC DEVELOPMENT (1973).

<sup>3</sup> PHILLIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW 316 (1993).

<sup>4</sup> See Katharina Pistor, *Company Law and Corporate Governance in Russia*, in THE RULE OF LAW AND ECONOMIC REFORM IN RUSSIA 165 (Jeffrey D. Sachs & Katharina Pistor eds., 1997) (analyzing the role of corporate law in determining the outcome of privatization); Katharina Pistor, *Privatization and Corporate Governance in Russia: An Empirical Study*, in PRIVATIZATION, CONVERSION AND ENTERPRISE REFORM IN RUSSIA 69 (Michael McFaul & Tova Pelmutter eds., 1995) (attributing the failure of privatization to weak corporate legal structure). For a more skeptical view in hindsight, see Bernard Black et al., *Russian Privatization and Corporate*

Similarly, improvements in corporate governance have become a major goal for economies in East and South East Asia that were hit by the 1997-98 East Asian financial crisis.<sup>5</sup>

These efforts have been buttressed by empirical research suggesting that the quality of corporate law, as measured by a number of indicators on minority shareholder protection, is an important determinant for capital market development, which in turn fosters economic growth.<sup>6</sup> East Asian economies with more effective corporate laws were found to weather the financial crisis of 1997-98 better than those that scored worse on both the law on the books and the effectiveness of legal institutions.<sup>7</sup> Similar research on transition economies, however, has not replicated those results. The massive legal changes, especially in corporate law in the region, have had remarkably little impact on the development of financial markets.<sup>8</sup>

These empirical studies have broadened the scope of comparative legal research. Previously, the voluminous comparative corporate governance debate had focused on a handful of countries, mostly Germany, Japan, and the United States.<sup>9</sup> Meanwhile data-

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*Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000) (theorizing that rapid large-firm privatization in Russia did not help the economy because Russia lacked a strong economic infrastructure and corporate governance regulations).

<sup>5</sup> See Bernard Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 J. CORP. L. 539 (2001) (noting Asian recognition of the contribution of corporate law to economic prosperity).

<sup>6</sup> 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) (theorizing that countries with poor investor protection have smaller, narrower capital markets). For a theoretical foundation of this research, see Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

<sup>7</sup> Simon Johnson et al., *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141 (2000) (suggesting that protection of minority shareholders may reduce expropriation by managers, and thus diminish the fall of asset prices).

<sup>8</sup> Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. OF TRANSITION 325 (2000).

<sup>9</sup> The literature is too voluminous to be quoted here in full. Some of the most important papers and books include: COMPARATIVE CORPORATE GOVERNANCE—THE STATE OF THE ART AND EMERGING RESEARCH (Klaus J. Hopt et al., 1998); JEREMY EDWARDS & KLAUS FISCHER, BANKS, FINANCE AND INVESTMENT IN GERMANY (1994); MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 147-230 (1994) (broadly comparing corporate structure in the three countries); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993); Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Con-*

bases have been created to allow regression analyses for over seventy countries.<sup>10</sup> Yet, this type of analysis has not answered two fundamental questions: What is good corporate law, and how does good law evolve?

The most important database that has been created assumes that it is possible to identify—from the perspective of financial economics—key indicators for minority shareholder protection. The six variables these studies identified have produced results that do indeed suggest that these variables make a difference.<sup>11</sup> Yet, there remains the possibility that variables other than those identified explain the differences in outcome. Indeed, as this Article will demonstrate, several of the variables that were associated with the common law system in these studies were either abandoned early by countries belonging to the common law system, or adopted by them only in response to European Union (“EU”) harmonization requirements. This also implies that the reasoning that these variables reflect a firmer commitment by common law countries to protect private property rights is not fully convincing. If there is indeed a link between legal family (common law versus civil law family) and the performance of stock markets, it must be something other than the variables identified. This Article suggests that the answer might lie in the propensity of different legal systems to innovate by allowing sufficient room for experimentation, and by responding to the need to close loopholes that may open up in this process.

This proposition holds an answer to the second question: How does good corporate law evolve? This Article argues that a continuous evolution of law is a key ingredient to “good” law. The corporation has been a remarkably resilient legal institution for 200 years of industrialization and modernization largely because of its

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*tract, Culture, and the Rule of Law*, 37 HARV. INT’L L.J. 3 (1996); Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993) (explaining how managers in the United States hold more power than managers in Japan and Germany).

<sup>10</sup> See La Porta et al., *Legal Determinants of External Finance*, *supra* note 6 (including forty-nine countries in the analysis); Pistor et al., *supra* note 8 (coding the same provisions for twenty-four transition economies).

<sup>11</sup> The six variables are: (1) one-share-one-vote, proxy voting by mail; (2) cumulative voting rights; (3) preemptive rights; (4) no blocking of shares prior to the shareholder meeting; (5) anti-directors’ rights (litigation rights); and (6) not more than ten percent of shares required to call an extraordinary shareholder meeting.

capacity to adapt constantly to a changing environment.<sup>12</sup> Legal systems that have facilitated this process of adaptation and were able to respond to new legal lacunae created by change have proved to be more successful over time. From the perspective of legal innovation, common law countries have been more successful than civil law countries, and origin countries have been more successful than transplant countries. One factor that cuts across jurisdictions is competition: when legal systems were exposed to competitive pressures, they were more likely to innovate than when competitive forces were absent. Delaware, of course, is a key example of the effects of regulatory competition in corporate law. The evolution of corporate law at the end of the 19th century demonstrates that this is not an isolated phenomenon, as is evidenced by the erosion of the concession system in France and subsequently in Germany. France responded to the competitive "threat" of companies that were allowed to freely incorporate in England by moving from the concession to the free registration system, and Germany soon followed suit. The forces of regulatory competition in Europe declined as these jurisdictions found ways to ensure that domestic corporations followed domestic corporate law.<sup>13</sup> In addition, World War I brought an end to the internationalization of economic activities, which had a notable impact on competition.<sup>14</sup>

Our conclusions are drawn from a detailed mapping of the evolution of corporate law in ten jurisdictions since the beginning of the 19th century. Four leading market economies and representatives of the most influential legal systems in the world, France, Germany, England, and the United States are included in the analysis. In addition, we include six transplant countries, which received their corporate laws either directly or indirectly from

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<sup>12</sup> See Mary O'Sullivan, *The Innovative Enterprise and Corporate Governance*, 24 CAMBRIDGE J. ECON. 393 (2000) (discussing the importance of the innovative capacity of companies).

<sup>13</sup> The most effective tool to date has been the "real seat theory." According to this theory, companies must be incorporated in the jurisdiction where they have their headquarters and/or their main operation. France established this doctrine in the 1860s. For recent developments on the seat theory in the case law of the European Court of Justice, see Peter Behrens, *International Company Law in View of the Centros Decision of the ECJ*, 1 EUR. BUS. ORG. L. REV. 125 (2000).

<sup>14</sup> On the effect of competition on financial market development, see RAGHURAM G. RAJAN & LUIGI ZINGALES, *THE GREAT REVERSALS: THE POLITICS OF FINANCIAL DEVELOPMENT IN THE 20TH CENTURY* (The World Bank, Working Paper, 2000).

these four jurisdictions. These are Chile, Colombia, Israel, Japan, Malaysia, and Spain.

The research is designed to be explorative in nature. We use an open-ended list of legal indicators to identify patterns of legal change and pay tribute to the idiosyncracies of legal evolution in different countries. We use statutory law as a source to analyze the timing and locus of legal change. This is admittedly a narrow approach, especially in jurisdictions, such as the United States, where corporate law has, to a large extent, been shaped by case law. Still, even in these jurisdictions, the law on the books offers crucial information about changes in the scope of judicial review and contractual freedom in corporate law. We also acknowledge that change in the formal law is not necessarily identical with change in the organization and administration of the firm. But the statutory law establishes the framework that shareholders of the firm may use to structure their relations. It also reflects policymakers' perceptions of the role of the corporation and its shareholders, and documents their response to changes in the business environment.

To capture the evolution of corporate law, we identify the allocation of key decision-making rights among shareholders of the firm, including rights relating to the existence of the corporation as an independent entity, its governance structure, and issues of corporate finance. These decision-making rights may be vested with the state, or may be allocated to shareholders, including shareholders, managers, creditors, and labor. We observe whether the allocation of rights is prescribed by law, mandatory, or whether shareholders may opt out of legal provisions.

Our analysis yields a simple observation: Legal systems had largely similar laws on the books at the outset, but subsequently followed different paths. The original laws were short and simple. They were concerned with conditions for establishing the corporation, but hardly addressed its internal organization, transaction control, or shareholder suits. Today, the ten jurisdictions have rather elaborate corporate codes, but with different emphases. Some emphasize minority shareholder rights, others focus on creditor rights or shareholders of companies that are members of company groups. Some have primarily mandatory provisions, others offer only rules off the shelf and allow for extensive opt-out.

In explaining these evolutionary developments, this Article suggests a refocus of the corporate law and governance debate. Most studies of corporate governance today emphasize shareholder rights. Similarly, policymakers urge countries around the

world to incorporate legal rules that protect minority shareholders.<sup>15</sup> This policy stance reflects a preoccupation of the comparative corporate governance literature with the principal-agent problem. According to this view, shareholders as the principals of the corporation require legal protection to control management as their agents. Without this legal protection, managers might be inclined to maximize their personal benefits rather than shareholder value.

Our analysis of the evolution of corporate law suggests that the function of corporate law is much more complex, involving a tradeoff between agency problems and flexibility. Early corporate laws had relatively effective solutions for the agency problem, including the ultra vires doctrine, unanimous shareholder vote provisions, and creditors' rights to petition for the liquidation of the firm if minimum capital requirements were not met. Such legal provisions limit agency problems, but at the same time greatly restrict the ability of corporations to respond to a quickly changing environment. A corporate law that allows greater flexibility implies more misuse, and thus higher agency costs. The historical challenge of the corporate law has been to balance these two conflicting interests and develop complementary legal control mechanisms that afforded corporations (i.e., corporate management) with substantial flexibility without creating a control vacuum. These complementary control mechanisms include the strengthening of shareholders' exit rights, judicial recourse, as well as the establishment of a regulator to supervise capital markets.

Our findings suggest two central claims. The first concerns the process of evolution: The most important differences among the ten jurisdictions analyzed in this study are their relative positions on the flexibility-rigidity continuum and whether they have been able to develop complementary control devices to compensate for the legal void that results from greater flexibility. We argue that striking the right balance between flexibility and control is the key ingredient for ensuring the adaptability of the corporate form to a constantly changing environment. The Schumpeterian process of creative destruction applies not only in economics,<sup>16</sup> but also holds important lessons for the evolution of law.

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<sup>15</sup> See, e.g., ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT ("OECD"), *OECD PRINCIPLES OF CORPORATE GOVERNANCE* (1999).

<sup>16</sup> JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* 81-86 (1942).

Our second claim concerns the starting point of evolution. We find that irrespective of legal family, transplant countries reveal different patterns of legal development than do origin countries. Some countries show extreme volatility in legal change after the enactment of the first corporate statute. This volatility can be interpreted as a response to the economic impact of the enactment of new law, or as a rejection of certain aspects of a law that had been more or less imposed on a country. In other countries, the law on the books did not change for decades, despite a remarkable economic takeoff—evidence that the process of creative destruction of law had not taken hold. We conclude from this analysis that the acceptance of law in a transplant country is not a foregone conclusion. Users as well as lawmakers need to recognize the relevance of the law for economic undertakings and learn how to adjust law based on their own experience. Moreover, they need to develop appropriate complementary institutions, which frequently are less developed in transplant countries than in the origin countries from which the law is borrowed. Some transplant countries have sought to make up for the lacunae of legal institutions by strengthening state regulation or by allowing little flexibility in their laws. The problem with this approach is that while it avoids some of the pitfalls of a flexible law, it restricts the capacity for innovation and change. It also retards the development of other complementary institutions, which are necessary when a country moves from a rigid to a more flexible regime.

The Article proceeds as follows: Section 2 sets forth the scope of the analysis. It presents the selection of countries and the legal indicators we use to identify patterns of legal change. Section 3 traces the evolution of corporate law in the four origin countries included in the sample using a common taxonomy of shareholder rights. The discussion shows that the area where legal systems reveal the greatest divergence is the governance of corporate finance. Civil law countries subjected corporations to a strict legislated regime, whereas common law countries allowed substantially more flexibility and by implication, a reallocation of control rights from shareholders to managers. Section 4 analyzes the tradeoff between rigid and flexible laws, responses to the legal void that often results from greater flexibility, and the emergence of complementary control devices. Section 5 traces the evolution of law in the six transplant countries in the sample. Section 5 also analyzes complementary controls in transplant countries and seeks explanations for the fact that they seem to be less developed than in most origin coun-

tries. Section 6 makes some concluding observations about the evolution of corporate law in comparative perspective.

## 2. SCOPE OF ANALYSIS: SELECTION OF COUNTRIES

Our analysis begins with the first enactment of general corporate statutes<sup>17</sup> and traces the development of corporate law until the end of the 20th century. The beginning of the period is marked by the enactment of the *Code de Commerce* in France in 1807.<sup>18</sup> This code, along with other Napoleonic codes, was subsequently enacted in many parts of Europe and thereafter was transplanted to Latin America and parts of Africa. In the United States, New York was the first state to enact a corporate statute in 1811, which was limited in application to manufacturing companies, followed by New Jersey in 1816. Delaware's corporation law,<sup>19</sup> which has come to dominate in the United States, was enacted in 1883. In England, codification of corporate law began in 1844.<sup>20</sup> The revised and first comprehensive companies act of 1862<sup>21</sup> became part of a package of codified common law that was later transplanted to British colonies. In Germany, the political development delayed codification for much of the 19th century.<sup>22</sup> Prussia enacted a corporate law in 1843.<sup>23</sup> In 1860, the General Commercial Code for all of Germany—including Austria—was enacted,<sup>24</sup> which devoted a section

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<sup>17</sup> We use the term "statute" when referring to general legal enactments that may be termed "act," "law," or "code" in different jurisdictions.

<sup>18</sup> CODE DE COMMERCE [C. COM.], adopted by Law No. 2804, November 1807, Bull. des Lois No. 164 (1808), 161-299 (Fr.) [hereinafter CODE DE COMMERCE].

<sup>19</sup> Act Concerning Private Corporations, 17 Del. Laws 147 (1883) [hereinafter Private Corporations Act].

<sup>20</sup> Joint Stock Companies Act, 7 & 8 Vict., c. 110 & 111 (1844) (Eng.).

<sup>21</sup> Companies Act, 25 & 26 Vict., c. 89 (1862) (Eng.).

<sup>22</sup> Norbert Horn, *Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860-1920), Deutschland, England, Frankreich und die USA im Vergleich*, [Enterprise Organization Relating to Law on Shares in High Industrialization (1860-1920), Germany, France, and the USA in Comparison], in RECHT UND ENTWICKLUNG DER GROßUNTERNEHMEN IM NEUNZEHNEN UND FRÜHEN ZWANZIGSTEN JAHRHUNDERT [LAW AND THE FORMATION OF BIG ENTERPRISES IN THE 19TH AND EARLY 20TH CENTURIES], 123 (Norbert Horn & Jürgen Kocka eds., 1979).

<sup>23</sup> Gesetz über die Aktiengesellschaften, v. 29.11.1843 (G-Slg. Königl. Preuss. Staaten Nr. 31 S. 341) (The Kingdoms of Prussia) [hereinafter Prussian AktG].

<sup>24</sup> Handelsgesetzbuch (HGB), reprint in BGBl. Norddtsch. Bd. Nr. 32, 379, Append. C Part 3, p. 445 (1869) (Deutscher Bund) [hereinafter Handelsgesetzbuch].



to joint stock companies. A later revision (1884) of this law for unified Germany<sup>25</sup> served as a model for Japan.<sup>26</sup>

The four countries that were first to enact general corporate statutes have spearheaded the development of corporate law. An analysis of the evolution of corporate law in these countries and the extent to which they have followed similar or perhaps different paths may shed light on the evolution of an institution, which has played a crucial role in capital formation since the advent of industrialization. It may also help to understand variations in the development of different legal systems, in particular the common law and civil law systems. England and the United States represent the core countries of the common law family, Germany and France represent those of the German and French civil law families respectively.<sup>27</sup>

Another question this Article seeks to address is whether similar patterns of legal evolution, which can be found in countries that developed formal corporate law internally, also characterize the evolution of law in countries that received formal law by way of transplant. In Europe, the evolution of the corporation can be traced to commercial societies of the Middle Ages on the one hand and state chartered, though mostly privately financed corporations, on the other.<sup>28</sup> The majority of countries around the globe

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<sup>25</sup> Gesetz betreffend die Kommanditgesellschaften auf Aktien und die Aktiengesellschaften, v. 31.7.1884 (RGBl. S. 123-70) (German Reich) [hereinafter AktG 1884].

<sup>26</sup> SHŌHŌ Law No. 48 of 1899 (Japan).

<sup>27</sup> The differentiation of legal families has a long tradition in comparative law even though legal scholars continue to debate the criteria that distinguish them. Konrad Zweigert & Hein Kötz, *INTRODUCTION TO COMPARATIVE LAW* 63 (1998). For corporate law, the distinction between statutory or codified law and case law is less obvious than in the general case, as in both England and in the United States this law was codified in the 19th century. In fact, common law countries have witnessed an increasing number of statutory enactments over the past two hundred years in other areas as well. Conversely, in 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. In light of these developments, comparative legal scholars have concluded that the differences between legal families can be found less in the contents of laws, but rather in the history of the law, legal processes and legal culture. *Id.* at p. 1-12. Recent empirical findings, however, suggest that differences in the contents of legal rules concerning shareholder and creditor rights protection may in fact be more pronounced. For these results, see Rafael La Porta et al., *Law and Finance*, *supra* note 6, and Rafael La Porta et al., *Legal Determinants of External Finance*, *supra* note 6.

<sup>28</sup> For a comparative overview in the major European and North American jurisdictions, see Helmut Coing, *HANDBUCH DER QUELLEN UND LITERATUR DER*

copied or received the foundations of their corporate law from the core Western European countries (France, England and Germany) as a result of colonization, legal imposition after a lost war, or as a result of (semi-) voluntary subjugation to foreign pressure in an attempt to retain or regain their sovereignty.<sup>29</sup>

The fact that the transplant of similar if not identical laws within decades after their enactment in the Western origin countries did not produce similar results questions the importance of formal laws on the books for economic development. However, there may be more to effective law-making than getting the rules on the books right. Without a demand for law, which could be spurred by socioeconomic development, the law will exist on the books, but will be ignored in practice.<sup>30</sup>

This Article seeks to address these questions by including several countries that received their formal corporate law externally rather than developing it internally. We selected at least one country for each of the main legal families. For common law, we include Israel and Malaysia. For French civil law, we include Spain and two Latin American countries—Chile and Colombia. Finally,

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NEUEREN EUROPÄISCHEN PRIVATRECHTSGESCHICHTE, III/3 (1986), and BLUMBERG, *supra* note 3, at 3; for England, see PAUL L. DAVIES, *GOWER'S PRINCIPLES OF MODERN COMPANY LAW* 18 (6th ed. 1997) with further references.

<sup>29</sup> By far the largest number of countries received Western law by way of colonization. Outside Europe, the only major exception is Japan, which in turn transplanted the law it had received from Europe to Korea and Taiwan when it colonized these territories. Within Europe, the history of legal transplantation is more complicated. Although warfare played an important role in particular for the dissemination of the Napoleonic codes, most countries regained independence shortly thereafter. The major national codifications of the 19th century were enacted by independent states, even though they borrowed heavily from the nation that had conquered them earlier (in particular France). In part this may be attributed to the fact that some of these countries shared a common legal history, which facilitated transplantation and made solutions of the conquering nation acceptable in the receiving country. In part, the implementation of French law was viewed as an instrument to modernize societies whose backwardness had been demonstrated by France's victory during the Napoleonic wars. For a summary of the history of legal transplantation in the 19th century, see Dan Berkowitz et al., *Economic Development, Legality, and the Transplant Effect*, EUR. ECON. REV. (forthcoming 2002) with further references.

<sup>30</sup> For a detailed analysis of the irrelevance of formal law in early Asian economic development, see KATHARINA PISTOR & PHILIP WELLONS, *THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT* (1998). There is strong empirical support that the demand for law has implications for the development of effective legal institutions. See Berkowitz, *supra* note 29.

for the German legal family, we include Japan.<sup>31</sup> Table 1 lists the countries included in the study and classifies them according to legal family and origin.

Table 1: Country Selection<sup>32</sup>

Legal Family	Origin	Transplant
French civil law	France	Spain, Chile, Colombia
German civil law	Germany	Japan until 1950
Common law	USA (Delaware)	Israel, Malaysia, Japan since 1950

## 2.2. The Scope of Corporate Law

Defining the scope of corporate law can be problematic. "Corporate law" may be defined by the contents of the formal legal acts labeled corporate law, companies act, or the like. Alternatively, it may be defined functionally as all legal rules that seek to influence the organization of the corporation or the rights and obligations of its various shareholders, irrespective of the title of a specific legislative enactment that may contain such provisions. Shareholder protection, for example, can be found not only in corporate statutes, but also in securities market regulation. Similarly, creditor protection may be included in the corporate law as well as in bankruptcy law or the civil code. Moreover, the effectiveness of legal protection afforded by substantive legal provisions depends on the accessibility and effectiveness of procedural rules. Thus, at least

<sup>31</sup> The classification of Japan into one of the legal families poses difficulties in particular in the area of corporate law. At the end of the 19th century, Japan enacted codes in key areas of civil and commercial law that were primarily influenced by German law. But after World War II, the United States ensured the revision of the corporate law based largely on Illinois law. See Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, 150 U. PA. L. REV. 527, 527 (2001) (discussing how both the Model Business Corporation Act and the Modern Japanese Commercial Code were based on the Illinois Business Corporation Act of 1933) [hereinafter West, *Puzzling Divergence*].

<sup>32</sup> Technically, the United States is a transplant, because its legal system is derived from English common law. But, since the early 19th century, the development of corporate law in the United States has been sufficiently idiosyncratic to warrant a classification as an origin country. See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1780-1860* (1977) (discussing the development of law in the United States).

indirectly, such factors as civil procedure law and judicial institutional structure are important elements of the legal framework for corporations.

While we acknowledge the importance of related areas of the law, this Article begins with an overview of the law found in relevant corporate statutes. Doing so helps define the scope of the analysis for a larger number of jurisdictions.

### 2.3. Legal Indicators

Corporate statutes have grown into lengthy documents incorporating many indicators. The goal of this Article is only to identify patterns of legal change across ten different jurisdictions. We start from the simple observation that indicators for "good" corporate law that have been identified by previous studies were, for the most part, not initially present in corporate law across the board, including in common law countries, but emerged over time. We demonstrate this finding by analyzing the first English corporate law of 1844 and identifying the dates when the relevant provisions were included in the law.

Table 2: *Minority Shareholder Protection in English Law*<sup>33</sup>

Protection	Date of Enactment	Comment
Proxy by mail	1948	Prior to 1948 shareholders could vote by proxy only, if this had been stipulated in the articles of incorporation; no mentioning of proxy by mail
Cumulative voting	(-)	(-)

<sup>33</sup> To compile this table, we consulted the English Companies Act from 1844 to the present. See Companies Act, 1989, c. 40 (Eng.); Companies Act, 1985, c. 6 (Eng.); Companies Act, 1980, c. 22 (Eng.) [hereinafter Companies Act 1980]; Companies Act, 1967, c. 81 (Eng.); Companies Act, 1948, 11 & 12 Geo 6, c. 38 (Eng.) [hereinafter Companies Act 1948]; Companies Act, 1929, 19 & 20 Geo 5, c. 23 (Eng.) [hereinafter Companies Act 1929]; Companies (Consolidation) Act, 1908, 8 Edw. 7, c. 69 (Eng.) [hereinafter Consolidation Act]; Companies Act, 1900, 63 & 64 Vict., c. 48 (Eng.); Directors Liability Act, 1890, 53 & 54 Vict., c. 64 (Eng.); Companies Act, 1880, 43 Vict., c. 19 (Eng.); Companies Act, 1879, 42 & 43 Vict., c. 76 (Eng.); Companies Act, 1867, 30 & 31 Vict., c. 131 (Eng.); Companies Act, 1862, 25 & 26 Vict., c. 89 (Eng.) [hereinafter Companies Act 1862]; Act for Limiting the Liability of Members of Certain Joint Stock Companies, 1855, 18 & 19 Vict., c. 133 (Eng.) [hereinafter Limited Liability Act]; Joint Stock Companies Act, 1844, 7 & 8 Vict., c. 110 & 111 (Eng.).

No blocking of shares	(-)	(-)
Shareholder suit	1844	Direct suit implied in 1844; derivative action recognized in 1975
Preemptive rights	1980	In response to EU harmonization requirements
Shareholders representing not more than ten percent of total stock can call extraordinary shareholder meeting	1909	The 1862 law required twenty percent The threshold was lowered to five percent in 1948

As can be seen, as of 1844, none of the indicators was mentioned explicitly in statutory law. With regard to the absence of the blocking of shares, this can be noted positively. The right to judicial recourse was nowhere mentioned in statutory law but was implied, as England already had a history of case law in partnership and corporate law. All other indicators were either never addressed in English law (cumulative voting, for example) or were included at a later time, in one instance only under pressure from European harmonization guidelines (preemptive rights). We draw two conclusions from this observation. First, with the exception of litigation rights (excluding derivative suits) the indicators emerged over time and do not seem to represent anything genuine about common law. Second, explaining the evolution of corporate norms seems to be more important than identifying a particular set of indicators.

To trace the patterns of legal change over time, we identify core aspects of corporate law and trace the allocation of decision-making rights over these issues. These core aspects include the right to make decisions that affect the existence of the corporation as an independent entity, its governance structure, and its financial structure.<sup>34</sup> For each of these issues, we identified a list of variables.<sup>35</sup> Table 3 below lists the three areas and the relevant variables in each category.

<sup>34</sup> See OECD PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 15, at Pt. 1, § 1B (defining "fundamental corporate changes" as "1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions that in effect result in the sale of the company").

<sup>35</sup> The list was not exhaustive. We wanted to leave sufficient room for innovations that some countries, but not others, made.

Table 3: Taxonomy of Legal Indicators<sup>36</sup>

Existence	Governance Structure	Corporate Finance
Formation	Board Structure	Capital increase
Liquidation	Function of board(s)	Capital decrease
Term	Appointment of board members	Issuing of shares
Merger	Dismissal of board members	Valuation of in kind contributions
	Scope of Management Powers	Repurchase of shares
	Powers of shareholder meeting (SHM)	
	Voting rules	
	Majority requirements	
	Right to call SHM	

We created a matrix for each country indicating the allocation of control rights over these matters. The allocation of control rights can be mandatory or optional. Where it is mandatory, the allocation of control rights is made by law and cannot be changed. For example, the law may stipulate that decisions concerning the formation of a corporation and changes in its articles of incorporation (charter)<sup>37</sup> can be made only by shareholders. Thus, shareholders could neither delegate these rights to management, nor could creditors include provisions in their contracts that would allow them to participate in these decisions. Where the allocation of control rights is optional, it may vary for different corporations and may change over the lifetime of the corporation. The crucial question then becomes not who holds the control rights over a specific issue, but who controls charter changes in midstream, which may result in a reallocation of control rights.<sup>38</sup> Lastly, the law itself can prescribe certain substantive issues, rather than only allocating control rights over them. Minimum capital requirements, or mandatory provisions on the board structure (one-tier or two-tier structure) are examples for such provisions, that are removed from the shareholders' control.

<sup>36</sup> These sources have been compiled by authors.

<sup>37</sup> The legal terminology for the various corporate documents differs from country to country. We use the term "charter" across all jurisdictions to denote the founding document or constitution of the corporation. This term should not be confused with the state "chartering" a company, i.e., authorizing a specific undertaking and endowing it with certain privileges.

<sup>38</sup> For a discussion of charter changes in midstream, see Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

### 3. THE EVOLUTION OF CORPORATE LAW IN ORIGIN COUNTRIES

Using the above-described indicators, we recorded the contents of the relevant provisions found in the law. We did not convert the indicators into binary variables that could be used for statistical analysis. While the quantitative analysis of law has sparked much interest in legal issues and has produced interesting results, such analyses have at least four limitations. First, coding legal provisions as binary variables while giving each indicator equal weight assumes that a higher number of indicators provides better legal protection. Yet, it is conceivable that some indicators have more bite than others. Thus, adding more indicators may distort the picture rather than help assess differences in the quality of law. Second, depending on when the list is closed, the results may be biased against some jurisdictions, despite the fact that a few well-placed legal constraints may have the same effect as a larger number of rules. Finally, a closer analysis of the indicators that have been used in previous studies reveals that their function may be more ambiguous than has been assumed.<sup>39</sup>

Our analysis starts from the simple premise that an important function of corporate law is the allocation of control rights among different shareholders.<sup>40</sup> We suggest that the allocation of control rights has implications for the flexibility of the corporation to respond to a changing environment. It also influences the long-term evolution of corporate law, because the initial allocation of rights

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<sup>39</sup> For example, the Rafael LaPorta, Florencio Lopez-de Silanes, Andrei Shleifer, Robert Vishney ("LLSV") studies use preemptive rights, i.e., the right of existing shareholders of first refusal when the corporation increases its capital and issues new stock, as one of the six indicators in their anti-director index, which purports to measure the level of minority shareholder protection. Preemptive rights may, however, benefit existing block-holders, not minority shareholders because they force the company to return to existing financiers rather than reach out to new investors, thus creating a more dispersed ownership structure over time. Eddy Wymeersch, *Das Bezugsrecht der alten Aktionäre in der Europäischen Gemeinschaft: eine Rechtsvergleichende Untersuchung*, DIE AKTIENGESELLSCHAFT 382 (1998). While our methodology may unfortunately result in a more lengthy analysis than a statistical study, we believe that by sacrificing brevity, we achieve significant gains in accuracy.

<sup>40</sup> This premise is influenced by the property rights theory of the firm. See Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 692 (1986) (developing "a theory of integration based on the attempt of parties in writing a contract to allocate efficiently the residual rights of control"); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990) (studying "how changes in ownership affect the incentives of non-owners of assets (employees) as well as the incentives of owner-managers").

may trigger legal responses to problems that occur because of the way in which rights were allocated in the first place. Where the initial allocation of control rights has not changed over time, i.e., because the law mandates a certain allocation without allowing for flexibility, we should observe relatively few legal innovations of change taking place primarily outside the framework of the law. Where the allocation was optional rather than mandatory, or where it has become more flexible over time, we may observe either a legal vacuum or legal responses that filled the void in areas where control rights have been shifted. Additional governance devices may have emerged outside the narrow corporate law as substitutes or complements to more rigid control allocations in earlier laws.

We begin our analysis by examining two early evolutionary factors: entry conditions and limited liability. We then turn to the allocation of control rights.

### 3.1. *Early Evolution*

#### 3.1.1. *Entry Conditions*

Until well into the 19th century, the allocation of control rights among the shareholders of the corporation was secondary to the reservation of control rights by the state. The state's veto power over incorporation can be traced to the incorporation of state-chartered companies in the Middle Ages. For companies to be recognized as independent legal entities and for them to freely sell their shares, they required state approval (concession).<sup>41</sup> However, promoters of commercial undertakings frequently found ways around these restrictions. In particular, in England during the economic boom following the 1688 Revolution, it became common to buy charters from moribund companies.<sup>42</sup> This practice was stopped with the enactment of the Bubble Act in 1719,<sup>43</sup> which sought to re-establish the prerogative of the Parliament to grant

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<sup>41</sup> Horn, *supra* note 22, at 127.

<sup>42</sup> See DAVIES, *supra* note 28, at 24. See also MICHAEL SMART, ON LIMITED LIABILITY AND THE DEVELOPMENT OF CAPITAL MARKETS: A HISTORICAL ANALYSIS (1996) at [http://www.papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1175](http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1175).

<sup>43</sup> Bubble Act, 6 Geo. 2, c. 18, 1719 (Eng.). The Bubble Act was repealed in 1825 by the Bubble Companies Act. Bubble Companies Act, 6 Geo. 4, c. 91, 1825 (Eng.).



charters of incorporation.<sup>44</sup> In France, free registration of all private companies was proclaimed in 1791 in the aftermath of the revolution.<sup>45</sup> The boom in startups and the following bust led to a complete reversal in 1793.<sup>46</sup> However, in 1796, the principle of free incorporation had been re-established, only to be replaced once more in 1807 with the concession system by the restorative Napoleonic *Code de Commerce*.<sup>47</sup> This system was retained until 1867, when France moved to a system of free registration.<sup>48</sup> In England, the Bubble Act was repealed in 1825.<sup>49</sup> The ensuing railway mania with its many successful companies, but also widespread fraud and pyramid schemes led to the enactment of the Joint Stock Companies Act in 1844.<sup>50</sup> It established the principle of free incorporation subject only to registration, but did not recognize limited liability – which was recognized by law only in 1855.<sup>51</sup>

The shift from the concession to the free registration system in France in 1867 was induced by the expansion of activities of English companies on the continent. Germany soon followed suit with an amendment of the general commercial code for all of Germany in 1870.<sup>52</sup>

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<sup>44</sup> Under the act, “the acting or presuming to act as a Corporate Body or Bodies, the raising or pretending to raise transferable Stock or Stocks . . . without legal Authority . . . shall for ever be deemed to be illegal and void, and shall not be practiced or in any wise put in execution.” Bubble Act, *supra* note 43. See DAVIES, *supra* note 28, at 24 (discussing the history of the South Sea Bubble and the enactment of the Bubble Act).

<sup>45</sup> NORBERT HORN, *GESELLSCHAFTSRECHT IN FRANKREICH*, tbl.1 (Helmut Coing ed., 1988).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> Law No. 15,328 of July 24, 1867, 30 Bull. Lois 11<sup>e</sup>S., B. No. 1513, 95 n.15,328 (Fr.) [hereinafter Law of July 24]; see also Horn, *supra* note 22.

<sup>49</sup> Bubble Companies Act, *supra* note 43.

<sup>50</sup> Joint Stock Companies Act, *supra* note 20.

<sup>51</sup> Limited Liability Act, *supra* note 33.

<sup>52</sup> At that time, another form of company dominated, the *Kommanditgesellschaft* (“KG”), which has at least one unlimited member. For all others, liability is limited to their contribution. The provisions of the corporation use this form as the model and add provisions only where deviations are necessary. The predominance of the KG (*société en commandite* in France) in Europe in the first part of the 19th century can be largely explained by the fact that unlike the corporation with full limited liability, a special concession was not required for setting up this company. Horn, *supra* note 22, at 123; WERNER SCHUBERT & PETER HOMMELHOFF, *HUNDERT JAHRE MODERNES AKTIENRECHT* (1985). This form of company was not known in England. Some commentators suggest that this may have been the result of England lagging behind the Continent in bookkeeping techniques in early modern times. See DAVIES, *supra* note 28, at 19.

The development of the principle of free incorporation without special state approval was slightly different in the United States. By the end of the eighteenth century, there were about 300 incorporated companies in the United States, most of them providing public services, and only eight manufacturing companies.<sup>53</sup> Until the 1830s, when different states began to enact general corporate laws, most companies were incorporated by a special bill adopted by Congress.<sup>54</sup> Subsequently, states began to adopt general corporate laws and allowed companies to incorporate under these laws. Still, many companies preferred to incorporate by special bill because they often bargained with the legislature for special privileges, including monopoly rights in public work projects.<sup>55</sup> Delaware enacted its first general corporate law in 1883,<sup>56</sup> after a constitutional amendment in 1875 established the right of the state legislature to enact such a law.<sup>57</sup> Incorporation by special bill remained possible until 1897, when another amendment of the Delaware Constitution stipulated that from now on, incorporation as well as renewal of existing incorporations could be achieved under the general law only.<sup>58</sup> The reason was that special bills had led to much controversy and allegations of corruption.

### 3.1.2. *Limited Liability*

Not all jurisdictions recognized limited shareholder liability in their original statutes. England was the first country to move towards free registration in 1844,<sup>59</sup> but did not recognize limited li-

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<sup>53</sup> See BLUMBERG, *supra* note 3, at 6 (stating that by 1801 there were only eight manufacturing corporations and 317 corporations of all types in the entire country).

<sup>54</sup> RUSSEL CARPENTER LARCOM, *THE DELAWARE CORPORATION* 2 (1937). New York was the first state to enact a general corporate law—as early as 1811. See Act Relative to Incorporations for Manufacturing Purposes, Ch. LXVII, 1811 N.Y. Laws 34 [hereinafter Manufacturing Incorporations Act].

<sup>55</sup> LARCOM, *supra* note 54.

<sup>56</sup> Act Concerning Private Corporations, *supra* note 19.

<sup>57</sup> Act to Ratify a Proposed Amendment to the Constitution of this State, Jan. 28, 1875, 1875 Del. Laws ch. 1,1-2.

<sup>58</sup> See LARCOM, *supra* note 54, at 7 (quoting the Delaware Constitution of 1897, which states “No corporation shall hereafter be created, amended, renewed, or revived by special act, but only by or under general law, nor shall any existing corporate charter be amended, renewed, or revived by special act, but only by or under general law . . .” DEL. CONST. of 1897, art. IV, § 1).

<sup>59</sup> Joint Stock Companies Act, *supra* note 20.

ability of shareholders at that time.<sup>60</sup> Only after several court decisions that recognized contractually granted limited liability did the legislature follow suit.<sup>61</sup> In the United States, different states pursued different strategies with respect to limited liability. In California, limited liability was recognized only in 1931.<sup>62</sup> In Delaware, prior to 1967, the law left it to the certificate of incorporation to determine “whether the private property of the stockholders . . . shall be subject to the payment of corporate debts, and if so, to what extent.”<sup>63</sup> Only the 1967 code established limited liability as a default rule.<sup>64</sup> For the French legislature, by contrast, limited liability was an essential feature of the corporation, recognizing it right away with the first codification in 1807.<sup>65</sup> Germany followed in 1861.<sup>66</sup>

Table 4: *Legal Recognition of Shareholders’ Limited Liability*<sup>67</sup>

	First Corporate Statute	Free Incorporation	Limited Liability Recognized by Law
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<sup>60</sup> A myth has been created in parts of literature, especially economics literature, that England was first in developing key elements of the corporate law, including limited liability. See, e.g., RAJAN & ZINGALES, *supra* note 14; WORLD BANK, WORLD DEVELOPMENT REPORT: BUILDING INSTITUTIONS FOR MARKETS 65 (2001) (citing an earlier draft of this paper which served as a background report). In that draft we noted that France proclaimed free registration of companies in 1791, but repealed that provision shortly thereafter. We also noted that joint stock companies existed in England much earlier, but did not claim that England had “features of incorporation” as early as 1688. In fact, the Bubble Act of 1719 explicitly restated the rule that incorporation required an act of parliament.

<sup>61</sup> See Limited Liability Act, *supra* note 33 (describing the method of obtaining limited liability for members of certain joint stock companies).

<sup>62</sup> Shareholder liability was not joint and several, but pro rata. BLUMBERG, *supra* note 3, at 12. There is no evidence that the lack of full limited liability prevented firms from incorporating in Delaware.

<sup>63</sup> Act of Mar. 10, 1899, ch. 273, § 26, 21 Del. Laws 444 [hereinafter 1899 Del. Laws].

<sup>64</sup> 56 Del. Laws 50, § 102 (6), (1967) (stating that a certificate of incorporation may include “a provision imposing personal liability for the debts of the corporation on its stockholders or members to a specified ex ante and upon specified conditions; otherwise, the stockholders or members of a corporation shall not be personally liable. . . .” (emphasis added)).

<sup>65</sup> CODE DE COMMERCE, *supra* note 18, art. 33.

<sup>66</sup> Handelsgesetzbuch, *supra* note 24.

<sup>67</sup> Table was compiled by authors on the basis of relevant statutory laws. For France, see CODE DE COMMERCE, *supra* note 18; Law of July 24, *supra* note 48. For Germany, see Handelsgesetzbuch, *supra* note 24; Gesetz Betreffend die Kommanditgesellschaften auf Aktien und die Aktiengesellschaften (AktG), v.11.6.1870 (BGBl. Norddtsch. Bd. Nr. S. 375) (Norddeutscher Bund) [hereinafter AktG 1870]. For England, see Joint Stock Companies Act, *supra* note 20; Limited Liability Act, *supra* note 33. For the United States, see Private Corporations Act, *supra* note 19.

France	1807	1867	1807
Germany	1861	1870	1861
England	1844	1844	1855
United States			
New York	1811	1811	1811
California	1849	1849	1931
Delaware	1883	1883	1883 (1967)

Shifting the right to incorporate from the state to shareholders also meant that the state gave up control rights over future changes in the articles of incorporation. State approval for such changes was no longer necessary. To be sure, special rules existed for some commercial undertakings, including banking and insurance, but for general commercial activities the state had largely relinquished *ex ante* control—i.e., control over entry into the market.

With the principle of free incorporation having been established, the state's attention shifted to other areas. One was *ex post* control. The 1899 Delaware law, for example, stipulates that the legislature may dissolve any corporation "at leisure" created under its act, or alter, or amend its charter of incorporation.<sup>68</sup> There is, however, little evidence that this provision has been much used. More important was the attempt by legislatures to establish a viable legal framework that could replace the *ex ante* control function it had exercised hitherto. The move to a system of free registration was accompanied in all countries by the enactment of a much more elaborate corporate law. As long as the state—be it the legislature or bureaucracy—could verify the content of the charter of any corporation that wished to enter the market, there was little need to design a general governance structure. The focus of legislatures shifted to the conditions for incorporation. The new corporate laws stipulated entry requirements that applied to all corporations and had to be met before a company could commence operation as a legally founded joint stock company. They included the minimum number of founders of a corporation, disclosure requirements regarding the contents of the companies' statutes, the scope of its activities, as well as capital requirements, in particular provisions on the amount of capital that had to be paid up at the time of registration. While the precise stipulations differed from country to country,<sup>69</sup> it is notable that legislatures in all jurisdic-

<sup>68</sup> 1899 Del. Laws, ch. 147, § 14, 212.

<sup>69</sup> For example, France required seven founders. CODE DE COMMERCE, *supra* note 18. England required twenty-five. Joint Stock Companies Act, *supra* note 20. France, Germany, and England stipulated the proportion of capital that must be

tions extended the scope of corporate law provisions to cover these issues.

The new liberalized entry requirements were soon put to a test. Most countries experienced a founders' boom after the liberalization of corporate law, which in some cases was followed by a major bust. The major case for a boom and bust in the market followed by a legislative backlash, however, is Germany.<sup>70</sup> While the causality between the liberalization of the law in 1870 and the founders' boom and bust that followed is still subject to dispute,<sup>71</sup> the close timing suggested to contemporary lawmakers a close relation between the two events. They responded with two major legal enactments: the revised corporate law of 1884, which cemented the principles of a mandatory corporate law that was highly protective of shareholders and creditors; and the Stock Exchange Act of 1896, which introduced publication requirements and liability for wrongful information in the prospectus.<sup>72</sup>

### 3.2. Allocation of Control Rights

The state's relinquishing of its right to approve each new corporate entry did not end state involvement in corporate affairs. Instead, new avenues were sought to ensure that others would take over the monitoring function that hitherto had been assumed by the state. This was accomplished by exceedingly elaborate corporate statutes that allocated key control rights to various shareholders of the corporation. The following sections document the allocation of key control rights, which we have defined as the existence of the corporation as an independent entity, its governance structure, and corporate finance.<sup>73</sup>

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paid in at the time of registration, while Delaware left this to charter provisions. Private Corporations Act, *supra* note 19.

<sup>70</sup> For a discussion of the backlash effect on legal development, see Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

<sup>71</sup> Horn, *supra* note 22.

<sup>72</sup> Enforcement of the act, however, proved to be problematic. Only shareholders still in possession of the relevant shares could file a claim. For a critique of this provision, compare HORST ROLLER, PROSPEKTHAFTUNG IM ENGLISCHEN UND DEUTSCHEN RECHT (1991), with HANNO MERKT, *Zur Entwicklung des Deutschen Börsenrechts von den Anfängen bis zum Zweiten Finanzmarktförderungsgesetz*, in BÖRSENREFORM—EINE ÖKONOMISCHE, RECHTSVERGLEICHENDE UND RECHTSPOLITISCHE UNTERSUCHUNG 15 (Klaus J. Hopt & Bernd Rudolph eds., 1997).

<sup>73</sup> See Table 2 *supra*, and accompanying text.

### 3.2.1. *Existence of the Corporation as an Independent Entity*

By the end of the 19th century, the founding shareholders had acquired control rights over the creation of a corporation subject to the mandatory provisions of the law. Another question is whether shareholders also hold the control rights over the continuing existence of the corporation as an independent entity, in particular over liquidation and mergers. With respect to liquidation, shareholders in all countries share control rights with creditors and, in most, also with the state.

All jurisdictions had established voting requirements for the voluntary dissolution of the corporation and replaced earlier provisions that required a unanimous vote for liquidation.<sup>74</sup> Germany, in particular, required supermajority votes. Apparently, the strong control rights these rules gave to minority shareholders were offset by the holdup problems they created. Some jurisdictions also gave creditors a say in liquidation. Moreover, as early as 1861, German law required that creditors were notified about the pending dissolution and were given twelve months to file their claims.<sup>75</sup> Prior to that date, assets could not be liquidated.<sup>76</sup>

In a merger, reorganization, or other form of corporate restructuring, one of the companies frequently ceases to exist as an independent entity. Unlike liquidation, post-merger the assets are still used as a going concern, but may become part of a different legal entity. This result has implications for the position of the shareholders of the formerly independent entity, which is why they are frequently given control rights over such transactions. Most of the early statutes did not address mergers explicitly. Technically, a merger could be consummated by dissolving the target company according to the general rules on dissolution. In France, a unanimous shareholder vote was required until the law was revised in 1913.<sup>77</sup> In Germany, simple majority sufficed under the 1861 law,

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<sup>74</sup> See Prussian AktG, *supra* note 23, § 28 (requiring state approval for the voluntary dissolution of the corporation). By contrast, the 1884 revision of the HGB required “only” a supermajority vote of the company’s shareholders. See AktG 1884, *supra* note 25, § 242. Article 46 of the French Code de Commerce of 1807 required unanimous shareholder vote. CODE DE COMMERCE, *supra* note 18, art. 46. The amended code of 1867 required only “shareholder vote.” See Law of July 24, *supra* note 48, art. 31.

<sup>75</sup> See Handelsgesetzbuch, *supra* note 24, § 245.

<sup>76</sup> *Id.*

<sup>77</sup> Prior to 1913, the French Code de Commerce did not address mergers. However, commentators suggested that a merger could be commenced by dis-

but government approval was required.<sup>78</sup> Later, majority requirements were raised to a qualified majority of three-quarters.

In England and the United States, the *ultra vires* doctrine stood in the way of merger transactions. Until 1898 when New Jersey changed its law, corporations in the United States could not acquire shares in other corporations, as this was deemed to be beyond the purpose of a typical manufacturing or trading corporation.<sup>79</sup> In 1899, Delaware followed the example New Jersey had set in 1898 and stipulated that corporations could acquire stock in other corporations registered in Delaware or elsewhere and exercise all rights shares conferred to their owners.<sup>80</sup> Delaware thus became a home for nationwide trusts and holding companies. Soon, they came under scrutiny of antitrust agencies, driving many firms into full vertical integration.<sup>81</sup> Delaware facilitated this development by lowering the threshold for asset mergers. Until 1929, all merger transactions required a qualified majority vote by shareholders.<sup>82</sup> Since then, a simple majority has been deemed sufficient for asset mergers, i.e., for the sale, lease, or other form of disposal of any or all of the corporation's assets.<sup>83</sup> In other words, control rights over corporate restructurings were shifted away

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solving the company, which required a unanimous shareholder vote. See CELLÉRIER LUCIEN, *ÉTUDE SUR LES SOCIÉTÉS ANONYMES EN FRANCE ET DANS LES PAYS VOISINS*, 1905 Paris: Sirey, NR 600 f. Article 31 of Law of July 24, *supra* note 48, was modified by Law of Nov. 22, 1913, changing this to allow a supermajority vote of three-quarters for a merger.

<sup>78</sup> This was true, however, to the extent that a merger was contemplated in the articles of incorporation. *Handelsgesetzbuch*, *supra* note 24, § 215. However, that merger was contemplated in the articles of incorporation.

<sup>79</sup> LARCOM, *supra* note 54.

<sup>80</sup> Section 23 of the 1883 Delaware corporate law stated that shares held in other corporations did not confer voting rights. *Private Corporations Act*, *supra* note 19, § 23. However, the same provision insisted that this did not give companies general permission to acquire shares in other corporation, as this had to be explicitly authorized. This provision was changed in the 1889 revision of the law. 21 Del. Laws, ch. 273, 444 (1899). From then on, any corporation created under the laws of the state of Delaware could purchase, hold, sell, assign, etc. shares of other corporations.

<sup>81</sup> This asset loophole was closed only by the Celler-Kefauver Act adopted in 1950. On the interpretation of antitrust law and their application to mergers, see HANS B. THORELLI, *THE FEDERAL ANTITRUST POLICY: ORIGINATION OF AN AMERICAN TRADITION* (Johns Hopkins Press 1955).

<sup>82</sup> Section 55 of the 1899 law required a qualified majority vote of two-thirds. 21 Del. Laws, ch. 273, 444 (1899). In the 1929 revision of the law, the threshold for approving changes in corporate capital or the transfer of major assets was lowered to a simple majority rule. See 36 Del. Laws 366, ch. 135, § 26 (1929).

<sup>83</sup> *Id.*

from minority shareholders, who could veto these transactions as long as supermajority requirements applied. While asset mergers still needed shareholder approval, management gained substantial discretion, especially in companies with dispersed shareholders.

The two continental jurisdictions also gave creditors control rights in merger transactions. France introduced consent requirements for merger transactions in 1935.<sup>84</sup> Germany required notification, but not consent in the corporate law.<sup>85</sup> The fact that English or U.S. law does not allocate similar control rights to creditors does not mean that they may not contract for such rights. The difference is that some countries *mandate* creditor consent and thus allocate control rights to creditors, while others leave it to the bargaining power of the parties.

### 3.2.2. Corporate Governance

The earlier corporate statutes did not pay much attention to the governance structure of firms. All laws initially stipulated that the company would be managed by directors, or by trustees who were shareholders of the firm. At the time these codes were drafted, this reflected existing business practice. Increasingly, management was professionalized and delegated to outsiders, resulting eventually in the separation of ownership and control.<sup>86</sup> In the corporate law of 1844, England did not have any provisions requiring that directors be shareholders of the firm.<sup>87</sup> Delaware required three founding shareholders in the 1883 law, but subsequently dropped this requirement.<sup>88</sup> This is somewhat surprising, as in the United States the emergence of professionally managed firms occurred much earlier than in England.<sup>89</sup> One would, therefore, have expected that Delaware preceded England in dropping this provision. The

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<sup>84</sup> D.P. 1935. 4. 221.

<sup>85</sup> *Handelsgesetzbuch*, *supra* note 24, § 242.

<sup>86</sup> ADOLF AUGUSTUS BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 112-40 (rev. ed. 1968).

<sup>87</sup> Compare Joint Stock Companies Act, *supra* note 20, with Manufacturing Incorporations Act, *supra* note 54, § 1 (requiring a minimum of five founding shareholders and stipulated that only directors could be shareholders of the firm).

<sup>88</sup> Compare Private Corporations Act, *supra* note 19, § 10, with 56 Del. Laws, ch. 50, § 101(a), 151 (1967) (“[A]ny person, . . . singly or jointly with others . . . may incorporate.”).

<sup>89</sup> ALFRED D. CHANDLER, JR., *SCALE AND SCOPE—THE DYNAMICS OF INDUSTRIAL CAPITALISM* 222 (1990); Leslie Hannah, *Visible and Invisible Hands in Great Britain*, in *MANAGERIAL HIERARCHIES* 41, 42 (Alfred D. Chandler & Herman Daems eds., 1980).



fact that this was not the case suggests that, in order to trigger a change, legal amendments may not be needed, at least not if formal requirements can be easily circumvented.<sup>90</sup>

The four jurisdictions differ considerably in the role the legislature assumes in prescribing the governance structure of the firm. The two extreme cases in the four-country sample are Delaware (United States) and Germany. Delaware law has left the design of the governance structure primarily to the founding shareholders or promoters of the corporation. Moreover, it relaxed the general assumption that only shareholders could decide the governance structure. The board of directors was empowered to set up board committees and to delegate management tasks to them. The law recognized that decisions taken by the committees had binding effect on the corporation. England introduced similar changes in 1862,<sup>91</sup> but neither France nor Germany allowed as much flexibility in its corporate laws. In fact, France clarified in the 1966 law that board committees had purely advisory functions, but could not take binding decisions for the corporation.

The 1899 Delaware law went even further and indicated that shareholders could delegate the right to change the bylaws (not the corporate charter) of the corporation to the board.<sup>92</sup> While shareholders could choose not to insert such a provision in the charter, the change in the law gave directors the bargaining power to negotiate a shift in control rights in their favor. Shareholders initially retained indirect control rights by controlling the composition of the board and by having the right to fire board members prior to the expiration of their terms.<sup>93</sup> In 1927, however, a provision was introduced that allowed the board to fill vacancies among its members.<sup>94</sup> Shareholders could challenge this filling by demanding an extraordinary shareholder meeting,<sup>95</sup> but the primary control right had shifted to the board itself. The 1967 Delaware law reemphasized this shift in control rights by allowing the directors who had been appointed by the board to serve not only until the next annual meeting, but in case of staggered boards, up to a

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<sup>90</sup> Obviously, it is easy to ensure that a candidate for the board acquires some shares just to ensure that he qualifies for elections.

<sup>91</sup> See Joint Stock Companies Act, *supra* note 20 (authorizing committees to bind corporations).

<sup>92</sup> 1899 Del. Laws ch. 21, § 26, 444.

<sup>93</sup> *Id.* §§ 20-21.

<sup>94</sup> 1927 Del. Laws ch. 35, § 30, 220 [hereinafter 1927 Del. Laws].

<sup>95</sup> *Id.*

maximum of three years.<sup>96</sup> Moreover, directors intending to resign in the future could participate in naming their successors. These provisions made it possible for directors to temporarily (not indefinitely) perpetuate their control over the corporation without much shareholder control.

In Germany, by contrast, the legislature mandated a governance structure with exceedingly rigid provisions. An 1861 law<sup>97</sup> established a simple one-tier board structure, with an optional two-tier structure;<sup>98</sup> by 1884 the two-tier structure had become mandatory.<sup>99</sup> The justification for this more elaborate governance structure was that the supervisory board was to replace the state as monitor of the corporation.<sup>100</sup> Its task was not to manage, but to supervise management. To underline this function, the 1884 law<sup>101</sup> specified that members of the supervisory board could not concurrently serve on the management board. The members of the supervisory board were elected by the shareholder meeting. Before 1937, members of the management board could be elected either by the meeting, or appointed by the supervisory board.<sup>102</sup> The latter became mandatory in 1937, creating a clear representative model.<sup>103</sup> Whereas in Delaware, board members serve only for one year,<sup>104</sup> in Germany, members of both boards serve for up to five years.<sup>105</sup> Members of the supervisory board can be recalled at any time by the shareholder meeting with a supermajority vote. How-

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<sup>96</sup> Staggered boards were allowed in 1883 with three classes of directors being elected at subsequent shareholder meetings. See Private Corporations Act, *supra* note 19. Directors could thus serve for up to three years.

<sup>97</sup> Handelsgesetzbuch, *supra* note 24.

<sup>98</sup> *Id.* § 225.

<sup>99</sup> AktG 1884, *supra* note 25, § 209.

<sup>100</sup> See Hommelhoff, *supra* note 52; Klaus J. Hopt, *Zur Funktion des Aufsichtsrats im Verhältnis von Industrie und Bankensystem*, in RECHT UND ENTWICKLUNG DER GROßUNTERNEHMEN IM NEUNZEHNTE UND FRÜHEN ZWANZIGSTEN JAHRHUNDER [LAW AND THE FORMATION OF THE BIG ENTERPRISES IN THE 19TH AND EARLY 20TH CENTURIES], *supra* note 22, at 227.

<sup>101</sup> See AktG 1884, *supra* note 25.

<sup>102</sup> *Id.* § 236.

<sup>103</sup> For a comparison of corporate governance with models of representative or direct democracy see Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

<sup>104</sup> Private Corporations Act, *supra* note 19.

<sup>105</sup> A provision stating a maximum five year terms was first introduced in the 1937 revision of the German corporate law. See Gesetz über Aktiengesellschaften und Kommanditgesellschaften auf Aktien (AktG), v. 30.1.1937 (RGBl. I S.29-165) § 23 (Third Reich) [hereinafter AktG 1937].

ever, since 1937, members of the management board can be removed only for cause. Formally, this makes it more difficult to remove directors.<sup>106</sup>

England and France fall somewhere between Delaware and Germany. In England, directors are regarded as trustees of the corporation who are elected by shareholders. Since 1862, the board may delegate tasks to committees, which may make binding decisions on behalf of the company.<sup>107</sup> Legal requirements for the dismissal of board members have been relaxed over time. Whereas the 1862 law stipulated that directors could be dismissed prior to the end of the term only, if provision for this had been made in the charter, an amendment of 1908<sup>108</sup> established that shareholders could dismiss directors at any time with an ordinary resolution, i.e., by simple majority vote. Unlike Delaware, however, the law made no attempt to strengthen the position of other board members in replacing vacancies. Control rights over these issues were left with shareholders.

France did not regulate the board structure in detail in 1807, but left this to the articles of incorporation. In practice, articles typically provided for the appointment of an executive officer in charge of day-to-day management.<sup>109</sup> This feature was recognized in the 1867 code.<sup>110</sup> The board is also responsible for dismissing the head of the administration. In 1966, the law was amended to in-

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<sup>106</sup> German law also regulates the number of members serving on the supervisory board. In 1937, when this was first done, the number was linked to the amount of statutory capital of the firm. In addition, legislation on co-determination, introduced in 1976, regulated the composition of the supervisory board, and linked the number of board members to the number of employees of the company. Companies with more than 2000 employees were mandated to have fifty percent employee representatives on the supervisory board. The chairman of the board, who is elected by the shareholder representatives, has two votes in case of a tie. For details on co-determination and its historical evolution in Germany, see Katharina Pistor, *Codetermination in Germany: A Socio-Political Model with Governance Externalities*, in *EMPLOYEES AND CORPORATE GOVERNANCE* 163, 163 (Margaret M. Blair & Mark J. Roe eds., 1999) (contrasting "social governance" and "firm-level governance").

<sup>107</sup> Companies Act 1862, *supra* note 33, § 66.

<sup>108</sup> Consolidation Act, *supra* note 33.

<sup>109</sup> See LEOPOLD MALEPEYRE & CHARLES F. JOURDAIN, *TRAITÉ DES SOCIÉTÉ COMMERCIALES* 247-49, 253-56 (1835). See also *id.* at 476 (discussing the deed of incorporation of the Railway Company between Paris and Orleans).

<sup>110</sup> See Law of July 24, *supra* note 48, art. 22 (amending the CODE DE COMMERCE).

clude an option for a two-tier management structure along the lines of the German model.<sup>111</sup>

In England and the United States, the delineation of responsibilities of shareholders and managers has been left largely to the corporate charter (articles of incorporation), i.e., in theory to the founding shareholders, but in practice to the promoters of companies. Directors overstepping the established boundaries were acting *ultra vires*. Transactions *ultra vires* were null and void and directors could be held personally responsible. The success of the *ultra vires* doctrine as an instrument to control management has had mixed results.<sup>112</sup> In Delaware, courts soon accepted very broad definitions of the corporation's powers, which effectively undermined the doctrine's effect. In England, the *ultra vires* doctrine still applies in principle.<sup>113</sup> However, the doctrine's effect has been mitigated by provisions in the 1948 law allowing a much broader definition of the purpose of the corporation.<sup>114</sup> An EC directive introduced in England, after it joined the European Communities, which eliminated the third party effect (voidance of any transactions) further mitigates the doctrine.<sup>115</sup> Under German law, a corporation is also required to state its purpose in the charter.<sup>116</sup> But overstepping these boundaries or any other restrictions shareholders may place on directors has no effect *vis-à-vis* third parties. Legal certainty was deemed more important than sanctioning *ultra vires* transactions.

In contrast to the Anglo-American jurisdictions, both France and Germany created a mandatory governance structure with a clearly defined division of power between shareholders and directors. The corporate laws of these countries enumerate exclusive rights of the shareholder meeting, which cannot be delegated to or appropriated by the board. Powers not included in this list are assumed to be within the realm of the board's power. The flip side of

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<sup>111</sup> Art. 118 Law No. 66-537 of July 24, 1966 (revising the CODE DE COMMERCE), J.O. 26 Juill., p. 6402 (1); BLD 1966, 353-404) (Fr.) [hereinafter Law of July 24, II].

<sup>112</sup> See Charles Carpenter, *Should the Doctrine of Ultra vires be Abolished?*, 33 YALE L.J. 49 (1923) (discussing the costs and benefits of the *ultra vires* doctrine).

<sup>113</sup> DAVIES, *supra* note 28, at 201, 211. See also Companies Act 1862, *supra* note 33, art. 12 (incorporating and discussing the *ultra vires* doctrine).

<sup>114</sup> Companies Act 1948, *supra* note 33.

<sup>115</sup> Most of the changes incorporating European harmonization directives, including this one, were included in the 1980 revision of the Companies Act. See Companies Act 1980, *supra* note 33.

<sup>116</sup> See Handelsgesetzbuch, *supra* note 24, § 209.

the assumption is that shareholders are explicitly denied the right to participate in management decisions unless the board decides to seek shareholder approval on these issues.

The effectiveness of rights allocated to shareholders is related to voting rules. The one-share-one-vote rule was a contentious issue in the 19th century.<sup>117</sup> Per capita voting was common practice in many countries and was widely perceived to be more democratic.<sup>118</sup> In fact, early French commentators found it necessary to justify that corporate practice using the one-share-one-vote rule did not violate public policy.<sup>119</sup> The 1867 French law<sup>120</sup> stipulates the one-share-one-vote rule as a default rule, but at the same time established a voting ceiling of ten shares per person.<sup>121</sup> Similar concerns in England led to the adoption of a regressive voting system. For the first ten shares, shareholders were given one vote per share. An additional vote was given for every five shares thereafter, up to one hundred shares. After the first one-hundred shares, shareholders received only one vote for every ten shares.<sup>122</sup> To this day, voting by showing hands, i.e., voting per capita rather than per share, is still recognized as common business practice,<sup>123</sup> although a poll can be called in controversial matters.

Of the four countries discussed, France was the only nation to allow corporate charters to exclude shareholders with only a few shares from participating in shareholder meetings and from voting. It also included provisions for multiple voting rights, although af-

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<sup>117</sup> For the history of voting rights in the United States and Europe in the 19th century, see Colleen A. Dunlavy, *Corporate Governance in the Late 19th Century Europe and USA – The Case of Shareholder Voting Rights*, in *COMPARATIVE CORPORATE GOVERNANCE* 5 (Klaus J. Hopt et al. eds., 1998). For France, see MALEPEYRE & JOURDAIN, *supra* note 109, at 220-22.

<sup>118</sup> See Dunlavy, *supra* note 117 (discussing voting rights and trends).

<sup>119</sup> See MALEPEYRE & JOURDAIN, *supra* note 117 (discussing the history of voting rights in France).

<sup>120</sup> Law of July 24, *supra* note 48.

<sup>121</sup> See *id.*, art. 174 (equal distribution of voting rights) and art. 27, para. 1 (allowing the articles of incorporation to restrict the right to participate at shareholder meetings to shareholders holding at least a certain number of shares).

<sup>122</sup> Similar voting systems existed in France. The charter of the Société Anonyme Chemin de Fer d'Orléans founded prior to 1833, for example, provides that for five shares, there is one vote; for ten, two; for twenty, three; and for forty, five. No shareholder has more than five votes, even if his holdings exceed forty shares.

<sup>123</sup> See DAVIES, *supra* note 28, at 589 (stating that “unless the company’s regulations otherwise provide, voting is in the first instance by show of hands, i.e., those present indicate their views by raising their hands”).

ter 1930, double voting rights may be exercised only if the shares had been registered for at least two years. Germany allowed voting ceilings in the 1884 law<sup>124</sup> and also recognized multiple voting rights until 1937, when the latter were declared void.<sup>125</sup> As of 1998, voting ceilings are also prohibited for companies that are listed on the stock exchange.<sup>126</sup> In the United States, the movement towards the one-share-one-vote rule as the default rule occurred earlier than in other countries, but even there, this rule was never made mandatory in corporate law.<sup>127</sup> Strong encouragement for the one-share-one-vote rule came, however, from the New York Stock Exchange after 1926, although more recently the rule has been questioned in light of severe competition from Nasdaq, which does not impose this rule.

Cumulative voting has been advocated as a means to strengthen minority shareholder rights. In fact, the Russian corporate law now makes it mandatory for companies with more than one thousand shareholders.<sup>128</sup> Cumulative voting is also one of the indicators used to assess the scope of minority shareholder protection in the Rafael LaPorta, Florencio Lopez-de Silanes, Andrei Shleifer, Robert Vishney ("LLSV") studies. The only jurisdiction in our sample to introduce cumulative voting rules was Delaware, where they became optional in 1917.<sup>129</sup> On its face, cumulative voting increases the likelihood that small shareholders can elect their representatives to the board, because it allows them to bundle their votes and place them all behind one candidate. Historically and practically, cumulative voting has been more ambivalent, as it allows current directors who are either shareholders themselves, or

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<sup>124</sup> AktG 1884, *supra* note 25, § 222.

<sup>125</sup> AktG 1937, *supra* note 105, § 12.

<sup>126</sup> § 134 AktG as amended by Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.4.1998 (BGBl. I S. 786-94) (F.R.G.) [hereinafter KonTraG 1998].

<sup>127</sup> Note, however, that companies listed on the New York Stock Exchange (NYSE) had to comply with this rule.

<sup>128</sup> Art. 66 § 4, Russian Law on Joint Stock Companies, adopted by the Russian State Duma on Nov. 24, 1995; Ross. Gazetta, Dec. 29, 1995 (Russ.). The law entered into effect on Jan. 1, 1996. *See id.* art. 94.

<sup>129</sup> For the history of cumulative voting rules see Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 142-60 (1994). His detailed analysis of the introduction of cumulative voting in two waves (at the turn of the century, and again after World War II), and their reversal (in the mid-1950s many states that had made cumulative voting mandatory first, relaxed this to opt-in provisions), documents that legal change is often not a one-way road, but quite a dynamic process.

hold proxy rights of smaller shareholders, to ensure that their interests influence the outcome of board elections.<sup>130</sup>

### 3.2.3. *Corporate Finance*

Corporate finance is the area of greatest divergence among the four jurisdictions and also the area where we observe the most substantial change over time. All countries studied initially left most decisions over corporate capital, including changes in corporate capital, pricing and placement of shares in the hands of shareholders. Some decisions, in particular the repurchase of shares and—at least in some countries—the decrease in corporate capital, were removed from shareholder control. They were either flatly prohibited or required state approval. In Delaware, in particular, these restrictions gave way in the early 20th century to a very flexible regime in which shareholders can delegate many rights to management.<sup>131</sup> Germany, by contrast, has upheld most restrictions and has begun to relax some of them only over the last couple of years.

Corporate capital was—and often still is—regarded as a trust fund to protect creditors. In the United States, the trust fund theory was first formulated in *Wood v. Dummer* in 1824,<sup>132</sup> which depicted corporate capital as the price shareholders have to pay for the privilege of obtaining limited liability.<sup>133</sup> The doctrine worked in practice as long as contributions were in cash rather than in-kind. Once in-kind contributions became acceptable, this opened the door for watering stock, as the actual value of these contributions could differ substantially from the value of stock given out in return.<sup>134</sup> The key question was whether, in the case of insolvency, the contribution could be re-assessed and shareholders could be held liable for additional contributions. Since shares were trans-

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<sup>130</sup> *Id.*

<sup>131</sup> LARCOM, *supra* note 54.

<sup>132</sup> *Wood v. Dummer*, 30 F. Cas. 435. (C.C. Me. 1824) (No. 17,944).

<sup>133</sup> Justice Story, in *Wood v. Dummer*, stated: “the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. . . . The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal responsibility, and *substitutes* the capital stock in its stead.” (emphasis added). *Id.* at 436. Note that although the case involved a bank, the doctrine applied to corporations more generally. For an account of similar views in German doctrine, see ERNST-JOACHIM MESTMÄCKER, VERWALTUNG, KONZERNGEWALT UND RECHTE DER AKTIONÄRE 227 (1958).

<sup>134</sup> LARCOM, *supra* note 54.

ferable this raised the question of whether the original or also subsequent shareholders could also be held liable.

Two responses can be observed to this problem. One was to shield shareholders from the risk of reappraisal. Several states included provisions that assured shareholders that the valuation of their contributions was final, and thus could not be challenged by creditors in the future. This was accomplished by making the directors' assessment conclusive, which was done in Delaware in 1899.<sup>135</sup> Another response was to require a third party appraisal at the time the contribution was made. France required an independent appraisal of in kind contributions in 1867.<sup>136</sup> Germany left the evaluation to shareholders but required that the charter explicitly state the number of shares issued in return for the contribution.<sup>137</sup> In 1978, Germany followed the French model, which had become the EU model, and required independent appraisal for in-kind contributions. In England, explicit provisions on the valuation of in-kind contributions did not exist before 1980, when independent appraisal became the norm following EU directives.

The next logical step in shifting control rights over issues of corporate finance from the state/legislature to shareholders, and ultimately management, was to drop the legal requirement that only shares with specified par value could be issued. Delaware was among the first states in the United States to allow the issuance of non par value stock in 1917.<sup>138</sup> Even before this change, the nominal value itself was established in the charter rather than being mandated by law. The only mandatory requirement was that at least U.S. \$1000 of the capital had to be paid in before a company could commence operation.<sup>139</sup> Germany, by contrast, mandated a minimum par value of shares of R.M. 1000 in 1884.<sup>140</sup> This was a major increase after the 1870 law and it demonstrates the legislature's belief that it had to prevent small investors from investing in

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<sup>135</sup> According to the Act of Mar. 10, 1899, *supra* note 92, § 137, the valuation of in-kind contributions by directors was deemed conclusive.

<sup>136</sup> Law of July 24, *supra* note 48, art. 4.

<sup>137</sup> See AktG 1870, *supra* note 67, § 209b.

<sup>138</sup> Act of Mar. 20, 1917, ch. 113, § 4(a) 29 Del. Laws 320 (1917). For a comparison with legal developments in other states at the time, see LARCOM, *supra* note 54.

<sup>139</sup> Under the 1917 law, this provision applied only to companies that issued shares at par value. However, the 1927 law clarified that for stock that issued without par value, the board of directors had to determine the minimum amount that had to be paid in. Act of Mar. 2, 1927, *supra* note 94.

<sup>140</sup> AktG 1884, *supra* note 25, § 207.



stock. In 1937, Germany introduced minimum capital requirements of RM 500,000, and DM 100,000 in 1965.<sup>141</sup> Minimum capital requirements were introduced in France in 1966 and extended to the United Kingdom after it joined the European Union in 1980.

The contrast between the flexibility of the Delaware law and the rigidity imposed by most other corporate laws, especially by the German law, is most pronounced in the allocation of control rights over decisions concerning the use of financial instruments for structuring control transactions, including authorized stock, preemptive rights, and the repurchase of shares. Authorized but unissued stock places the decision of timing of a stock placement in the hands of directors.<sup>142</sup> Preemptive rights give current shareholders a priority right to acquire newly issued stock in proportion to their current stake in the company.<sup>143</sup> Any relaxation of preemptive rights shifts the right over placing this stock with outside shareholders to the board of directors or to management, respectively. Similarly, the prohibition of share repurchase by the corporation limits the board's ability to use repurchase as a defense strategy, but it also prevents the board from offering repurchase as a substitute for dividend payments.

Delaware had shifted control rights over these issues from shareholders to directors by 1930.<sup>144</sup> In Germany, they remain

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<sup>141</sup> This reflected the basic concept that the legal form of the publicly traded joint stock company should be reserved for large corporate undertakings. For smaller companies, a special law on limited liability companies was introduced in 1892. Capital requirements are still only half of that required for the large corporation, but stakes in the limited liability company cannot be publicly traded. Recognizing the increasing importance of tradability of shares for small and medium size companies, an amendment to the law on joint stock companies introduced in 1994 relaxed some of the existing entry barriers. The minimum capital requirement, however, was left unchanged. It is not clear that this does impose a major entry barrier. Its significance lies more in the fact that the legislature still regards this as an important device for protecting creditors and for regulating the market for publicly traded, as opposed to closely held, corporations. However, the EU is now contemplating dropping these provisions in an attempt to streamline its corporate law harmonization requirements. See EDDY WYMEERSCH, *COMPANY LAW IN EUROPE AND EUROPEAN COMPANY LAW* 29 (Fin. L. Inst. Working Paper Series, 2001) [hereinafter WYMEERSCH, *COMPANY LAW*].

<sup>142</sup> MELVIN ARON EISENBERG, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS* 70 (8th ed. 2000) (stating that in the case of authorized stock "the power to *issue* authorized stock, and the price at which the stock will be issued, is in the hands of the board, subject only to certain very limited constraints").

<sup>143</sup> *Id.* (explaining that while at common law, shareholders had a preemptive right, this right was soon "riddled with exceptions").

<sup>144</sup> See 1927 Del. Laws, *supra* note 94, § 10 (providing that the articles of incorporation may deny preemptive rights). The concept of authorized stock was

firmly vested in the hands of shareholders, reducing the ability of firms to flexibly respond to new business opportunities. Although it became possible in Germany for shareholders to authorize unissued stock in 1937,<sup>145</sup> a number of strings were attached. The board could dispose of the issued stock only for a period of five years. Stock had to be authorized at least at the minimum nominal value required by law and could not be sold for less than par. Should a change become necessary, another decision by a shareholder meeting was required. Since 1897, the German law guarantees shareholders a preemptive right.<sup>146</sup> Although this right can be waived by a three-quarters majority vote, it proved to be difficult to combine the authorization of unissued stock with a waiver of preemptive rights. This resulted less from the wording of the law, than from case law. The German Supreme Court (BGH) ruled in 1978 that preemptive rights could be waived only if shareholders were compensated for relinquishing these rights.<sup>147</sup> This required that the transaction over the newly issued shares was sufficiently specified to assess its benefits and compare them with the benefits of preemptive rights which shareholders were asked to relinquish. This caused difficulties in cases where new stock was to be authorized, but the right to place this stock left with management, because the return for shareholders could not be specified at the time the stock was issued.

After having confirmed these criteria in several decisions,<sup>148</sup> first signs that the court might change its opinion appeared in 1994 in a case involving a major bank (Deutsche Bank).<sup>149</sup> In this decision, the court held that the plan to place stock on a foreign stock exchange (Tokyo) was sufficiently specified to justify a waiver of preemptive rights. Moreover, an amendment of the corporate law

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explicitly recognized in the 1929 law, *supra* note 82. See discussion *supra* Section 3.2.3. (discussing minimum capital requirements, which never existed under Delaware law, and par value).

<sup>145</sup> See AktG 1937, *supra* note 105, § 169 (giving shareholders the power to authorize unissued stock).

<sup>146</sup> See AktG 1884, *supra* note 25, § 282. Since 1937, preemptive rights may be waived by a three-quarters majority vote. See AktG 1937, *supra* note 105, § 153 (codifying this provision).

<sup>147</sup> BGH Frankfurt, Neve Juristische Wochenschrift [NJW], 27 (1978), 1316 (F.R.G.).

<sup>148</sup> See in particular the Holzmann decision, BGH Frankfurt, Neve Juristische Wochenschrift [NJW], 43 (1982), 2444 (F.R.G.).

<sup>149</sup> BGH Frankfurt, Neve Juristische Wochenschrift [NJW], 21 (1994), 1410 (F.R.G.).

introduced in the same year<sup>150</sup> signaled that lower demands should be placed on the authorization of stock, as long as it amounted to less than ten percent of total capital. In 1997, the court finally put aside the specification requirement and accepted a waiver of preemptive rights with the general justification that the shares could be used for future control transactions.<sup>151</sup>

The Deutsche Bank decision came seventy years after Delaware enacted an amendment giving shareholders the right to restrict preemptive rights in the charter. As of 1967, corporate charters must explicitly stipulate preemptive rights for them to be applicable at all.<sup>152</sup> This is a 180-degree change from the early 19th century, when courts ruled that preemptive rights were a core right of shareholders that could not be taken away from them.<sup>153</sup> Common law, however, cannot be held responsible for this opinion, as preemptive rights were not included in the English companies' act prior to England joining the European Community ("E.C.").<sup>154</sup> Preemptive rights were included only after the United Kingdom joined the EU and was required to harmonize its law with the EU directives on corporate law.<sup>155</sup> France allowed preemptive rights to be waived by simple majority vote already in 1935 (i.e., shortly after Delaware).<sup>156</sup>

The ability of shareholders to ensure that their stake is not diluted by the issuance of shares to outsiders seems to follow directly from shareholders holding the residual rights of control. Preemptive rights were also used by LLSV as one of the indicators for minority shareholder protection. Why then has this right been dismantled over time? The reason can be found in the benefits arising from placing newly-issued shares to the highest bidder rather than to existing shareholders. When markets are working effectively and shares are placed on the open market, shareholders gain little

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<sup>150</sup> Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts (KI AktG), v. 2.8.1994 (BGBl. IS. 1961) (F.R.G.).

<sup>151</sup> BGH Frankfurt, *Neve Juristische Wochenschrift* [NJW], 42 (1997), 2815 (F.R.G.).

<sup>152</sup> 56 Del Laws, c. 50, § 102(b)(3), 151 (1967).

<sup>153</sup> LARCOM, *supra* note 54.

<sup>154</sup> *See supra* Table 2.

<sup>155</sup> Companies Act 1980, *supra* note 33.

<sup>156</sup> A special decree enacted in August of 1935 allowed preemptive rights to be waived upon request by the board of directors. This provision was later incorporated as art. 186 in the Code de Commerce. *See* Law of July 24, II, *supra* note 111.

from preemptive rights. They can buy shares at market value and thus ensure that their stakes are not diluted. When markets do not work well and/or shares are placed with targeted investors rather than on the open market, the position of shareholders is potentially at greater risk. However, even then placing shares with outsiders may benefit existing shareholders not the least because it opens new sources of funds.

Another example of the flexibility/rigidity continuum across jurisdictions in matters relating to corporate finance is the repurchase of a company's own shares. Obviously, this may open the door for misuse, as directors may be tempted to manipulate share prices or use repurchase as a defense strategy against hostile takeovers. With the exception of Delaware, all countries prohibited the purchase of a company's own shares by the corporation in early statutes. Initially, Delaware law did not explicitly allow the repurchase, but a provision in the 1899 law, that stated that the corporation could not vote its own stock<sup>157</sup> implied at least that the corporation could hold its own stock. By 1931, it was clearly established that the corporation could buy its own stock at any time and that directors were the ones in charge of this transaction.<sup>158</sup> In other countries, exceptions were allowed only for repurchases as a means to reduce corporate capital, which had to follow other procedures established by law, including shareholder supermajority vote. England allowed the issuance of redeemable stock in 1929.<sup>159</sup> In 1948, it also relaxed some of the restrictions on repurchasing common stock.<sup>160</sup> In response to the economic recession in Germany in the early 1930s, two emergency regulations relaxed the prohibition and permitted share repurchase, if this was done to avoid major damages for the corporation.<sup>161</sup> The 1937 law enumerated exemptions from the general prohibition of repurchase, provided that not more than ten percent of total stock was acquired.<sup>162</sup>

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<sup>157</sup> 1899 Del. Laws, *supra* note 92, § 24.

<sup>158</sup> It was now possible for the corporation to redeem its own stock by resolution of the board of directors. See Act of Apr. 9, 1931, ch. 129, 37 Del. Laws 464 (1931).

<sup>159</sup> Companies Act 1929, *supra* note 33.

<sup>160</sup> Companies Act 1948, *supra* note 33.

<sup>161</sup> Verordnung des Reichspräsidenten über Aktienrecht, Bankenaufsicht und über eine Steueramnestie (VO Aktienrecht), v. 21.9.1931 (RGBl. I S. 142) (Weimar Republic); Dritte Verordnung des Reichspräsidenten zur Sicherung von Wirtschaft und Finanzen und zur Bekämpfung politischer Ausschreitungen (VO Wirtschaftssicherung), v. 6.10.1931 (RGBl. I S. 537) (Weimar Republic).

<sup>162</sup> AktG 1937, *supra* note 105, § 65.

The list of exemptions was expanded in 1965 and again in 1998.<sup>163</sup> This last amendment reflects the continued reservation of the legislature with respect to the repurchase of shares by stating that in no case is trading in company shares sufficient to justify share repurchases.

### 3.2.4. *Allocation of Control Rights in Four Origin Countries*

The four origin countries have pursued different strategies in allocating control rights over key decisions as the previous discussion reveals. France and Germany exhibit stronger legal prescriptions than England or Delaware. Only over the past decade have laws become more flexible, but even then only for particular target companies, such as “small corporations.” The general philosophy of corporate law in these countries—as well as in Europe—is that a mandatory protective law is needed. In the past, the emphasis has been on creditor rights, and—certainly in Germany—on labor. More recently, the emphasis has been on minority shareholder rights. But the prevailing approach has been that the law mandates the allocation of rights and does not allow for a reallocation of these rights by the shareholders of the firm.

In England, control rights are vested primarily with shareholders. This has changed only recently and primarily as a result of EU legislation,<sup>164</sup> which emphasized creditor protection.<sup>165</sup> Delaware differs from the other three jurisdictions in the extent to which directors are vested with primary control rights over key decisions. While in the initial law this has affected primarily the governance structure of firms (directors were empowered to change bylaws), subsequently it was extended to other key areas including merger transactions and corporate finance. In the following Section, we explore the implications of the different allocation of control rights for the development of corporate law.

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<sup>163</sup> KonTraG 1998, *supra* note 126, § 71.

<sup>164</sup> For a summary of the contents and scope of EU harmonization directives, see WYMEERSCH, *COMPANY LAW*, *supra* note 141. For the impact of these harmonization directives on developments of English company law, see DAVIES, *supra* note 28.

<sup>165</sup> England has been able to fend off the intrusion of labor protection into the EU and thus into English law. See Bridget Montgomery, *The European Community's Draft Fifth Directive: British Resistance and Community Procedures*, 10 *COMP. LAB. L.J.* 429 (1989) (justifying skepticism that worker participation will be harmonized in the EC in the near future by exploring British labor realtions).

#### 4. FLEXIBILITY, LEGAL VOID, AND COMPLEMENTARY CONTROL DEVICES

The allocation of control rights has implications for the responsiveness of the corporation to a changing environment and for its ability to innovate and adapt in a competitive environment. If shareholders were to exercise all key control rights unanimously, the responsiveness of the corporation would be seriously impeded. The separation of ownership and control is a response to the problem of effective management when a firm has taken on multiple owners in order to satisfy its capital needs.<sup>166</sup> Once that separation had taken place, the question arose, how much power should be *legally vested* with management, and how much power shareholders as well as other shareholders should retain. As we have seen in the previous Section, different countries have taken different approaches to solve this issue.

A related question is: Who should make this allocation, lawmakers or shareholders? By and large, civil law countries have taken the approach that the legislature should make the allocation, leaving little room for shareholder to reallocate rights the legislature had vested with them. By contrast, in common law countries, the statutory law has been less rigorous, leaving substantial room for the reallocation of rights. The more flexible approach of the common law has opened the possibility for substantially more experimentation. The key elements of the traditional corporate finance doctrine had all fallen in Delaware by the late 1920s.<sup>167</sup> In England, several of these rights never existed (preemptive rights) and others were liberalized even earlier (i.e., authorized stock could be issued since 1862).<sup>168</sup>

A more flexible corporate law enhances the responsiveness of firms to changing market conditions. Proponents of the contrac-

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<sup>166</sup> BERLE & MEANS, *supra* note 86, at 66 (distinguishing degrees of control from almost complete ownership, majority control, and the absence of majority control in firms with highly dispersed ownership). Their primary concern was that the separation of ownership and control had gone too far in the United States. "If the separation of ownership and control had progressed no further than this, the problems resulting from it would not have assumed major proportions." *Id.* at 68. The absence of majority owners, however, left management in control. In fact, the authors define management as "that body of men who, in law, have formally assumed the duties of exercising domination over the corporate business and assets." *Id.* at 196.

<sup>167</sup> See discussion, *supra* Section 4.3 (tracing the history of corporate finance doctrine in Delaware).

<sup>168</sup> *Id.*

tual theory of the corporation have long hailed the superiority of a corporate law that allows companies to opt out of the corporate law and design their own charter on a contractual basis.<sup>169</sup> Opponents have warned that this may be to the detriment of shareholder rights.<sup>170</sup> Our analysis suggests that both sides have a point. Greater flexibility has by and large led to a shift of control rights from shareholders to directors and not the other way around. The gain was greater flexibility, which enabled the corporation to react quickly to a changing environment and to implement strategic moves without going through cumbersome procedures to ensure shareholder rights.

The puzzle is why the greater flexibility of corporate law with the extended control rights it leaves with management has not led to a complete expropriation of shareholders, but has actually enhanced shareholder value.<sup>171</sup> The answer seems to lie in the control devices that have emerged to fill the control void that resulted from the reallocation of control rights. In the following Section we will discuss three control devices that filled the control vacuum resulting from a more flexible law: exit rights, judicial recourse, and securities market regulation and supervision. Table 5 summarizes the relationship between flexible control rights and complementary control devices.

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<sup>169</sup> See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) (arguing such opting out is more efficient); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 86-117 (1993) (addressing costs and benefits of mandatory corporate laws); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989) [hereinafter Romano, *Wrong Question*] (questioning several justifications for mandatory corporate laws).

<sup>170</sup> See Bebchuk, *supra* note 38 (analyzing how unrestrained company choice of corporate law rules harms shareholders).

<sup>171</sup> See Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001) (presenting evidence that greater flexibility has enhanced shareholder value).

Table 5: Allocation of Control Rights and Complementary Control Devices

	Rigid Law	Flexible Law	Complementary Controls
Existence as Independent Entity	Unanimous vote/supermajority for mergers	Simple majority for mergers	Exit rights Judicial Recourse
Corporate Governance	Two-tier board structure Incompatibility of dual seats Delineation of shareholder and manager rights	Charter determines structure and rights Directors may change bylaws and delegate management functions	Judicial Recourse
Corporate Finance	Minimum capital requirements Par value of shares Restrictions on repurchase Strict preemptive rights	Directors determine timing and placement of stock - authorized stock - (no) preemptive rights	Securities Regulation

#### 4.1. Exit Rights

One way to compensate shareholders for less extensive control rights is to strengthen their exit rights. There has been much discussion in the comparative corporate governance literature about the costs and benefits of the two mechanisms of control, voice and exit.<sup>172</sup> Voice refers to the control rights, discussed above, the most important among them being voting rights on key decisions. Exit refers to the right of shareholders to leave the corporation at any time by selling their shares. Even where an unrestricted exit option exists, it might be worth little when the share value declines prior to exit as a result of a decision taken by the board or at the shareholder meeting. Recognizing the adverse effect these decisions might have, particularly on the value of minority stock, minority shareholders were protected either by mandatory takeover rules (England) or by giving dissenting shareholders the right to demand the repurchase of their shares at a fair price if they dis-

<sup>172</sup> This terminology was introduced by Hirschman. See ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES*, (1970). Representative of the extensive literature on this matter are Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, in 3 *THE NEW PALGRAVE DICTIONARY ECON. & L.* 459 (Peter Newman ed., 1998); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 *COLUM. L. REV.* 1277 (1991).



sented from key decisions that could affect their rights.<sup>173</sup> Delaware introduced such a rule for merger transactions in 1899.<sup>174</sup> Unlike other states in the United States, it never extended appraisal rights beyond merger transactions.<sup>175</sup>

The appraisal right as it has developed in the United States should be distinguished from the mandatory appraisal of merger transactions under EU and the corresponding national laws of Germany, France, and England. In the latter case, any merger transaction triggers a mandatory appraisal and minority shareholders are bound by the outsider appraisers' assessment. A mandatory takeover rule requires a bidder who acquires a stake exceeding a certain minimum to extend his offer to all remaining shareholders. Within Europe, England led the development of mandatory takeover law with its voluntary take over code that dates back to the 1950s. The EU has long intended to adopt a takeover directive very much in line with the English model, but so far without success.<sup>176</sup> Germany has meanwhile adopted its own takeover law, which modifies the strict neutrality rule for the board and gives management greater leeway to engage in defensive action. It is noteworthy, however, that neither Germany nor France had any comparable *ex ante* exit protection in the case of a merger or takeover. Instead, Germany purported to protect minority shareholders in company groups *ex post*, i.e., after the merger or acquisition had already taken place, and provided that the ac-

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<sup>173</sup> For an overview of the history of appraisal rights in the United States, see Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79 (1995).

<sup>174</sup> Section 54 of the Delaware Corporate law stated that upon a board resolution and approval by a two-thirds shareholder vote, two or more companies could be consolidated and that a new entity could be created by one acquiring the shares of another. See Act of Mar. 10, 1899, *supra* note 92.

<sup>175</sup> For evidence on how divergent corporate statutes in the United States are to this day on this issue, see Siegel, *supra* note 173, at 90-95. She notes that there is probably no area in corporate law where states diverge as much from each other, from the American Law Institute's Principles of Corporate Governance, or from the Model Business Corporation Act, as in the use of this remedy. *Id.* at 124-29.

<sup>176</sup> The Thirteenth Directive was ultimately rejected by Germany, where companies increasingly opposed the strict neutrality rule included in the directive. For a discussion of the pros and cons of the neutrality rule in the context of European governance systems see Christian Kirchner & Richard W. Painter, *European Takeover Law – Towards a European Modified Business Judgment Rule for Takeover Law*, 1 EUR. BUS. ORG. L. REV. 353 (2000); Peter O. Mülbert & Max Birke, *In Defense of Passivity – On the Proper Role of a Target's Management in Response to a Hostile Tender Offer*, 1 EUR. BUS. ORG. L. REV. 445 (2000).

quired company remained a legally independent company.<sup>177</sup> German scholars insisted that this ex post protection was equivalent to the ex ante protection demanded by the Thirteenth Council Directive on takeovers.<sup>178</sup> The Directive has not been implemented so far.<sup>179</sup>

#### 4.2. *Judicial Recourse*

In common law countries, shareholders have always had access to judicial recourse to defend their rights. Corporate law grew out of partnership and trust law, which had in fact developed through case law. Civil law countries, by contrast, had the choice to create procedures that would either facilitate litigation, or make it more difficult. They opted for the latter, although France in fact included derivative actions in the corporate law in 1966.<sup>180</sup>

The function of litigation is to resolve disputes over the allocation of rights between shareholders and directors and/or management. Where shareholders design their own governance structure and shift control rights during the lifetime of the corporation, the need for this control device is readily apparent. What is less clear is how the dispute can be resolved in light of the fact that the law itself offers little guidance as to how control rights should be allocated. The existence of legal principles that deal with shared or overlapping control rights outside the corporate law, in particular the common law principles of fiduciary duty, has proved important for courts in common law jurisdictions. An important procedural device to enhance judicial recourse was to give shareholders the right to sue on behalf of the corporation (derivative action). Judicial recourse seriously restricted the scope of managerial power under Delaware law. As early as 1913, the Delaware Chancery Court stated that a court would not be bound by formalities or the letter of the law when scrutinizing fraudulent action by corpo-

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<sup>177</sup> In Germany, company groups proliferated particularly in the 1920s. For a detailed account of this development in comparison with the evolving industry structure in the United States, see GERALD SPINDLER, *RECHT UND KONZERN—INTERDEPENDENZEN DER RECHTS—UND UNTERNEHMENSENTWICKLUNG IN DEUTSCHLAND UND DEN USA* (1993).

<sup>178</sup> Peter Hommelhoff, *Konzerneingangsschutz durch Takeover-Recht?*, in *FESTSCHRIFT FÜR SEMLER* 455 (Bierich et al. eds., 1993).

<sup>179</sup> The Directive failed in the summer of 2001 amidst concerns of German companies that the strict neutrality rule propagated by the Directive would disadvantage German companies and make them easy takeover targets.

<sup>180</sup> Law of July 24, II, *supra* note 111, art. 244.

rate managers.<sup>181</sup> By 1939, it was firmly established that directors were subject to principles of fiduciary duty.<sup>182</sup> The increasing flexibility in the statutory corporate law was thus paralleled by a strengthening of judicial oversight. As Professor Coffee put it, the fiduciary duty is “corporate law’s most mandatory core.”<sup>183</sup>

Interestingly, English law has been much more restrictive in allowing shareholders to bring suit on behalf of the company. In principle, it was held that the shareholder meeting rather than individual shareholders should have the right to sue on behalf of the company. Case law has over time relaxed these provisions, leading in substance, and since 1975, in words, to the acceptance of derivative actions, albeit on a much more limited basis than in the United States. Importantly, only since 1975 could shareholders be indemnified by the corporation for taking such action.<sup>184</sup> Previously, shareholders bore the cost of litigation, while the corporation would benefit from any compensation the action would bring.

Courts in civil law jurisdictions are more confined to the letter of law. This may be a reason why Germany and France, the two civil law jurisdictions in the sample, have opted for a mandatory allocation of control rights by law. This implies that courts have been much less involved in the development of corporate law in these jurisdictions. In fact, the law created substantial barriers for shareholders to turn to the courts. Derivative actions are still not recognized in Germany.<sup>185</sup> Even after the changes introduced in 1998, shareholders must still turn to the supervisory board, which instigates the lawsuit, or request the court to nominate special shareholder representatives. The threshold for the proportion of shares required for shareholders to demand an action of the super-

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<sup>181</sup> *Martin v. D. B. Martin Co.*, 88 A. 612, 614 (Del. Ch. 1913).

<sup>182</sup> *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

<sup>183</sup> John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621 (1989) [hereinafter *Coffee, Mandatory/Enabling*]. See also Andrew G.T. Moore, II, *Shareholder Rights Still alive and Well in Delaware: The Derivative Suit: A Death Greatly Exaggerated*, 38 ST. LOUIS U. L.J. 947 (1994) (highlighting how shareholder derivative suits are protected under Delaware law).

<sup>184</sup> The restrictive elements were established in *Foss v. Harbottle*, 2 Hare 461 (1843). The terminology “derivative action” was accepted in *Wallersteiner v. Moir* (No.2), 1 All E.R. 849 (C.A. 1975). For the development of shareholder action under English law, see DAVIES, *supra* note 28, at 658.

<sup>185</sup> There is no provision in the law that would authorize shareholders to bring such actions. In fact, as explained below, even direct shareholder actions are limited.

visory board has been reduced in 1998 from ten to five percent.<sup>186</sup> However, the substantive requirements for launching a lawsuit have been raised simultaneously. The court is required to nominate a special representative who will instigate the lawsuit only if evidence suggests that shareholders have been damaged by serious misuse or fraud.<sup>187</sup> Nevertheless, courts are increasingly recognizing their role in balancing the tradeoffs between greater flexibility and the protection of shareholders. In 1985, the German Supreme Court accepted that a shareholder who was challenging the sale of core assets of the corporation had standing in an action brought against management.<sup>188</sup> While one could have expected that this decision would have encouraged litigation, there has been comparatively little follow up. The same is true for France, where derivative actions were recognized by law in 1966 (called "action social").<sup>189</sup> A possible explanation for the absence of litigation even in the face of procedural devices that make it possible to take recourse to the courts is that in the absence of a well-developed body of case law, the outcome of litigation is still hard to predict.<sup>190</sup> This would suggest that the choice of a highly regulated mandatory corporate law has retarded the development of shareholder litigation as a complementary control device.

#### 4.3. Securities Regulation

Litigation offers a mechanism of ex post control for disgruntled shareholders. With the development of capital markets legislatures increasingly felt that litigation alone was not sufficient to protect investors, but that regulatory regimes ought to be established that ensured some ex ante control of investors. The United States is the first country that developed a comprehensive regulatory regime for securities at the federal level in 1933-34. Still, experiments

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<sup>186</sup> See KonTraG 1998, *supra* note 126, § 147.

<sup>187</sup> Art. 147 Section 3 was revised by the law on transparency and control for enterprises. Gesetz Über Transparent und Steuerung für Unternehmen v.30.4.1998 (BGBl. I S. 786, 788) (F.R.G.).

<sup>188</sup> Holz Müller Case; see BGHZ 83, 122.

<sup>189</sup> See Law of July 24, II, *supra* note 111, art. 245. See also Decree N. 67-236 of March 23, 1967, J.O. Mar. 24, 1967, 2843; D.S.L. 1967, 137 (Fr.).

<sup>190</sup> Other reasons include differences in civil procedure rules. Civil law systems do not have "discovery," i.e., the right of parties to request extensive disclosure of information from another. Nor are class actions or contingency fees accepted, which create incentives for attorneys to organize class actions to overcome the collective action problems that shareholders face.

with financial market regulation can be traced to the seventeenth century, when England first enacted legislation on brokers and jobbers, i.e., financial intermediaries.<sup>191</sup> However, self-regulation remains the primary mode of financial market regulation in Britain to this day, even though this system is now undergoing extensive reforms.<sup>192</sup> In Germany, the first law on securities exchanges (*Börsengesetz*) was enacted in 1896, as one of the legislative responses to the crash of the market in the 1870s.<sup>193</sup> It dealt primarily with the regulation of financial intermediaries, but also included a provision on promoter liability for wrongful information related to a public issuance. The law did not specify the type of information that had to be disclosed in the prospectus, however. Moreover, a central agency to enforce these regulations did not exist in Germany at the time. Market supervision was conducted by regional agencies in the individual states. A federal market supervision agency was not established until 1994.<sup>194</sup> The triggering event was an EU directive, which required member states to establish effective supervisory agencies.<sup>195</sup> France created a state monopoly over the official bourse in 1724 following a stock market crash.<sup>196</sup> Since the late 1960s, it has begun to reform the structural features of its financial markets, by allowing other than state appointed stock

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<sup>191</sup> LARRY NEAL, *THE RISE OF FINANCIAL CAPITALISM* (1990). For a discussion of early English securities legislation see Brian R. Cheffins, *Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom*, in SOCIAL SCIENCE RESEARCH NETWORK ELECTRONIC PAPER COLLECTION (2000), at <http://papers.ssrn.com/sol3/delivery.cfm/000728500.pdf?abstractid=218655>.

<sup>192</sup> Manning Gilbert Warren, III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L. L.J. 185 (1990); Lawrence J. White, *Competition versus Harmonization—An Overview of International Regulation of Financial Services*, in INTERNATIONAL FINANCIAL MARKETS: HARMONIZATION VERSUS COMPETITION 5 (Claude E. Barfield ed., 1996).

<sup>193</sup> An overview of the history of securities market regulation in Germany can be found in Merkt, *supra* note 72. For the development of securities market regulation since 1998, see Martin Weber, *Die Entwicklung des Kapitalmarktrechts 1998-2000: Organisation, Emission und Vertrieb*, 29 NEUE JURISTISCHE WOCHENSCHRIFT 2061 (2000).

<sup>194</sup> The BaW was established by the Gesetz über den Wertpapierhandel und zur Änderung Börsenrechtlicher und Wertpapierrechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz), v. 30.7.1994, (BGBl. I S. 1749) (F.R.G.). See *id.* sec. 3.

<sup>195</sup> LOUIS LOSS & EDWARD M. COWETT, *BLUE SKY LAW* (1958).

<sup>196</sup> For an overview of the history of the French regulatory regime for stock markets and stock exchanges, see Andreas Pense & Hans-Jürgen-Puttfarcken, *Französisches Börsen- und KapitalMarktrecht*, in BÖRSENREFORM—EINE ÖKONOMISCHE, RECHTSVERGLEICHENDE UND RECHTSPOLITISCHE UNTERSUCHUNG 995, 1003 (Klaus J. Hopt et al. eds., 1997).

brokers to trade on the exchange and encouraging self-organization. Moreover, a securities commission was established in 1967 to supervise capital markets.<sup>197</sup>

In the United States, state legislation spearheaded the development in securities market regulation with the adoption of the blue-sky laws beginning in 1913.<sup>198</sup> After the market crash during the Great Depression, the federal legislature felt compelled to intervene and establish a regulatory framework for interstate commerce in securities. The result was the securities market regulation of 1933-34, and the creation of the Securities and Exchange Commission (SEC). Unlike most blue-sky laws, which used merit requirements as entry barriers to the market and gave a designated state agency the right to refuse a public offering unless it offered a "fair value," the federal regulation focused on disclosure. Although disclosure requirements are mandatory, they do not attempt to allocate control rights or to interfere with the design of the governance structure or financial strategies of the firm. Their primary purpose is to ensure that those wishing to participate in the corporate enterprise are adequately informed to make rational decisions, but to let them judge the merits of the investment opportunity. Prior to the enactment of securities and exchange regulations, disclosure requirements existed in many corporate laws in the form of annual financial reports to be presented to shareholders. The novelties of securities regulation are the extension of the right to adequate information from corporations to shareholders and the public at large and the creation of a new enforcement agency.

The merits of a regulatory system with a strict mandatory disclosure regime have been subject to much debate.<sup>199</sup> There is empirical evidence that a strong mandatory disclosure regime has had

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<sup>197</sup> The Securities Commission was later replaced by the Stock Exchange Counsel (now Counsel of Capital Markets). *Id.*

<sup>198</sup> On the history of blue-sky laws, see Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991).

<sup>199</sup> Even this rather limited function of securities regulation has been subject to much debate. See, e.g., Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & ECON. 613 (1981); George J. Stigler, *The Economics of Information*, 69 J. OF POL. ECON. 213 (1961). For a defense of the federal securities regime, compare Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983) with John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984). Critical, however, is Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998), who advocates state competition in securities regulation.

a positive impact on capital market development.<sup>200</sup> There is also substantial evidence that companies have migrated to strictly regulated markets in the past, rather than engaging in a race to the bottom by selecting less regulated markets for public issuances. A possible explanation for this trend advanced in the literature is that securities market regulation is a functional substitute for weak corporate law protection of shareholders.<sup>201</sup> The underlying assumption of this proposition is that investors value legal protection and therefore place a discount on shares in markets where their interests are not well protected. Firms wishing to raise funds at reasonable costs therefore migrate to markets that offer sufficient protection.

The analysis presented in this Article suggests a different argument. We propose that a shift of control rights from shareholders to management, and thus the dismantling of key shareholder rights, was crucial for enhancing the adaptability of the firm to a changing environment. This in turn raised the value of firms that were able to exploit new growth opportunities and to succeed in highly competitive markets. Securities regulation developed into an important complement to make this process sustainable by effectively reducing the likelihood of securities fraud and thereby enhancing confidence in the market. Viewed from this perspective the migration of firms from "bad" corporate law regimes signals that they have gained some flexibility, but are willing to accept outer limits established by securities regulations. The point is that these rules are not substitutes for weak shareholder protection. In fact, many firms that have migrated to the United States in recent years have more extensive/rigid shareholder protection at home than companies that are registered in the state of Delaware. As discussed above, the dismantling of some of these rules was a precondition for firms to migrate to other markets. Rather, these companies have gained substantial flexibility and tied their hands by buying into a credible enforcement system.

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<sup>200</sup> See La Porta et al., *Legal Determinants of External Finance*, *supra* note 6 (using accountant regulations as a proxy for disclosure). See also Pistor et al., *Law and Finance in Transition Economies*, *supra* note 8 (showing that in transition economies, an index for securities market regulation correlates positively with market development, unlike other indices that capture corporate law provisions).

<sup>201</sup> John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999) [hereinafter Coffee, *The Future as History*].

We therefore propose that strong securities market regulation is not a substitute for weak shareholder rights, but that the two are complements: lower mandatory protection especially in areas related to corporate finance allows for greater flexibility. The potential for misuse that greater flexibility creates is mitigated by effective securities market regulation. The discussion of shareholder litigation leads to similar results. Shareholder suits are important governance devices if the allocation of control rights is flexible and determined by shareholders rather than by law. The responsibility to delineate the rights of various shareholders in a particular conflict shifts to the courts. As long as the allocation of rights are determined ex ante by the legislature, there is little demand for litigation.

#### 4.4. Summary

In sum, we can sketch rather different patterns of the evolution of corporate law for the four origin jurisdictions—England, France, Germany, and Delaware. They all start from rather similar initial conditions: a set of very simple rules about the formation of corporations without much attention paid to issues of governance or corporate capital. Statutory corporate law becomes more comprehensive over time in all four jurisdictions. Yet, while in the civil law countries the increasing detail is paired with a legal mandate, in common law countries shareholders have much more extensive rights to opt out of the statutory legal rules. In the civil law countries that have adhered to a highly mandatory corporate law, the statutory law remained the primary foundation for the protection of various shareholders in the corporation. Over time, statutory protections were again extended by statutory law. By contrast, in the common law countries that pursued a path of more enabling corporate law, complementary control mechanisms emerged, including a strengthening of exit rights, judicial recourse, and a new regulatory regime for securities markets. Absent these control devices, one might have seen a greater “race to the bottom.”<sup>202</sup> This has not materialized. In fact, empirical evidence suggests that shares of companies that are incorporated in Delaware are traded at higher value than shares of comparable companies that are reg-

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<sup>202</sup> Famous for the claim that Delaware in particular was leading the race to the bottom in corporate law is William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).



istered in other states.<sup>203</sup> We argue that this can be best explained by the fact that shareholders pay a premium for a corporate law that gives management substantial flexibility while still being assured that the power of management is not unlimited. It may be checked by courts in an *ex post* fashion. It also is monitored in part by a securities regulator. Courts and regulators have played a far less important role in continental Europe. Given the highly mandatory corporate law, there is perhaps less need for these institutions. But the price shareholders pay is that the management of their firms is less flexible in exploiting new opportunities.

## 5. LEGAL TRANSPLANTS

We now turn to an analysis of the development of corporate law in Spain, Chile, Colombia, Israel, Malaysia, and Japan. All countries received their formal corporate law from France, England, and Germany/United States, respectively.<sup>204</sup> We will discuss countries that received their formal law from the same source together and draw comparisons to the origin country. The analysis follows the same structure as the analysis of the origin countries and addresses the existence of the corporation as an independent entity, its governance structure, and issues of corporate finance.

The main question pursued in this Section of the Article is whether transplant countries exhibit different patterns of legal evolution than origin countries. Recall that recent empirical studies have shown that common law countries as a group outperform civil law countries in the scope of minority shareholder protection they offer and in the performance of their stock markets. Other studies, however, have shown that legal families have only limited predictive power with regard to the effectiveness of legal systems.<sup>205</sup> Our database allows us to “test” these competing propositions by examining the pattern of legal change in transplant coun-

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<sup>203</sup> Daines, *supra* note 171.

<sup>204</sup> As will be explained in more detail below, these countries received core parts of their legal system, including civil, commercial, and criminal law, as well as civil and criminal procedure law either from their current or former colonial powers or ruler, or from another Western power of their choice (i.e., Japan in the late 19th century). For a brief history of the development of private law in these countries, compare the relevant country reports in Viktor Knapp, *National Reports*, INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW (Drobnig et al. eds., 1972). For the German and French civil law countries in the sample (see *supra* Table 1), see JOHN HENRY MERRYMAN ET AL., *THE CIVIL LAW TRADITION: EUROPE, LATIN AMERICA, AND EAST ASIA 1247* (1994).

<sup>205</sup> See, e.g., Berkowitz et al., *supra* note 29.

tries. We start our analysis from the conclusions drawn in the previous section of the Article, namely that superior legal systems are not encapsulated in particular legal provisions found in statutory law, but in the extent to which they promote responsiveness and change without creating a control vacuum.

If legal families are the overriding factors that determine the quality of corporate law, and common law has certain features that allow it to be more responsive than civil law, irrespective of whether the country in question is an origin or transplant country, we should observe similar patterns of legal change in Israel and Malaysia as in England and the United States. If, however, transplant countries reveal quite different patterns in the evolution of corporate law than do origin countries, we should observe similar patterns of legal change in transplant than in origin countries, and across transplant countries independent of the legal system from which they received their law.

Our analysis reveals that there is more evidence to support the latter proposition than the former. We find two distinct patterns of legal change in transplant countries that do not have a counterpart in origin countries. One is lethargy. The other is quite the opposite—erratic change. In several transplant countries, the law hardly changed for decades during which the respective country was undergoing substantial socioeconomic change. In other words, formal law in these countries was quite unresponsive to change. This is true in particular in the two common law countries examined, Israel and Malaysia, but also in Japan, a country that is usually classified as a civil law country but has received U.S. style corporate law after World War II.<sup>206</sup> Legal change caught up with socioeconomic change only much later.

The second pattern, erratic change, can be observed in several French civil law countries included in our analysis. Spain in the 19th century is a glaring example, where the corporate law started off as one of the most liberal corporate laws in 1829, only to be superseded by a highly restrictive version twenty years later.<sup>207</sup> This had a crippling effect on economics and in response, the legislature turned the clock back to 1829. Obviously, we observe a certain level of responsiveness by lawmakers to socioeconomic change,

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<sup>206</sup> For a detailed analysis of the patterns of legal change in Japan following World War II in Japan, see West, *supra* note 31.

<sup>207</sup> For a detailed analysis of the changes introduced in Spain at the time, see our analysis *supra*, Section 5.1.1.

but one that prefers bold measures over efforts to fine tuning. The example also demonstrates how important complementary control mechanisms are. Where they were absent, a highly enabling corporate law had quite unsettling consequences.

Colombia is another example in which we can observe erratic change. In this case, change did not result from the effect the previously adopted corporate law had on domestic affairs, but rather from the eclectic choice of countries from which to borrow corporate law. Colombia first followed the Spanish example and enacted a liberal corporate law in 1853.<sup>208</sup> Unlike Spain, this did not have much impact, mostly because economic development lagged behind so that the private corporation did not take hold in the country. Later, Colombia chose to update the corporate law by following the Chilean model. While this led to some remarkable change in the statutory law, it had no discernible effect on the Colombian economy. The lesson we draw from this analysis is that countries that receive foreign law are frequently unprepared for the changes it brings,<sup>209</sup> leading us to suggest that there is a "late development" phenomenon in the evolution of legal systems as there is with respect to economic systems.

### 5.1. *Existence of the Corporation as an Independent Entity*

#### 5.1.1. *French Civil Law Countries*

In some respects one might still argue that transplant countries benefited from the wisdom gained in origin countries. This is most prevalent with regards to the entry conditions for corporations. At the time most of the transplant countries in our sample received

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<sup>208</sup> See discussion, *supra* Section 5.1.1.

<sup>209</sup> A similar argument is often made for economic development. By emulating institutions from advanced countries, less developed countries were long thought to be able to advance more rapidly than developed countries had. This proposition has, however, proved to be unfounded in the realities of most countries. One explanation is the late development phenomenon. In an attempt to catch up, late developers often pursue different strategies even when emulating, in part, more advanced countries. Gerschenkron suggested many years ago that the process of capital accumulation takes quite different form in late developers as compared with more advanced countries. ALEXANDER GERSCHENKRON, *ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE* 5 (1962). Another explanation is path dependency. Socioeconomic change takes place within the constraints of existing formal and informal institutions. This is bound to result in different paths of development. See DOUGLASS CECIL NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* 93 (1990) (discussing the concept of path dependency).

their corporate laws, the origin countries already allowed free incorporation and had enacted a number of safeguards to balance this change. Thus, most transplant countries went through a much shorter period of trial and error. The most notable exceptions are Spain, which bypassed the leading European powers in 1829 only to repeal this change shortly afterwards, and Chile, where incorporation remained subject to state approval until the late 20th century.

Spain experienced a substantial influx of French law during the reign of the Bourbons in the late eighteenth century. The law governing commercial activities, however, was based primarily on Spanish imperial law.<sup>210</sup> It regulated entrance to the market, but left customary trade to govern transactions among entrepreneurs.<sup>211</sup> The Napoleonic codes arrived in Spain with the French troops. After they left in 1815, the codes were kept on the books on a preliminary basis, but they were subsequently replaced with national legislation, which resembled the French law in many aspects, but was not identical to it. The Spanish Código de Comercio of 1829 broke with a long tradition of special privileges, which granted far-reaching autonomy to merchants in Spain.<sup>212</sup> It legalized the relationship between the state and entrepreneurs as well as among them. Forty years before France introduced a system of free incorporation subject only to registration, Spain did so in the 1829 law.<sup>213</sup> Although courts had substantial discretion in refusing registration, a special state concession was not required.

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<sup>210</sup> FRANZ EHRENFRIED, *DAS AKTIENRECHT SPANIENS VON SEINEN ANFÄNGEN BIS ZUR GEGENWART* (1936). See also MATTHIAS FREY, *DIE SPANISCHE AKTIENGESELLSCHAFT IM 18 JAHRHUNDERT UND UNTER DEM CÓDIGO DE COMERCIO VON 1829* 232-37 (1999) (noting that the enactment of the Spanish Code of Commerce, due to the strong influence of the French model, broke with a long tradition of special privileges and far-reaching autonomy of the merchants in Spain, introducing a new structure attributing much more influence to the State on commerce and commercial jurisdiction). This caused much protest from the courts, confronted and seemingly somewhat paralyzed by the transplant of an unknown legal order, they accuse it of being theoretical and without knowledge of reality. Combined with a strong recession of commerce due to other factors (i.e., epidemics, war), it took a long time before the inherent systematic value of the work was recognized and scholars started to pay attention to commercial law. Only in 1883 was commercial law officially introduced as a subject to academic curricula.

<sup>211</sup> Coing, *HANDBUCH DER QUELLEN*, *supra* note 28.

<sup>212</sup> FREY, *supra* note 220, at 232-37.

<sup>213</sup> Código de Comercio [C.Com] de Mayo 30, 1829, arts. 290, 293 (Gaceta de Madrid 1829) (Spain) [hereinafter Código de Comercio 1829].

In response to the liberalization of entry requirements, Spain experienced a major founders' boom, followed by a severe crash.<sup>214</sup> The backlash occurred twenty years later, in 1848.<sup>215</sup> The amended code demanded a royal decree as a condition for incorporation. This stifled the market and had adverse effects on economic development.<sup>216</sup> In 1869, the pendulum swung back to free incorporation.<sup>217</sup> At that time, the leading European powers, including France, had also dropped the concession requirement, whereas Spain had spearheaded this development in 1829, she now mimicked it. For the long-term development of corporate law in Spain, the revision of the Código de Comercio in 1885 has been decisive. A major characteristic of this code was its emphasis on creditor's rights. For example, merger transactions were made subject to creditor's consent unless provisions were made to fully preserve their rights.<sup>218</sup> Case law based on the 1885 code required unanimous approval of merger transactions.<sup>219</sup> The 1951 revision of the code<sup>220</sup> upheld most of these provisions.

After 1815, an independence movement swept Latin America. New states were formed and constitutions adopted, which were modeled after the French constitution of the First Republic, or the U.S. constitution, or a combination of both.<sup>221</sup> The enactment of civil and commercial law was delayed until mid-century in most of the newly independent states. Chile was one of the first countries

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<sup>214</sup> This resembled the experience of several origin countries. See *supra*, sec. 3, especially the discussion of Germany's founders' boom in the 1870s.

<sup>215</sup> For a discussion on the phenomenon of backlash in the evolution of corporate law, see Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996).

<sup>216</sup> Law of Jan. 28, 1848, *Ley Sobre Sociedades Mercantiles por Acciones*, (Spain); Decree of Feb. 17, 1848, arts. 1, 2, and 4, (XLIII-I Colección Legislativa de España 100-109) (Madrid 1849) (Spain).

<sup>217</sup> Law of Nov. 12, 1869, *Quiebra de las Compañías de Ferrocarriles, Canales y Demás Obras Públicas*, arts. 2-3, (Gaceta of Nov. 14, 1869) (Nr. 318) (Spain) [hereinafter *Quiebra de las Compañías*].

<sup>218</sup> Art. 188 No. 2, *Código de Comercio (C.Com)*, Royal Decree of Aug. 22, 1885 (Gaceta of Oct.16 – Nov. 24, 1885) (Nr. 289-328) (Spain) [hereinafter *Código de Comercio 1885*].

<sup>219</sup> See EHRENFRIED, *supra* note 210, at 246.

<sup>220</sup> Law of Jul. 17, 1951, *Ley Sobre Régimen Jurídico de las Sociedades Anónimas (B.O.E. of Jul. 18, 1951) (Nr. 199)*, corrected in B.O.E. of Aug. 6, 1951 (Nr.218) (Spain) [hereinafter *Ley Sobre Régimen*] (Sp.).

<sup>221</sup> For a discussion of the American influence on Latin American constitutions, see Robert J. Kolesar, *North American Constitutionalism and Spanish America: "A Special Lock Ordered by Catalogue, Which Arrived with the Wrong Instructions and No Keys?"*, in AMERICAN CONSTITUTIONALISM ABROAD 41 (George Billias ed., 1990).

in Latin America to enact major codifications for civil and commercial law.<sup>222</sup> It borrowed from France as well as Spain, which, as we have seen, was strongly influenced by French law. The drafters of the code did not only copy the law on the books, but incorporated case law and in part legal doctrine that had developed in Europe since the codes had been enacted there.<sup>223</sup> The 1853 law set the grounds for strong state control over commercial activities, which lasted in the area of corporate law until 1981.<sup>224</sup> Two presidential decrees were required for a company's complete incorporation: one authorizing incorporation, the other verifying lawful incorporation and allowing the commencement of business. Only then could a company be registered, but in any case only for a fixed term, which was to be stipulated in the charter. State control also extended to mergers and liquidation. A 1970 amendment reallocated control rights over mergers to shareholders and required a supermajority vote of two-thirds.<sup>225</sup> In 1981, Chilean corporate law experienced a major revision.<sup>226</sup> The new law borrowed heavily

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<sup>222</sup> Law of Nov. 8, 1854, *Ley Sobre Sociedades Anónimas (Chile)* [NOTE: There is no *Diario Oficial* source for this law]. See MIGUEL CRUCHAGA, *SOCIEDADES ANÓNIMAS EN CHILE Y ESTUDIOS FINANCIEROS* (1929) (reprint, Chilean original appeared between 1880-87).

<sup>223</sup> *Country Reports, Chile*, 1 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW (Viktor Knapp ed., 1972); JOHN HENRY MERRYMAN, *THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA* 26 (2d ed. 1985) (discussing codes and codification).

<sup>224</sup> This is reflected in the fact that until 1981, companies wanting to incorporate needed special state approval ("concession"). See *Código de Comercio*, arts. 427, 434 [C. COM] (1865) (Chile) [NOTE, there is no D.O source for this law]; Law No. 17308 of June 29, 1970, *Modifica el Código de Comercio*, art. 427 (D.O. 1970, 17308) (Chile); Art. 126 of the *Código* as amended by Law No. 18046 of Oct. 21, 1981, *Ley sobre Sociedades Anónimas (LSA)* (D.O. 1981, 18046) (Chile); Law No. 18045 of Oct. 21, 1981, *Ley de Mercado de Valores (LMV)* (D.O. 1981, 18045) (Chile).

<sup>225</sup> Law No. 17308 of June 29, 1970, *Modifica el Código de Comercio*, (D.O. 1970, 17308) (Chile) *modifying* art. 108 (5) of Decree with Force of Law (DFL) No. 251 of May 20, 1931, *De la Superintendencia de Compañías de Seguros, Sociedades Anónimas y Bolsas de Comercio* (D.O. 1931, 251) (Chile); Decree with Force of Law (DFL) No. 4705 of July 14, 1947 (Chile).

<sup>226</sup> Two laws were introduced that substantially altered the existing code, namely Law No. 18046, *supra* note 225, and Law No. 18045, *supra* note 225. With these new enactments, the aim of government surveillance has changed. Surveillance has shifted to control of compliance with laws and the corporation's own regulation (deed of incorporations, bylaws), as well as creating the necessary transparency, i.e., guaranteeing information of shareholders, creditors and business partners of the corporation and public in general for more efficient functioning of economic activity. The concept of government intervention by the supervisory authority for the protection of investors and minority shareholders has been

from the United States. It introduced the principle of free incorporation—over one hundred years later than the origin countries France and Spain—and shifted control rights over liquidation and mergers to shareholders. Unlike Spain, Chile did not include strong creditor protections in its law.

Colombia introduced one of the most liberal incorporation regimes in the world in 1853.<sup>227</sup> The lawmakers followed essentially the 1829 Spanish code, apparently without recognizing that Spain itself had moved back to a concession system in 1848.<sup>228</sup> The country was economically backwards and had only few incorporated companies, all of which had been authorized under Spanish imperial rule. Even after the enactment of the new code, few entrepreneurs were aware of the possibilities it offered and continued to operate as unlimited partnerships rather than seeking the protection of limited liability that the law now offered. Thus, in contrast to Spain in 1829 where the liberalization of entry requirements led to a founders' boom, the equally liberal Colombian law had little impact on economic development. In 1887 the code was revised,<sup>229</sup> most likely in an attempt to stay in tune with legal developments in neighboring countries, where major revisions of commercial laws took place in the 1880s. There were few internal reasons for a major revision of the code. The model chosen this time was the Chilean law of 1854.<sup>230</sup> The copy was almost identical to the Chilean model, and included the rigid entry requirement of two presidential (rather than royal) decrees, this time ignoring that by then

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abandoned. Correspondingly, emphasis has relatively shifted to individual claims in court rather than regulatory intervention by government agencies. This new legislation is clearly inspired by U.S. law, introducing concepts like the distinction between open and closed corporations, shares without par value, and the necessity of fixing the price of placing of shares in capital increases, which can be a value superior or inferior to the par value, book value, or quotation at the stock exchange. For details see 2 ÁLVARO PUELMA ACCORSI, *SOCIEDADES (SOCIEDAD ANÓNIMA)* 397-98 (1996).

<sup>227</sup> Law of June 1, 1853, Código de Comercio (CÓD. COM.), Codificación Nacional (1852-1853) 351 (Colom.). The assessment follows from our analysis of entry requirements that existed in other jurisdictions at the time. See discussion of origin countries, *supra* Section 5.1.3.

<sup>228</sup> See generally ROBERT CHARLES MEANS, *UNDERDEVELOPMENT AND THE DEVELOPMENT OF LAW* (1980) (detailing the development of corporate law in Columbia in the 19th century).

<sup>229</sup> Law No. 57/1887 of Apr. 15, 1887, Adopta el Código de Comercio (CÓD. COM.), Codificación Nacional (1887) (Colom.).

<sup>230</sup> Law of Nov. 8, 1854, *Sobre Sociedades Anónimas (Chile)* [NOTE: There is no D.O. source for this law].

the Chilean model lagged far behind legal developments elsewhere in the world.

Colombia is an interesting example of a country that was backwards in socioeconomic, as well as in legal development. In particular, Colombia lacked domestic legal expertise to assess the implications of particular laws.<sup>231</sup> The choice of external models was determined primarily by the prestige of these models. Internal socioeconomic developments, as well as systematic concerns were ignored. There is little evidence that this approach to lawmaking has changed since. The last major revision of the Colombian commercial code was in 1971,<sup>232</sup> which is surprising in light of the extensive legal reform projects around the world in the area of corporate law, especially in the 1980s and 1990s.

### 5.1.2. *English Common Law Countries*

The two common law transplant countries we included in this analysis were both ruled by Britain for several decades. After the dissolution of the Ottoman Empire following World War I, Britain established a protectorate over the territories that were later to become the state of Israel. The territories that today comprise Malaysia were colonized by Britain in the late 1800s. The Federal Malay States were established in 1896 leading to an influx of English law.

The transmission of British law to its former colonies tended to be more gradual than the transplantation of statutory law from civil law countries. Unlike codified law, case law cannot be transplanted instantaneously. In most cases, a decree of the colonial power would rule that the English contract or company law as it existed at that particular date would now be applied in the colonized territories. Where English judges sat in court to apply the law, the evolving case law used English precedents. Yet, the different facts presented in the territories and recognition of local legal customs meant that case law increasingly diverged from that of the origin country.<sup>233</sup> Consistency in legal development was

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<sup>231</sup> For details see MEANS, *supra* note 228.

<sup>232</sup> Decree No. 410/1971, revising the Código de Comercio (CÓD. COM.) D.O. June, 1971, (Colom.).

<sup>233</sup> This is reflected in the development of entire bodies of law, which, at least in England, are referred to as, for example, "Chinese common law." For a comparison of the influence of different Western laws on the law in Southeast Asia, see M. B. HOOKER, A CONCISE LEGAL HISTORY OF SOUTH-EAST ASIA (1978); 2 LAWS OF SOUTH-EAST ASIA—EUROPEAN LAWS IN SOUTH-EAST ASIA (M.B. Hooker ed., 1988).



achieved by using the Privy Council in England as the Supreme Court for the colonial empire. Many countries continued to refer their cases to this court even after independence. In Malaysia this was the case until 1985.<sup>234</sup>

England also began to codify its law for the purpose of transplanting it to its colonies. India became the testing ground for this strategy.<sup>235</sup> It was in this tradition that the English Companies Act was introduced in the territories that eventually became Malaysia in 1866,<sup>236</sup> and in the territories under the British protectorate, which later became the state of Israel, in 1929.<sup>237</sup> The companies laws introduced in Israel and Malaysia closely mirror the timing of the transplantation. Free incorporation and shareholder control over major transactions were the hallmarks of English law at the time and were introduced, without change, in Israel and Malaysia.<sup>238</sup> Remarkably, however, the corporate law in both countries did not change much for long stretches of time after it was first enacted.

Malaysia revised its corporate law in 1965<sup>239</sup> using Australia rather than its former colonial power as a model. Since the Australian law of the time was still very faithful to the English model, the law ultimately closely resembled the 1948 English law.<sup>240</sup> In other words, it took Malaysia over twenty years to catch up with the development of the origin country from which it had received its law. Little in the revised code suggests that domestic developments influenced the new law, or put differently, that the statutory law responded to particular developments in Malaysia. After 1965, the

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<sup>234</sup> KATHARINA PISTOR & PHILIP WELLONS, *THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT* 223 (1999).

<sup>235</sup> The starting point was the Indian Contract Act of 1872, followed by the Negotiable Instruments Act of 1882, the Indian Patents Act of 1911, the Indian Copyrights Act of 1914, and the Bombay Securities and Control Act of 1925. For a chronological overview see *id.* App. 3A.

<sup>236</sup> In fact, at the time the Indian Companies Act was introduced, the territories that later comprised Malaysia were part of India. When the Straits Settlement separated in 1867, the act ceased to have effect, but was later replaced by a number of company ordinances (e.g., Ordinance No. V of 1889).

<sup>237</sup> Companies Ordinance 1929 Chukkei Eretz Israel, Chapter XXII, p. 155 (Isr.) [hereinafter Companies Ordinance 1929].

<sup>238</sup> *Id.* art. 3 (requiring seven founding shareholders for a publicly held corporation.).

<sup>239</sup> Companies Act, 1965, c. 125 (15 Apr., 1966) (Malay.) [hereinafter Companies Act 125].

<sup>240</sup> See PISTOR & WELLONS, *supra* note 235 (describing foreign law's influence on the development of Malaysian corporate law).

corporate law was revised quite frequently, especially during the second half of the 1980s, when changes in economic policies required adjustments of existing law.<sup>241</sup>

Israel left the English law unchanged for an even longer period, from its first enactment in 1929 until 1983. Beginning in 1967, a package of securities market regulations was introduced,<sup>242</sup> but the corporate law itself was revised only in 1983.<sup>243</sup> Some important changes affecting the control rights over the existence of the company as an independent legal entity were introduced at that time. Most importantly, a company's registrar was given the power to refuse incorporation on public interest grounds.<sup>244</sup> Again, this signals a different role of corporate law within the context of a political system that at least at times favored more extensive state control over economic activities than the origin country from which the law had been received. In 1999, this provision was repealed.<sup>245</sup> The registrar is now obliged to incorporate any company unless there is evidence of violations of the law, including procedural requirements for incorporation.

### 5.1.3. German and United States Transplants

With regards to the development of its corporate law, Japan is an odd case in our sample, because it received two corporate law transplants. The first was from Germany, which served as a model for much of the new formal law enacted during the Meiji Restoration.<sup>246</sup> The second was from the United States, or rather from the

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<sup>241</sup> See The Companies (Amendment) Act, 1985, c. A616 (Malay.); Companies (Amendment) Act, 1986, c. A657 (Isr.); Companies (Amendment Act), 1989, c. A720 (Malay.); Companies (Amendment) Act, 1991, c. A791 (Malay.) (outlining revisions to Malaysian corporate laws since the 1980s).

<sup>242</sup> Philip N. Pillai, *Securities Regulation in Malaysia: Emerging Norms of Governmental Regulation*, 8 J. COMP. BUS. & CAP. MARKET L. 39 (1986). See also MICHAEL T. SCULLY, *FINANCIAL INSTITUTIONS AND MARKETS IN SOUTHEAST ASIA: A STUDY OF BRUNEI, INDONESIA, MALAYSIA, PHILIPPINES, SINGAPORE, AND THAILAND* 110 (1984).

<sup>243</sup> Companies Ordinance (New Version) 5743-1983, Diney Medinat Israel (Nosach Hadash) No. 37, 5743 (19 Aug., 1983) 764 (Isr.) [hereinafter Companies Ordinance (New Version)].

<sup>244</sup> *Id.*

<sup>245</sup> Companies Law, 5759-1999, 1999, S.H. 189, No. 1711, 5759 (Isr.) [hereinafter Companies Law 1999]. The law now requires the registrar to register the company if he finds that all requirements under the law with respect to registration have been met. See *id.* § 10(a).

<sup>246</sup> See HARALD BAUM & EIJI TAKAHASHI, *COMMERCIAL AND CORPORATE LAW IN JAPAN: LEGAL AND ECONOMIC DEVELOPMENT AFTER 1868* (Röhl ed., 2000) (analyzing the evolution of Japanese corporate law and the impact of German law thereon).

state of Illinois, following World War II.<sup>247</sup> The change had little impact on incorporation, as free incorporation subject only to registration was recognized already in Japan's commercial code of 1899 law.<sup>248</sup> Yet, merger rules were affected by the change. While under the 1899 law, mergers required only public notice and a simple majority vote (by interest and number), the new law established a two-thirds majority requirement in number, provided that at least half of the stock was represented at the meeting.<sup>249</sup> This amendment strengthened control rights of minority shareholders.

## 5.2. Corporate Governance

Corporations in the transplant countries considered here are governed by a simple one-tier board structure. This is true even for Japan, despite the fact that at the time Japan adopted the German law, a two-tier structure had already become mandatory in Germany. The details of the function of boards were left to the charter in all countries.

### 5.2.1. French Civil Law Transplants

Where the state exercised control rights over the entry and exit of corporations, it also ensured that it had some say over the governance of firms. This was the case in Spain between 1848 and 1868, i.e., during the period when the government tried to regain control over the economy after the initial liberalization of 1829, only to thwart the already ailing economic development. During that period, the government reserved the right to monitor the corporation as well as to call a special shareholder meeting at any time. Shareholders representing at least ten percent of total stock were vested with this right only in 1947.<sup>250</sup>

Chile adopted the idea of continuous state monitoring in 1854 by including a provision that allowed the government to appoint a special inspector to supervise corporations. Creditor control in matters of corporate governance was particularly strong in Spain,

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<sup>247</sup> SHŌHŌ nado no Ichibu o Kaisei Suru Horitsu [Law to Revise a Portion of the Commercial Code], Law No. 167 of 1950 (Japan) [hereinafter 1950 Revision]. For an analysis of the evolution of corporate law since 1950, see West, *supra* note 31.

<sup>248</sup> SHŌHŌ, [Commercial Code], Law No. 48 of 1989 (Japan).

<sup>249</sup> 1950 Revision, *supra* note 248.

<sup>250</sup> This threshold was lowered to five percent in 1989. See Ley de Sociedades Anónimas, art. 100 (B.O.E., 1989, 178) (Spain), consolidated by, Ley de Sociedades Anónimas, art. 100 (B.O.E., 1989, 310) (Spain) [hereinafter Sociedades Anónimas].

but increasingly also in Chile. The Spanish Code of 1829 stipulated that creditors could sue management for ultra vires acts, thereby giving them some control rights over the scope of business activities.<sup>251</sup> Chile introduced strong protections for bondholders in 1929 and strengthened their rights in 1931.<sup>252</sup> Bondholders were to organize in special bondholder associations. In case of default, the association of bondholders could demand the replacement of individual directors deemed responsible for the default. By contrast, minority shareholders were given comparatively few control rights in Chilean law, apparently because state control was sought to be sufficient to take care of their interests. Under the 1931 law, shareholders representing at least twenty-five percent of common stock could demand an extraordinary shareholder meeting.<sup>253</sup> In other jurisdictions the relevant threshold at the time was ten percent, or even as low as five percent in England and Germany. Chile adopted the threshold of ten percent only in 1981,<sup>254</sup> and in Colombia it is still twenty percent today.<sup>255</sup>

As far as the delineation of powers between the shareholder meeting and the board is concerned, Spain, Chile and Colombia follow by and large the French model. This is also true for voting rights. As discussed above, under French law it was possible to disenfranchise shareholders who held less than a minimum number of shares. The same was true for the other countries belonging to the French civil law family. This rule enhances the control of blockholders and deprives minority shareholders of the right to a voice in the corporation, even in coalition with other minority shareholders. The other countries in the French legal family also copied the concept of the *actions industrielles*,<sup>256</sup> which gave the

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<sup>251</sup> Código de Comercio 1829, *supra* note 214, art. 277. See also Código de Comercio 1885, *supra* note 219, art. 156.

<sup>252</sup> See Decree with Force of Law (DFL) No. 251 of May 20, 1931, De la Superintendencia de Compañías de Seguros, Sociedades Anónimas y Bolsas de Comercio, D.O. May 22, 1931 (Chile) [hereinafter DFL 1931]; Law No. 4657 of Sept. 24, 1929, Establece Disposiciones Generales, Relativas a la Emisión de "Debentures," (D.O. Sept. 25, 1929) (Chile).

<sup>253</sup> See DFL 1931, *supra* note 253, art. 23.

<sup>254</sup> COD. COM, art. 58 no. 3 (1981), amended by Law No. 18045 of Oct. 21, 1981, Ley de Mercado de Valores (LMV) (D.O. Oct. 22, 1981) (Chile).

<sup>255</sup> Decree 410/1971, *supra* note 233, art. 423.

<sup>256</sup> These include "actions de jouissance" (reimbursed shares), "actions d'usufruit," or "actions industrielles," which can be issued by the corporation, granting rights to dividends but not to preferential rights upon liquidation. For details, see MALEPEYRE & JOURDAIN, *supra* note 109, at 199, 208.

founders of the corporation special shares with the right to dividends. The shares were to compensate for services rendered by the founders. However, they did not confer voting rights, and thus had no influence on the allocation of control rights among different groups of shareholders. These special shares were abolished in Chile in 1981,<sup>257</sup> but still exist in the other countries of this family, including in France.<sup>258</sup>

### 5.2.2. *English Common Law Transplants*

In Israel and Malaysia, designing the governance structure was, and still is, primarily the task of the articles of incorporation (charter). Fundamental decisions, including changes in the charter, bylaws, or the corporate capital, as well as decisions on mergers or liquidation, have to be approved by special resolution requiring three-quarters majority vote.<sup>259</sup> The shareholder meeting appoints and dismisses the members. In Malaysia, the board exercises the right to dismiss individual members at any time by ordinary resolution (simple majority vote). Israel retained the 1929 requirement of a special resolution (three-quarters majority vote) in 1983. In 1999, this provision was relaxed, and currently a simple majority suffices for dismissing members of the board.<sup>260</sup> The 1999 amendment also introduced cumulative voting rights, which are, however, optional. This change reflects the rather eclectic borrowing practice in the latest revision of the Israeli law, which drew upon English, EU, and U.S. material.

### 5.2.3. *German and United States Transplants*

In Japan, the American legal transplant established new requirements for firm governance. The 1950 law only stipulated that the board of directors shall manage the corporation.<sup>261</sup> Unlike the law of Delaware, board committees were not explicitly recognized in the Code, but after 1950, due at least in part to the large size of

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<sup>257</sup> For references to the text of the law and its major changes, see discussion, *supra* note 226.

<sup>258</sup> CODE DE COMMERCE [C. COM] Arts. 209-214 (Law No. 66-537 of July 24, 1966), revising the C. COM, J.O. 26 Juill., p. 6402 (1); BLD 1966, 353-404 (Fr.).

<sup>259</sup> See, e.g., Malaysian Companies Act (Act 125) §§ 30, 152(2), as amended. The Act requires a special resolution, i.e., three-quarters majority for changes in the corporate charter.

<sup>260</sup> Companies Law 1999, *supra* note 246, § 230 (Isr.) (stating that directors are dismissed by the General Meeting, unless otherwise provided in the bylaws).

<sup>261</sup> 1950 Revision, *supra* note 248, art. 260.

Japanese boards, firms formed committees, including executive committees, for more efficient decision making.<sup>262</sup> At least three directors elected by the shareholders served terms of up to three years and were responsible for management. The requirement that directors must be shareholders was dropped in 1950.<sup>263</sup> While nonvoting shares were recognized already in the 1898 law, a 1938 provision stipulated that such shares could not comprise more than one-quarter of total capital of the company.<sup>264</sup>

Compared with other jurisdictions, minority shareholders in Japan had little control under the commercial code of 1899.<sup>265</sup> Major changes in the corporate charter, capital increases, and so on, could be adopted with only a simple majority vote as compared to supermajority requirements in other jurisdictions. At the same time, the lower threshold created fewer hold up problems. In 1950, the vote was changed to require two-thirds of the votes of shareholders present at a meeting who hold shares representing more than one-half of the total number of issued shares.<sup>266</sup> This requirement ensured greater participatory power by shareholders, in contrast to the law of Delaware, where statutory shareholder protection such as supermajority requirements had already been relaxed. The 1950 revision of the commercial code also extended the right to call an extraordinary shareholder meeting. While the 1898 law required shareholders representing ten percent of total stock to request a meeting, the 1950 law gave this right to shareholders with only three percent of a firm's capital.<sup>267</sup>

The comparison between the Japanese law and the corporate law of the state of Delaware, which had developed into the leading state for corporate law in the United States, is revealing. American advisors chose the Illinois model because it offered "better" shareholder protection. They viewed the developments in Delaware

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<sup>262</sup> Although the Code contains no provisions regarding committees, they exist and often function under detailed rules. See TEIKAN SAKUSEI, HENKO NO TEBIKI [Handbook of Articles of Incorporation Creation and Amendment] 335 (Shigekazu Torikai ed., 1998). The jōmEnglandai often functions as an executive committee. See *Kyoto Daigaku Shōhō KenkyūEnglandai, Kabushika Kaisha Keiei Kikō no Jittai* [The Reality and Management Mechanisms of Corporations] 289 SHŌJI HOMU 12 (1963). Seventy percent of companies have at least one jōmEnglandai, and the percentage increases the larger the company.

<sup>263</sup> 1950 Revision, *supra* note 248, art. 166.

<sup>264</sup> *Id.* art. 242.

<sup>265</sup> SHŌHŌ, *supra* note 26.

<sup>266</sup> 1950 Revision, *supra* note 248, art. 343.

<sup>267</sup> *Id.* art. 237.

with suspicion and supported a stronger hand of the legislature in lawmaking—not unlike some of the civil law countries discussed above. The more pragmatic evolution of corporate law in Delaware, where practitioners rather than law professors had the decisive influence on the laws' contents, took a different, and ultimately more successful, path.

### 5.3. Corporate Finance

When discussing corporate finance provisions for the four origin countries in the sample, we noted the variance in the flexibility as indicated by the allocation of control rights over financial issues. At one extreme, the German model is characterized by the prescription of detailed capital requirements as well as strong shareholder control rights, with directors implementing decisions but not making them. At the other extreme, Delaware requires that control rights be shared between shareholders on the one hand and directors on the other, the latter having substantial leeway in determining the pricing and placement of shares once shareholders have agreed to a capital increase. The six transplant countries are closer to the German than to the Delaware model.

#### 5.3.1. French Civil Law Transplants

Spain, Chile, and Colombia all place substantial emphasis on protecting creditor rights by giving them veto rights over several decisions relating to corporate finance. While creditor rights protection is also an important issue in German law, the latter confines these rights to notification requirements, but does not grant veto rights over decisions on capital increases or decreases. By contrast, creditor consent is required for capital decreases under the Spanish Código de Comercio of 1885.<sup>268</sup> French law introduced this feature only in 1930—an interesting example of reverse transplantation where an origin country incorporates provisions first introduced in a transplant. Under Spanish law, the veto right of ordinary creditors was transformed, in 1951, into a right to demand additional security in case of a merger, but bondholders still must consent to the merger transaction. Decisions over increasing corporate capital are squarely in the hands of shareholders. Since 1885 a simple majority has sufficed.<sup>269</sup> In 1989 a quorum requirement of fifty per-

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<sup>268</sup> Código de Comercio 1885, *supra* note 219, art. 168(8).

<sup>269</sup> This follows from the fact that the code does not stipulate any supermajority requirements for increases in corporate capital. Only the 1885 code

cent was introduced, which ensures that the majority of shareholders is present when taking such decisions. There is no evidence that authorized but unissued stock is allowed under Spanish law or that directors have much flexibility in the use of the corporation's financial instruments.

The 1854 Chilean law went far beyond the Spanish model and introduced unanimous shareholder voting for changes in corporate capital. Only in 1970 was this relaxed for decisions concerning capital increases, which from then on required "only" a seventy percent majority vote for capital increases. The 1947 revision made changes in corporate capital much more flexible by requiring only simple majority both for increases and reductions in corporate capital. Unlike Spain, a quorum is not required, but the simple majority of the shareholders present suffices.<sup>270</sup>

Initially, the government determined the amount of corporate capital on a case-by-case basis. This followed directly from the fact that the government reserved the right to approve incorporation. Recall that Chile moved to a system of free incorporation only in 1981. Over time, the law standardized some entry requirements for incorporation. In 1931, the minimum capital requirement for all corporations was set at 500,000 Pesos.<sup>271</sup> A decree of 1970<sup>272</sup> further gave the government the right to refuse incorporation in case the capital was deemed to be insufficient for the purpose of the enterprise. Both provisions were dropped in the 1981 revision of the law.<sup>273</sup>

A similar trend from full government discretion to general rules applicable to all companies, and then to a formal reversal of this rule, can be observed for requirements on minimum subscription and minimum paid-in capital. After the 1981 revision, the general rule was that one-third of the capital had to be paid in at the time the company was incorporated.<sup>274</sup> Failure to do this led to

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stipulated supermajority requirements for decisions, such as changes in corporate capital. *See id.*

<sup>270</sup> *See* Decree with Force of Law (DFL) 4705 of July 14, 1947 art. 26 (Chile); because the meeting can make valid decisions if 50.01% of the shareholders are present, in effect this means that such decisions can be taken by twenty-six percent of the outstanding votes.

<sup>271</sup> Decree with Force of Law (DFL) 251 of May 20, 1931, art. 10 (D.O., May 22, 1931) (Chile).

<sup>272</sup> Law 17308 of June 29, 1970 (D.O. July 1, 1970) (Chile).

<sup>273</sup> Law 18046 of Oct. 21, 1981 (D.O. Oct. 22, 1981) (Chile).

<sup>274</sup> *Id.* art. 11.2.



an automatic reduction of the corporate capital after three years.<sup>275</sup> This rule was modified in 1997.<sup>276</sup> Currently the capital must be paid in over a period of three years.<sup>277</sup> Thus, the Chilean law evolved from very rigid state control to a substantially more flexible law especially in the area of corporate finance. Still, some rigidities remain, among them the provision introduced in 1981 that required thirty percent of the company's profits to be paid out in dividends.<sup>278</sup>

Within the French/Spanish legal family, Colombia has retained the most rigid regime in the area of corporate finance. An 1897 law prohibited a decrease in capital.<sup>279</sup> In 1931, the state acquired the power to approve any change in corporate capital. In addition, a unanimous vote by shareholders was required, a provision that was replaced only in 1970 by a seventy percent majority rule.<sup>280</sup> Government control was extended to the evaluation of in-kind contributions in 1951. Share repurchases are restricted and require shareholder approval.

### 5.3.2. *English Common Law Transplants*

Malaysia's regime for corporate finance as of 1965 combines some rigid elements with some more flexible ones. Under the 1965 law, a capital increase required only a simple majority.<sup>281</sup> More strings were attached to decreases in corporate capital, which require a special resolution, and a supermajority vote. Moreover, share repurchase was flatly prohibited under the 1965 law.<sup>282</sup> This provision was revised in 1997<sup>283</sup> to permit share repurchase under certain conditions, including capital decrease, solvency of the com-

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<sup>275</sup> *Id.*

<sup>276</sup> Law 19499 of Apr. 11, 1997 (D.O. Apr. 11, 1997) (Chile).

<sup>277</sup> Law 19301 of Mar. 7, 1994, art. 11.2 (D.O. Mar. 19, 1994) (Chile).

<sup>278</sup> See La Porta et al., *Law and Finance*, *supra* note 6, at 1130 (describing this feature of the French legal system. In fact, it seems to be confined to several Latin American countries that followed the Chilean model.)

<sup>279</sup> Law No. 57/1887 of Apr. 15, 1887, arts. 552 N°8, 559.2, *Adopta el Código de Comercio (C. COM.)*, *Codificación Nacional 1887*, 90 (Colom.) (requiring that the corporation's capital was stipulated in the charter and flatly prohibiting any decrease).

<sup>280</sup> See Decree No. 410/1971 of Mar. 27, 1971, arts. 145, 147 & 421 (revising the *Código de Comercio [C. COM.]*) (D.O. June 16, 1971) (Colom.).

<sup>281</sup> See *Companies Act 1965*, *supra* note 240, § 152(7) (Malay.).

<sup>282</sup> *Id.* § 67.

<sup>283</sup> *Companies (Amendment) Act 1997 (Act A1007)*, § 67 (Malay.).

pany, or the possible cancellation of all rights attached to the shares.

In Israel, under the 1983 law, changes in corporate capital, including capital increases and capital decreases, required a special resolution with a three-quarters majority vote.<sup>284</sup> In addition, capital decreases had to be approved by the court—a provision that can be found in earlier English corporate statutes, but was repealed in England in 1867.<sup>285</sup> Moreover, minority shareholders could appeal to the court to prevent a capital increase. Since 1999, a simple majority suffices for capital increases and capital decreases can be decided by the board of directors, unless the charter requires shareholder approval. Both creditors and shareholders can apply to the court and request a stop on capital decrease. As in England and Malaysia, preemptive rights did not exist in 1929, nor were they introduced in the 1983 revision of the law. Only in 1999 were preemptive rights introduced, albeit limited to private companies.<sup>286</sup> Interestingly, this happened at a time when other countries that so far had strongly adhered to the principle of preemptive rights were moving away from it. The 1999 changes did, however, relax existing law on corporate finance by permitting share repurchases by the corporation. The reason for the apparent inconsistency in the treatment of corporate capital—strengthening of shareholder rights by including preemptive rights on the one hand and relaxing mandatory rules by allowing for share repurchase on the other—may be the only recent experience with the Asian financial crisis. In crisis situations, a share repurchase can be an important device to prevent the total collapse of share prices.<sup>287</sup>

### 5.3.3. *German and United States Transplants*

Corporate finance regulation in Japan is a true hybrid of the two systems from which it derived its corporate law. The country has been much more faithful to the German model than one might

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<sup>284</sup> Companies Ordinance 1929, *supra* note 238.

<sup>285</sup> Companies Ordinance (New Version), *supra* note 244, § 45(1) (requiring only court “confirmation,” not approval).

<sup>286</sup> Companies Law 1999, *supra* note 246, § 290.

<sup>287</sup> Following the market crash in October 1987, for example, many companies instigated major stock repurchase programs. The SEC backed these transactions by stating that they could be made pursuant to the safe harbor provisions of the Exchange Act Rule 10b-18 or even outside the rule, as long as the issuer did not engage in manipulative practices. See *United States Financial Regulation Report*, Dec. 1, 1987, available at LEXIS, News Group File All.

expect. Several restrictions that recall the German model were introduced only recently. An example is minimum capital requirements, which were introduced in 1990 and levied at 10 million yen.<sup>288</sup> The 1898 law did not have the minimum capital requirement—nor did the German law at that time. Like the German model law, the Japanese law specified the minimum par value, which was levied in 1898 at 20 yen and in 1950 was raised to 500 yen. Also, like the German law, in-kind contributions were permissible, but the amount and the number of shares issued in return for the contribution had to be stated explicitly in the charter. The major amendment of the law prior to its replacement by the American-style law, the amendment of 1937,<sup>289</sup> restricted in-kind contributions. Only promoters were allowed to make in-kind contributions and a court appointed inspector had to ensure that they were assessed correctly. This provision was relaxed in 1990 to require an inspector only if the contribution is more than one-fifth of the capital or five million yen.<sup>290</sup>

Post-incorporation share transactions likewise are hybrids. With respect to share repurchases, Japanese law takes an equally restrictive position as German law. In principle, share repurchase is prohibited. The 1938 law exempted formal capital decreases and repurchases as part of merger transactions from this prohibition. The U.S.-style 1950 law<sup>291</sup> lifted the prohibition on repurchases, at least in cases where the repurchase was used to compensate minority shareholders who exercised appraisal rights. 1994 and 1998 Japanese amendments to the corporate law closely resemble recent changes in Germany, and allow repurchases also for employee compensation or stock option plans. Interestingly, preemptive rights were not included in the 1898 law despite the fact that they were known in Germany at the time. The 1950 law makes preemptive rights optional<sup>292</sup>—this time following the trend in other United States jurisdictions that moved away from mandating preemptive rights in statutory corporate law. In 1955, directors were given dis-

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<sup>288</sup> Shōhō nado no Ichibu o Kaisei Suru Horitsu [Law to Revise a Portion of the Commercial Code], Law No. 64 of 1990, art. 168-4 [hereinafter 1990 Revision].

<sup>289</sup> Shōhō nado no Ichibu o Kaisei Suru Horitsu [Law to Revise a Portion of the Commercial Code], Law No. 72 of 1938.

<sup>290</sup> 1990 Revision, *supra* note 289, art. 173.

<sup>291</sup> 1950 Revision, *supra* note 248.

<sup>292</sup> The relevant provision states that preemptive rights are available only if explicitly stated in the charter. *See id.*

cretion over specifying the rights of shares with each new issuance, placing preemptive rights squarely under the control of directors.

#### 5.3.4. *Summary*

Several features of the legal origins have influenced corporate finance provisions in transplant countries. The “Spanish” countries in the sample are much stronger on state as well as on creditor control than other countries, including France, the origin country for this legal family. This difference is important to note, because it refutes the assertion that the cause for the bad performance of the French legal family has much to do with France. In the LLSV data set, the French legal family comprises almost entirely of Latin American countries, as well as Spain and Portugal. Our historical analysis suggests that these countries followed a different path of legal evolution of corporate law than France. It may also explain the puzzle that LLSV themselves raise at the end of their original paper on law and finance, namely that after all France is a “rich” country.”<sup>293</sup>

The common law transplant countries did not evolve significantly during the first decades after the law was enacted. Malaysia’s law today still resembles the English law prior to 1972, when the United Kingdom joined the European Communities, although some important changes were introduced in 1999. These changes can be attributed to the experience of the Asian financial crisis and thus might be said to mark the event of corporate law change in response to domestic events. Israel also left the original law of 1929 unchanged for a long time. The 1983 revisions reflect government policies that favor state control. The 1999 revision of the law focuses more extensively on shareholder rights protection, but retains some flavor of a mandatory rather than enabling corporate law.

#### 5.4. *Complementary Controls in Transplant Countries*

For the four origin countries, we argued that jurisdictions that considerably relaxed statutory provisions and moved increasingly to an enabling corporate law developed important complementary control devices. We identified three such devices: exit rights, judicial recourse, and securities market regulation. The above discussion of the development of corporate law in the six transplant

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<sup>293</sup> La Porta et al., *Law and Finance*, supra note 6, at 1152.

countries has shown that these countries have not been much inclined to liberalize their statutory laws. This applies not only to the civil law transplants, but also to the common law transplants; though the law has become more flexible in Chile in 1981, and in Israel and Malaysia with the latest reforms in 1999.

If our argument that exit rights, judicial recourse and securities regulations are complementary to an enabling corporate law is correct, we should expect that the six transplant countries have not developed the full set of complementary control devices. Indeed, this is what we find especially with regards to exit rights and judicial recourse. We do, however, observe major strides towards the development of a securities regulation in several countries.

#### 5.4.1. *Exit Rights*

Exit rights are particularly underdeveloped in transplant countries. Japan is the only country where appraisal rights appear on the books, an artifact of the 1950 U.S.-based revision. Under the 1950 law, appraisal rights can be invoked in formal mergers when all or substantial parts of the firm's assets are sold, or when the business is put up for lease.<sup>294</sup> In 1966, the list of decisions that could trigger appraisal rights was extended to include amendments of the corporate charter,<sup>295</sup> and in 1999 to include compulsory share exchange.<sup>296</sup> We are not aware of mandatory takeover provisions in any of the transplant countries.

#### 5.4.2. *Judicial Recourse*

The two common law legal transplants received not only statutory corporate law from England, but also the notion that most, if not all, rights are justiciable. This principle together with procedural rules that give standing in court may be necessary, but not sufficient to make judicial recourse an effective complementary control device. When comparing English law with the law of Delaware, we noted already that shareholder suits are much less common in England and that derivative action was recognized only in the 1970s; whereas, this particular device has developed

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<sup>294</sup> 1950 Revision, *supra* note 248.

<sup>295</sup> Shōhō nado no Ichibu o Kaisei Suru Horitsu [Law to Revise a Portion of the Commercial Code], Law No. 83 of 1966.

<sup>296</sup> Shōhō nado no Ichibu o Kaisei Suru Horitsu [Law to Revise a Portion of the Commercial Code], Law No. 225 of 1999.

into the most potent weapon for shareholders in Delaware.<sup>297</sup> Unfortunately, we lack data on shareholder suits for Malaysia or Israel to explore the extent to which this control mechanism is used in practice. Better data exist for Japan. The 1898 law did not provide for derivative suits. Under the 1950 law, shareholders holding shares for at least six months could bring a derivative action if a request to the auditor did not result in legal action by the company. But, despite this change, and subsequent changes in the 1980s that were intended to strengthen shareholder democracy,<sup>298</sup> shareholders filed fewer than twenty derivative suits from 1950 to 1990.<sup>299</sup> In 1993, however, the filing fee for shareholder suits was lowered from a percentage of damages claimed to 8200 yen (about U.S. \$75).<sup>300</sup> The number of lawsuits including shareholder suits and derivative actions has since increased by over 10,000 percent.<sup>301</sup> This is important evidence that changes in corporate law may not suffice to ensure that complementary control mechanisms will be used in practice. Of at least equal importance are procedural rules, including filing fees as well as rules governing the fee structure of lawyers.<sup>302</sup> For the evolution of corporate law, this implies that legal change will remain partial as long as only some aspects of the system change, while other remain in place. Japan is a particularly good example to demonstrate the interplay of a system whose procedural rules stem from a civil law transplant and were not compatible with the new control mechanisms introduced with the U.S. style corporate law.<sup>303</sup> The experience of this country supports the notion that full convergence of corporate law or corporate

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<sup>297</sup> For a critical view of the effectiveness of shareholder litigation, see Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991).

<sup>298</sup> Yoichiro Taniguchi, *Japan's Company Law and the Promotion of Corporate Democracy: A Futile Attempt?*, 27 COLUM. J. TRANSNAT'L L. 195, 195 (1988).

<sup>299</sup> Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. INT'L LEGAL STUD. 351, 351 (2001). For an earlier discussion of shareholder derivative actions, see Mark D. West, *The Pricing of Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436 (1994).

<sup>300</sup> West, *The Pricing of Derivative Actions*, *supra* note 300.

<sup>301</sup> *Id.*

<sup>302</sup> It has often been noted that contingency fees play a crucial role in promoting class derivative actions, as lawyers serve an important role as intermediaries who solve the collective action problems shareholders face. See, e.g., Romano, *supra* note 298.

<sup>303</sup> Some changes in the Civil Procedure Code of Japan were introduced under American occupation. However, by and large, Japanese civil procedure continued to follow the German civil law model.

governance systems is unlikely, as existing institutions will shape the path of legal evolution.<sup>304</sup>

French civil law transplants were at first reluctant to grant shareholders extensive rights to judicial recourse. The 1829 Spanish code explicitly limited directors' liability by stipulating that managers, as long as they acted within the limits established by corporate bylaws, could not be held liable. An open question was whether directors could be held liable for failing to implement obligations of the bylaws. This was remedied in the 1869 revision of the law.<sup>305</sup> In principle, directors' liability was confined to violations of general agency law. A broader liability was introduced in 1951, but this time procedural rules limited litigation. A lawsuit could be brought only if the shareholder meeting, or at least ten percent of the stockholders supported it.<sup>306</sup> In 1989, this threshold was lowered to five percent.<sup>307</sup> Chile was even more restrictive. Until 1981, shareholders could merely apply to the supervisory authority to make use of its discretionary powers to intervene. Consequently, the only course of action was for damages that resulted from the revocation of the government license as a result of directors' misconduct. A general provision giving shareholders the right to sue management for damages was introduced only in 1981, but derivative action is still not an option.

As in Chile, Colombian law did not provide for shareholder suits. In 1931, shareholder suits became permissible, but only for intentionally caused damages.<sup>308</sup> The law did not specify the procedure for bringing a suit on these grounds, and thus shifted the burden of uncertainty to the parties contemplating to bring such a suit.

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<sup>304</sup> On the path dependency of corporate law and corporate governance, see Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *STAN. L. REV.* 127 (1999).

<sup>305</sup> *Quiebra de las Compañías*, *supra* note 218, art. 11.

<sup>306</sup> *Ley sobre Régimen*, *supra* note 221, arts. 80 (1), (3).

<sup>307</sup> *Sociedades Anónimas*, *supra* note 251, art. 134. It is worth noting that the 1951 liability norm imposed the high onus of proof of "*dolo o culpa grave*" with regard to the violation of corporate interest—a very imprecise and vague concept—that in practice was almost impossible to meet. Consequently, there were practically no such actions after 1951. In 1989, this was amended by requiring only "*dolo, culpa grave, o culpa leve*," i.e., normal negligence is sufficient.

<sup>308</sup> See Law No. 58/1931 of May 5, 1931, arts. 41 & 42 (D. O. May 8, 1931) (Colom.).

### 5.4.3. Securities Regulation

Securities regulations have also remained underdeveloped. While some countries experimented with establishing a legal regime prior to the advent of market development, others have lagged behind even as markets developed more rapidly. Several countries ensured direct state control over the markets by vesting a ministry or other executive agency with the right to regulate markets rather than establishing an independent regulator.

Moreover, it is important to note that in many countries the agency in charge of securities market regulation is not an independent agency, but operates under direct control of the Ministry of Finance, or an equivalent. Rather than using securities regulation as a complementary control device for shareholders and investors, it was frequently used as an instrument of direct state control.

Japan received a slightly modified version of the 1933-34 U.S. securities legislation in 1948.<sup>309</sup> A viable market, however, developed only in the 1970s.<sup>310</sup> Some of the institutional innovations that had been introduced under United States occupation were soon reversed. In particular, jurisdiction over capital market regulation and control was soon moved from the newly-created Japanese Securities and Exchange Commission back to the Ministry of Finance ("MoF"). This move was reversed only in 1992 when the Securities and Exchange Surveillance Commission ("SESC") was established. Yet, this entity is not formally independent from MoF, but an external bureau of the ministry.

Malaysia had one of the most developed capital markets in East Asia in the early 1970s.<sup>311</sup> At first, securities market regulation followed mostly the English system of market self-regulation.<sup>312</sup> In 1973, a comprehensive securities act was enacted and the Kuala Lumpur Stock Exchange promulgated detailed listing require-

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<sup>309</sup> See Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT'L. L. 423, 431 (1994) (stating that the 1948 version of the Securities and Exchange Law in Japan drew heavily on the U.S. Securities Act of 1933 and the U.S. Securities and Exchange Act of 1934).

<sup>310</sup> See PISTOR & WELLONS, *supra* note 30, at 94.

<sup>311</sup> Zeti Akhtar Aziz, *Financial Institutions and Markets in Malaysia*, in FINANCIAL INSTITUTIONS AND MARKETS IN SOUTHEAST ASIA: A STUDY OF BRUNEL, INDONESIA, MALAYSIA, PHILIPPINES, SINGAPORE, AND THAILAND 110 (Michael T. Skully ed., 1984).

<sup>312</sup> For a critique of this system in developing countries such as India, see Robert C. Rosen, *The Myth of Self-Regulation or the Dangers of Securities Regulation Without Administration: The Indian Experience*, 2 J. COMP. CORP. L. & SEC. REG. 261, 288 (1979).



ments.<sup>313</sup> Jurisdiction over market supervision was divided among several state agencies, including the Ministry of Finance, the Registrar of Companies, and the Capital Issues Committee. In 1993, after a decade of rapid market development, control was unified in the hands of a newly-established Securities Commission ("SC").<sup>314</sup> Prior to the Asian crisis, the SC was set to replace the detailed merit regulations with a system based primarily on disclosure. The crisis, however, led the state to re-capture control rights over economic activities, and the prospects for the liberalization of the securities regime are not clear at this point.

Israel has a comparatively well-developed market, although in recent years many important companies have migrated to U.S. markets.<sup>315</sup> As in Japan and Malaysia, growth accelerated only in the 1980s—with a substantial lag after a regulatory regime had been put in place. The securities and exchange law<sup>316</sup> introduced mandatory disclosure rules that are enforced by the Stock Exchange Authority ("SEA"). With the exception of rules introduced in 1981 that prohibit insider trading, there have been few changes to this law.

Spain enacted a law on stock exchanges as early as 1854. The primary task of the regulation at the time was to establish some form of order at the exchange. The law explicitly ruled that the regulator had to watch that brokers would appear "without weapons, walking sticks or umbrellas, indifferent of their rank."<sup>317</sup> The state did not intervene in the regulation of the exchange, which was entirely self-regulated. This has not fundamentally changed, although a state supervisory agency inspired by the U.S. model was established in 1988 to enforce securities regulations.<sup>318</sup>

Chile established a securities market supervision authority in 1931, but like Spain, authorized stock exchanges to self-regulate. The amount of information corporations had to submit to the authority prior to public offers was substantially increased in the 1981 law. In addition, insider trading was prohibited. The definition of

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<sup>313</sup> Securities Industries Act of 1973, Laws of Malaysia, Act 112 (repealed by Act 280).

<sup>314</sup> Securities Commission Act of 1993, Laws of Malaysia, Act 498 (1993).

<sup>315</sup> Edward Rock, *Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Markets*, 2 THEORETICAL INQUIRIES IN L. 711, 741 (2001).

<sup>316</sup> Securities Law, 1968, S.H. 541, 234 (Isr.).

<sup>317</sup> Decree of March 11, 1854, art. 3, n°3 (Spain).

<sup>318</sup> For serious violations, however, the Ministry of Economy has to be involved. Law 24/1988 of July 28, 1988 (Spain).

insider trading was expanded in 1994. Finally, Colombia created a supervisory authority for all corporations in 1931. In 1979, a supervisory authority for stock exchanges was created.

## 6. THE EVOLUTION OF CORPORATE LAW IN COMPARATIVE PERSPECTIVE: CONCLUDING OBSERVATIONS

In this Article, we analyzed in some detail the evolution of corporate law in ten jurisdictions. By its very nature, a cross-country comparison captures only part of the actual development in each country. Most importantly, we have neglected the analysis of case law, although we do note the importance of judicial recourse as a complementary control device. Nevertheless, we believe that our analysis has offered new insights into observable patterns of legal change. One of the most important lessons that can be drawn from this Article is that corporate law does not evolve in isolation, but in close interaction with socioeconomic conditions and politics, as well as other parts of the legal system. This implies that isolated change of some provisions in corporate law can have at best little impact on the overall direction of the evolution of corporate law.

Our findings have bearing on several debates that are currently unfolding in the comparative corporate governance literature, including the debate on convergence versus divergence, on the role of legal families in determining the content of law, and on the pattern of evolution in origin versus transplant countries. We briefly relate our main findings to each of these three literatures.

### 6.1. *Convergence Versus Divergence of Corporate Law*

The convergence versus divergence debate focuses on the trend in the late 1990s marked by the integration of financial markets and increasing competition for international capital. These forces are widely viewed as a motor for formal, or at least functional, convergence.<sup>319</sup> Others maintain that path dependency implies that coun-

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<sup>319</sup> Most explicit on the prospects of convergence are Hansmann and Kraakman, in a recent article, proclaiming that "shareholder value" has been accepted as the overriding goal for corporate governance, or is bound to be embraced by most jurisdictions shortly. See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440 (2001). On functional convergence, see Coffee, *The Future As History*, *supra* note 202; John C. Coffee, Jr., *Convergence and its Critics: What Are the Preconditions to the Separation of Ownership and Control?*, COLUM. CENTER FOR L. & ECON. STUD. (Working Paper No. 179, Sep. 2000); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, COLUM. CENTER FOR L. & ECON. STUD. (Working Paper No. 174, May 2000); Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory*

tries will continue to diverge even under pressures of global competition.<sup>320</sup> They reason that corporate law is only one element in a complex institutional structure, which adapts and changes only partially, and will ensure that different countries follow idiosyncratic paths of institutional change.

Taking a historically informed perspective, we propose that the history of the evolution of corporate law is one of initial convergence followed by increasing divergence, which has been only partially reversed over the past ten to fifteen years. The evolution of corporate law started from a rather primitive set of rules closely emulating existing charters of corporations, but failing to anticipate the challenges posed by business innovations which accompanied the take-off in industrialization and company formation, and which exposed weakness in the existing structure of corporate law. Each legal system responded to the challenges this posed in different ways. The next wave of corporate laws thus saw increasing divergence across legal systems. As we have documented, in some countries, the liberalization led to a founders' boom only to be followed by a major crash. While most countries experienced some financial market crises after the initial liberalization of corporate law, in some countries the boom and bust were stronger than in others.<sup>321</sup> A possible explanation is that countries that jump-started the process of industrialization and economic development relatively late, such as Germany or Spain, had not developed complementary control mechanisms (i.e., an experienced and effective court system) to deter rampant misuse of the possibilities the corporate form conferred to company promoters. In response, legislatures frequently imposed more rigid controls.

Perhaps more interesting than these immediate responses to a crisis is, why the rigid law remained on the books, despite the fact that it imposed substantial costs on companies incorporating in those jurisdictions. In a competitive environment we should observe the relaxation of rigid rules over time, if their costs exceeds their benefits. The resilience of rigid corporate laws can be explained by a combination of increasingly protective economic policies pursued by European countries since the late 19th century, and

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*Disclosure*, 23 CARDOZO L. REV. 675 (2002). For partial formal convergence of Japan's laws and regulations, see West, *Puzzling Divergence*, *supra* note 31.

<sup>320</sup> Bebchuk & Roe, *supra* note 306, at 134.

<sup>321</sup> For a scathing critique of the corporate form argued from the English experience, see H.A. Shannon, *The Limited Companies of 1866-1883*, 4 ECON. HIST. REV. 290 (1933) available at <http://www.jstor.org>.

in particular during the years leading to World War I, and restrictions on regulatory competition that were introduced not surprisingly by those countries that had imposed a more rigid regime. After having succumbed to the pressure from English corporations in moving from a concession to a registration system, France developed the "real seat theory," which compelled corporations with headquarter and major operations in France to incorporate under French law.<sup>322</sup> Germany and Spain also adhere to this doctrine. These legal barriers to regulatory competition have remained in place even as countries have opened their markets to international trade and capital flows.<sup>323</sup> Within these constraints, countries could afford to develop their own idiosyncratic version of corporate law, even if that imposed higher costs on their companies.<sup>324</sup> Some of the legal constraints were used as benchmarks for European company law harmonization, and thus were imposed on other countries within the European Union. The best example is the adoption by the United Kingdom of mandatory preemptive rights, after joining the union.<sup>325</sup>

None of this precludes the copying of Anglo-American elements of corporate law in response to increasing competitive pressures. However, these imports have not resulted in full-fledged convergence. Most importantly, Germany and France have upheld the hallmark of a strictly mandatory corporate law with only a few

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<sup>322</sup> Horn, *supra* note 22. For a deeper analysis of the "real seat theory" and its comparison with the "incorporation theory," see Karsten Engsig Sorensen & Mette Neville, *Corporate Migration in the European Union*, 6 COLUM. J. EUR. L. 181 (2000).

<sup>323</sup> In fact, even within Europe, the real seat theory to this day prevents the free movement of corporations, even after the European Court of Justice ruled that legal barriers were not consistent with the principles established by the Treaty. See ECJ Case 212/97 available at <http://www.curia.eu.int/en>. For a defense of the real seat theory, even after *Centros*, see Werner F. Ebke, *Centros - Some Realities and Some Mysteries*, 48 AM. J. COMP. L. 623 (2000). For a more moderate viewpoint, see Behrens, *supra* note 13.

<sup>324</sup> For a good summary of the achievements of corporate law harmonization in Europe thus far, see WYMEERSCH, *COMPANY LAW*, *supra* note 141.

<sup>325</sup> By contrast, co-determination never found sufficient acceptance by other member states and, indeed, stalled the harmonization of key areas of corporate law, including the fifth directive on the organizational structure of corporations and the tenth directive on the transfer of seat without liquidation. See Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT'L REV. L. & ECON. 203 (1994) (suggesting that co-determination has been the stumbling block at the core of European company law harmonization, and that flexible approaches to this problem are needed in order to achieve harmonization).

complementary control devices. Courts continue to play only a minor role in enforcing shareholder rights, despite the fact that both countries have increasingly acknowledged the need for some judicial review of directors' actions. Finally, national securities regulations have been strengthened to support the integration of financial markets, including the market for financial intermediaries in Europe.<sup>326</sup> Nevertheless, the effectiveness of securities market regulation on the common market is still subject to debate. While some favor a European regulator, others see the future in the cooperation of regulators.

We conclude from this that in countries where corporate law did not give much room for experimentation, complementary control devices have remained underdeveloped. The liberalization of corporate law may result in the development of such devices, including new ones. The point is that the outcome is difficult to predict and that we may in fact observe greater divergence than convergence in institutions as a result. Transplant countries suffer even more from the absence of complementary control devices, which may explain why many Israeli companies, for example, choose to incorporate in Delaware or list their shares on Nasdaq, or why we see extensive use of ADR facilities by Latin American countries in recent years.<sup>327</sup>

We thus follow the proponents of the path dependency argument: Given existing institutional constraints in different countries, the importation of elements of corporate law from other jurisdictions will introduce change, and responses to the change, but the outcome of this process is hard to predict and may very well lead to greater diversity, or divergence, rather than convergence of corporate law.<sup>328</sup>

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<sup>326</sup> For a recent overview of financial market regulation in Europe, see Guido Ferrarini, *Pan-European Securities Markets and Regulatory Responses*, 3 EUR. BUS. ORG. L. REV. (forthcoming 2002), available at <http://www.ssrn.com>.

<sup>327</sup> Coffee, *The Future as History*, *supra* note 201, explains this development with functional convergence. Companies emigrate from jurisdictions with weak corporate shareholder protection to jurisdictions with strong securities regulations, which essentially substitutes for weak corporate law. Our argument is slightly different. We suggest that a condition for migration is a more liberal corporate law which, however, requires complementary control devices. This argument is consistent with trends to liberalize corporate law and, by implication reduce—not strengthen—some of the statutory shareholder protections we observed in Chile.

<sup>328</sup> This does not exclude the possibility of functional convergence, i.e., similar outcomes irrespective of institutional differences. The concept of functional convergence is analytically difficult to handle. Much depends on what we regard

## 6.2. Legal Families

Our results confirm that legal families display differences in corporate law, certainly with respect to the origin countries, but to a lesser extent, with respect to legal transplants, as discussed later. Common law countries have relied less on legislated constraints on the corporate enterprise. Courts, self-regulators, and state regulators have filled much of the void. Civil law countries are more inclined to legislate mandatory structures and give less room for experimentation on the one hand, and for the evolution of complementary control devices on the other.

Our argument differs from the one put forward by LLSV. They purport to show that common law jurisdictions have stronger protection of minority shareholder rights than civil law countries. A closer examination of the origins of these protections and the time they were adopted in England, the mother country of the common law, however, has shown that it is hard to make a case that these are in fact genuinely common law type provisions. We have also demonstrated that with regard to legislated controls of shareholder rights on the books, Delaware has indeed followed a race to the bottom as proposed by Cary many years ago.<sup>329</sup> That, however, does not necessarily imply that Delaware law does not protect shareholder rights.<sup>330</sup> In fact, the Delaware example is a glaring example for how misleading assessments of law might be that rely only on a handful of indicators. Effective protection is the result primarily of strong courts that have upheld the principle of fiduci-

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as similar outcomes. If the criterion is raising capital through initial public offerings then functional convergence is achieved when companies from different jurisdictions follow this practice, even though they issue shares on foreign markets rather than at home. If a similar outcome however meant changes in the ownership structure and liquid capital markets at home, then migration allows companies to escape domestic constraints. But, if the outcome is divergence, they have to go to international markets, because domestic institutions are different.

<sup>329</sup> See Cary, *supra* note 202, at 705 (discussing Delaware's minimal standards of ensuring proper conduct of corporations and their behavior in the securities market).

<sup>330</sup> Important literature in corporate governance has long pointed out the benefits of an enabling, as opposed to mandatory, corporate law. See EASTERBROOK & FISCHER, *supra* note 170; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); Romano, *Wrong Question, supra* note 170, just to name a few. For a critique of this view, see Bebchuk, *supra* note 38, at 1820 (showing that unrestrained company choice of corporate law rules harms shareholders).

ary duty as the threshold for permissible actions by directors.<sup>331</sup> Procedural rules that encourage litigation and the structure of the chancery court have allowed the effective handling of litigations by judges who specialize in corporate law.<sup>332</sup> Delaware courts in combination with a strong securities market regulator have provided the institutional background against which a highly enabling law has given corporations ample room to experiment with the optimal allocation of control rights between shareholders and management. Seen in this light, the problem of civil law countries has been not so much to offer only weak corporate law protection, but to prevent legal innovations by imposing straightjackets of mandatory legal constraints on companies.

The legal family argument is misleading also in another respect. Much has been made out of the fact that countries belonging to the French legal family have "bad" corporate law,<sup>333</sup> or that corporations in particular from French legal systems have recently migrated to U.S. markets. In contrast, our analysis has revealed important differences between French law on the one hand and the laws of Spain, Chile and Colombia on the other. Until 1981, Chile subjected corporations wishing to enter the market to state approval requirements. The appointment of special corporate investigators allowed direct state control over corporations. Finally, creditor protection has been an important hallmark of the Spanish, Chilean and Colombian law to an extent not known in France. While this does not suggest that all is well in French corporate law, it does hint at least at the possibility that the causes for the problems that corporations in Latin American countries may face, are not directly related to their reception of French commercial law. Note also that in Chile the major reversal of 1981 towards a U.S. style corporate law did not go hand-in-hand with stronger shareholder rights protections, but rather with a more flexible corporate law. In summary, while we agree that countries belonging to a particular legal family share common characteristics, we disagree that the level of shareholder rights protection is the key element that accounts for these differences.

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<sup>331</sup> See Coffee, *Mandatory/Enabling*, *supra* note 184, at 1660 (stating that there is great judicial willingness to monitor a public corporation because of the shareholders' loss exposure).

<sup>332</sup> Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1065 (2000).

<sup>333</sup> Ross Levine et. al., *Growth: With a Focus on Latin America* (1999) (unpublished paper, on file with author).

### 6.3. *Legal Transplants*

Our study included not only origin countries, but also legal transplants in the analysis. We proposed, at the outset of the Article, that transplant countries might follow different trajectories of legal evolution than origin countries. This proposition was based on recent empirical findings that transplant countries differ remarkably from origin countries in the effectiveness of legal institutions, irrespective of which legal family they belonged to. The basic intuition is that even though transplant countries could in theory benefit from receiving a ready-made corporate law that has already gone through the process of trial and error in another jurisdiction, in practice a legal transplant may never take hold, because it offers a bad fit with existing institutions or socioeconomic conditions.

Tracing the evolution of corporate law in six transplant jurisdictions, we find that the pattern of legal change does indeed differ from those found in origin countries. Legal change is much less gradual, but tends to be erratic or stagnant even during periods of rapid socioeconomic developments—periods when corporate legal evolution in origin countries progressed substantially. We take this as an indicator that the actual reception of foreign law, as opposed to its enactment, does indeed take time. Law may be irrelevant for existing business relations at the time it is transplanted—as evidenced by the case of Colombia—or complementary institutions may not be in place to support a highly enabling corporate law—as the example of the Spanish commercial code of 1828 has shown. Most countries in our sample have at some point begun to change corporate laws in response to domestic problems or events. The beginning of an independent process of legal change seems to be a good indicator that a transplanted law has taken hold. The only country where we have not observed such a process is Colombia.

## 7. CONCLUSION

In conclusion, we suggest that the following factors determine the pattern of evolution of corporate law: (1) the demand for corporate law; (2) the broader institutional environment and the capacity of legal systems to develop complementary control mechanisms; (3) external competition, including market and regulatory competition. All three factors are highly interdependent and all interact with the broader socioeconomic, political situation within a



given country, as well as with the degree of external competition, including market and regulatory competition. These findings leave us skeptical of attempts to improve corporate law by transplanting a handful of indicators. Moreover, they are consistent with theories of path dependent legal evolution, but less so with claims of convergence of corporate law.

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