The Background of Modern American Business Law

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Introduction

This is an attempt to explain how common-law jurisdictions developed the distinctive notions of equity that are largely absent from civil law and to outline the major differences in business entity law in the U.S. compared to civil codes. Oddly, the origins of equity lay in "uses," that evolved into the trust, that came from Saxon and Norman concepts, but later disappeared from civil law. The use originated as a tax planning device, designed to avoid the tax imposed by kings who required payment for "livery of seisin," upon transfer of a deceased noble's estate and title, by vesting title in perpetuity in trustees for the use and benefit of heirs. It also served as a device for caretaking of estates when owners went off to the crusades.

Because legal ownership left the hands of the grantor, so did the power to monitor and sanction deviations from the instructions in the indenture. Kings designated Chancellors to handle petitions for righting wrongs not covered by the common law forms, who evolved into the Court of Chancery, with its unique notions of duties such as care and loyalty, and its unique and flexible remedies where damages were inadequate.

The jurisdiction of the Chancery Court, the origin of the recognition of trusts, gradually expanded into a more general jurisdiction over common law subjects, and at some point the concept of a "quasi trustee" developed to regulate the behavior of directors and agents. As law and equity merged the concepts were fully incorporated in Anglo-American law.

The final mystery is how concepts of use and the Saxon "Salman," a concept related to the Roman trusts, failed to develop on the continent in the same way, and notions of fiduciary duties disappeared. My speculation at this time is that civil codes were thought to occupy the law-making field, in the absence of a tradition of judicial law-making in the common law courts.

A brief review of the basic difference between continental and American approaches to corporate flexibility is included, noting that the problems of prescriptive "one size fits all" rules were solved by contracting for deviations that were tolerated by the courts.

[Σ] I thank the participants at the Emory - University of Georgia summer workshop for their helpful comments.

Other types of entities are described primarily for the purpose of illustrating how their origins and character differ from civilian counterparts with similar names.

The final section describes the basics of U.S. securities regulation, and will not offer much of interest to American scholars or lawyers.

I. Equity: The Special Feature of Common Law Systems

One of the unique features of the development of a legal system in England was its division between law and equity. In the fourteenth century there developed separate systems of justice in England.[1] The first and older one involved royal courts. The first of them, the Common Bench, had exclusive jurisdiction on all actions that existed before 1215, the date of the Magna Carta, the great treaty between the King and the nobles that limited the King's arbitrary power. This was the home of most of the common law actions, which were narrowly drawn, and had to be strictly complied with in order to plead a case. The second, the Coram Rege, heard mostly criminal cases, while the third, the Court of the Exchequer, heard mostly tax cases. Until the middle of the fourteenth century, there were no actions for civil harms to individuals. The old writ of trespass only covered acts that breached the King's peace by force and arms. By the middle of this century, the writ was basically expanded into "trespass on the case," to cover special cases for court relief, and included what we would call a tort, or negligence. Eventually this led to actions for breach of contract, called assumpsit at the time. One writer believes the related action for an accounting was the source of the duties we now call fiduciary duties, although other accounts, described below, reach different conclusions.[2]

The common law writs did not cover all possible complaints.[3] The common law was a primitive legal system, with strict pleading requirements - as was early Roman law.[4] As a result, there were many grievances for which there was no legal remedy. Roman law developed the concept of *Aequitas*, which gave judges known as *Praetors* discretion to do justice when no legal authority provided assistance.[5] English citizens with grievances could petition the King for relief. By the late 14th century plaintiffs were seeking relief from the Chancellor, the King's chief highest ranking officer, in lieu of direct petitions to

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1 Much of this is drawn from Charles Donohue, Jr., What Happened in the English Legal System in the Fourteenth Century and Why Would Anyone Want to Know?, 63 SO. METHODIST L. REV. 949 (2010).

2 J. H. Baker, An Introduction to English Legal History, 410, 414-15 (3d ed. 1990). Others claim fiduciary duties had older sources, many of which reached England through ecclesiastical courts. *See generally* Mary Szto, Limited Liability Company Morality: Fiduciary Duties in Historical Context, 23 Quinnipiac L. Rev. 61, 86-92 (2004).

3 Amy Morris Hess & George Gleason Bogert, The Law of Trusts and Trustees §3, at 24-25 (3d ed. 2007) (hereinafter "Bogert").

4 I John Norton Pomeroy, A TREATISE ON EQUITY JURISPRUDENCE §2 (4th ed., Spencer Symons, ed., 1941).

5 Id. at §4.

the King. The Chancellor appointed justices to carry out this work, who constituted the Chancery Court. Most of these justices were clerics as well as trained in the law.[6] They were also generally familiar with Roman law and its principles of equity. This led to the establishment of a court of Chancery under his supervision. It represented the "King's conscience," and it was said (recalling the divine right of kings) that the King could do no wrong. The Chancery had jurisdiction over all matters of equity, including trusts, land law, the administration of the estates of lunatics and the guardianship of infants, as well as other wrongs for which there was no adequate remedy at common law. Thus the Court of Chancery had a far greater power than the common law courts, whose decisions it had the jurisdiction to overrule for much of its existence, and was far more flexible.

A. The Development of the Trust

The most important legal concept that developed in the fourteenth century was the concept of a "use," which we now call a "trust." Its origins are difficult to trace, with some referring to Roman notions of the *fidelicommissio* (the functional equivalent of the modern trust), and related concepts of *fiducia and commendatio*.[7] Others attribute it to a Germanic idea, the Salman, which Germanic tribes apparently inherited from the Romans and brought to Britain through conquest in the early middle ages.[8] The Roman church also was thought to play a role, through the development of ecclesiastical ideas about how church property was owned, and what duties such ownership entailed. The concept of *utilitas ecclesiae* was used for the concept of ownership of church property by a bishop or an abbot, who had no beneficial rights, where property passed automatically to a successor upon the death of the cleric, which evolved into the Gallic "*al os*" and "*uese*" at the time of William the Conqueror in the 11th century.[9] The idea of a use in secular law may have originated during the Crusades of the 12th century, when noblemen traveled abroad to fight in the Holy Land. As they would be away for years at a time it was vital that somebody could look after their land with the authority of the original owner. What we now call a deed or indenture was then called a "feoffment," and it was used to convey title to land to one person for the benefit of another.[10] The common law of England did not provide for a way to dispose of land held by feudal tenure through wills, and instead uses were applied, which allowed a landowner to give his land to one or more feoffees for the use of the grantor, to dispose of it or treat it as the original

[6] Baker, *supra* note 2 at 114; 1 Pollock & Maitland, The History of English Law 172 (2d ed. Cambridge Univ. Press 1968) (1895) .
[7] Szto, *supra* note 2 at 89-92.
[8] Szto, *supra* note 2 at 93-94; Bogert, *supra* note 3 at 18-19.
[9] Szto, *supra* note 2 at 93-94, citing 2 Pollock & Maitland, The History of English Law, 234 (2d ed. Cambridge Univ. Press 1968) (1895).
[10] *Id.* at 228-29.

landowner provided.[11] The common law courts were hostile to this concept and would not recognize the use. Disputes arose over the transferee's performance (he was then called the "feoffee") and were the subject of petitions to the Chancery. Once the concept of a separation of legal ownership from the benefits of property was established in trusts and administration of estates, it was clear that the beneficial owners had no legal power to control the conduct of the feoffee or trustee, but needed the aid of the courts. And so the Chancery Court became active in the supervision of the good behavior of feoffees, trustees, and administrators.

Because the common law courts did not recognize trusts, it fell to equity and to the Court of Chancery to deal with them, as befitting the common principle that the Chancery's jurisdiction was for matters where the common law courts could neither enforce a right nor administer it.[12] The Chancery Court would enforce the duties of the feoffees, or trustees, as the grantor had intended. The use of trusts and uses became common during the 16th century. Indeed, it was used to evade royal taxation, by appointing a self-perpetuating committee of trustees to hold property as directed, until the middle of the 16th century, when the statute of uses banned this use. The trust, with more active management, replaced this form. The Chancery Court's sole jurisdiction over trusts lasted until its dissolution in 1873 through merger with the law courts.[13] Thereafter the English courts were unified, and had the full powers of both the law courts and the Chancery Court.

The United States inherited this system with independence in 1776.[14] To this day, there are separate Chancery Courts in some states, which are courts of equity in the English tradition. The most notable is the Delaware Chancery Court, but similar courts exist in a number of other states.[15] Delaware's is the most notable because of its jurisdiction over corporate disputes, and Delaware's dominance of incorporation of large publicly-traded corporations in the United States. Most states have merged their law and equity courts

[11] The use frustrated the King's ability to collect taxes on death, through "livery of seisin" granting title to the deceased's heirs. King Henry VIII, in dire need of more revenues, got Parliament to ban perpetual uses in the Statute of Uses in 1536. 27 Hen 8 c 10.

[12] 1 Pollock & Maitland, *supra* note 6 at 172-73 (2d ed. Cambridge Univ. Press 1968) (1895).

[13] http://en.wikipedia.org/wiki/Court_of_Chancery#Trusts_and_the_administration_of_estates (last visited 8/6/13). The Court of Chancery ended as a separate entity through merger with the law courts in 1873. Joseph Story, EQUITY JURISPRUDENCE, Chap. 2, p. 55, fn. (a) (14th ed., 1918).

[14] "Inheritance" is not entirely accurate. Most states simply adopted the common law of England, including adopting the English system of a court of equity and the concept of a trust. Bogert, *supra* note 3 §6, at 30-31.

[15] Mississippi, New Jersey and Tennessee also retain separate chancery courts, while Cook County, Illinois has a Chancery Division in its Circuit Court. http://www.bing.com/search?q=State+Chancery+Court&form=MSNH14&pc=U146D&refig=a05b549451204142874e5d335963d06d&pq=state+chancery+court&sc=0-13&sp=-1&qs=n&sk= (last visited Dec. 31, 2013).

into a single system, and the United States merged its federal law and equity systems in 1938. In contrast with the early law courts, which were bound by strict forms of action, the Chancellors were bound by no law, but only by the demands of justice as they saw it.[16]

B. Expansion of Equitable Jurisdiction

From its foundation, the Court of Chancery could administer estates, due to its jurisdiction over trusts. Here it supervised decedents' personal representatives in the administration, and notions of specific duties of these agents developed - what we now call fiduciary duties. But it developed concurrent jurisdiction with the law courts, especially where legal remedies were inadequate.[17] Because partnerships and their extensions, joint stock companies, were not recognized as entities at common law, but as aggregations of individuals, common law courts did not take jurisdiction over claims within the partnership or company. "The appearance of a plaintiff on both sides of the record forced the common law courts to say that the action was impossible, because no man could be both plaintiff and defendant."[18] Over time the Chancery Court expanded its jurisdiction, and developed - probably from administering estates, the notion of an "accounting." One writer describes the action as extended "to all cases where the taking of accounts was necessary to determine mutual rights and obligations."[19] At some time this action was extended to any agent, who was "bound to keep a regular account of his transactions, and always to be ready therewith, and that he ought to be willing faithfully, diligently, and accurately to account, without suppression, concealment, or overcharge, when called upon to do so."[20] One early nineteenth century case involved the purchase by an auctioneer of property he was obligated to sell at auction. His purchase was challenged, and the Court of Exchequer set aside the sale, based on the "well-known and established rule of equity that persons who are in any way invested with a trust or an employment to be performed by them to the advantage of their *cestui que trust* or principal are, prima facie, virtually disqualified from placing themselves in a situation incompatible

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[16] "Equity is a roguish thing. For Law we have a measure, know what to trust to; Equity is according to the conscience of him that is Chancellor, and as that is larger or narrower, so is Equity. 'T is all one as if they should make the standard for the measure we call a "foot" a Chancellor's foot; what an uncertain measure would this be! One Chancellor has a long foot, another a short foot, a third an indifferent foot. 'T is the same thing in the Chancellor's conscience." John Selden, TABLE TALK, 43 (Pollock ed., 1927)

[17] Pomeroy, *supra* note 3 at §§ 173-189, 216-22.

[18] Peter Turner, Equitable Doctrines in Business Associations, in Equity and Administration, Chap. 8 (2016), also found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2795112, at 9. (last visited 8/21/2016).

[19] D. M. Kerly, AN HISTORICAL SKETCH OF THE EQUITABLE JURISDICTION OF THE COURT OF CHANCERY, 148 (1890).

[20] George Jeremy, A TREATISE ON THE EQUITY JURISDICTION OF THE HIGH COURT OF CHANCERY, 513 (2d American Ed., 1840).

with the honest discharge of their duty."[21] While no authority is cited, the opinion assures the reader that there are "very many authorities" in support of this doctrine. One suspects that lawyers with experience in the Chancery Court assumed that other relationships of trust, albeit not involving a formal conveyance, would be subject to the same doctrine.

C. The Development of the Derivative Action

The derivative action addresses the problem of who can address wrongs to a corporation when its affairs are controlled by those accused of wrongdoing – the directors. With respect to royally chartered corporations, the sovereign initially reserved the right of visitation (inspection) of these entities, while ecclesiastical and charitable corporations were subject to visitation by the bishop or the founder.[22] By the 16th century, the Charitable Gifts Act provided the Chancellor with a mandate to inquire into corporate affairs on the complaint of an aggrieved party.[23] One case reasoned that if the King could visit his creations and enforce against wrongdoing, then by implication so could founders of private charities or someone nominated by the founder.[24] This was followed by a holding extending the right of action to members of corporations.[25] Here the justification given was the absence of an adequate remedy at law. The next step was the creation of a right of action on behalf of themselves and all other shareholders – the derivative action – designed to protect the entire corporation, rather than individual shareholders.[26]

While these developments occurred in England, similar developments were occurring in the United States. The first such case appears to be Robinson v. Smith, where shareholders of a joint stock company sued the directors for diverting corporate funds to unauthorized uses, which caused the company a great loss. In finding that the stockholders could bring such a suit alleging injury to the company, Chancellor Walworth, relying on English authorities, stating the reason for his ruling as follows:

> . . . since the introduction of joint-stock corporations, which are mere partnerships, except in form, the principles which were formerly applied to charitable corporations in England may be very appropriately extended to such companies here. The directors are the trustees or managing partners, and the stockholders are the *cestuis que trust*, and have a joint interest in all the property

21 Oliver v. Court, 8 Price 127, 1814-1823 All Eng. Rep. 645 (1820).

22 This account is taken generally from Lynden Grigg, The Statutory Derivative Act: Lessons that May be Learnt from its Past, 6 U. W. Sydney L. Rev. 63, 68-69 (2002).

23 43 Eliz. 1, c. 4.

24 Eden v. Foster, 2 P. Wms. 324, 24 E.R. 750 (1725).

25 Adley v. Whitstable Company, 17 Ves. Jun. 315, 34 E.R. 122 (1810)

26 Grigg, *supra* note , at 690-71.

> and effects of the corporation. See Wood, Inst. bk. 1, chap. 8, p. 110; 11 Co. 98, *b*. And no injury the stockholders may sustain by a fraudulent breach of trust can, upon the general principles of equity, be suffered to pass without a remedy.27

D. Concurrent Jurisdiction and Remedies.

How fiduciary duties moved from the concepts of trusts to other legal relationships in the law courts is a neglected subject.[28] One author notes that over time chancellors were appointed more from the common law bar than from the clergy, which led to more systematization of the *ad hoc* concepts of justice employed by earlier chancellors.[29] After the Bubble Act of 1720 prohibited trading in the shares of joint stock companies in England, corporate attributes of a separate legal personality, such as the power to convey business property without the consent of all investors (partners) in the company were achieved to a large extent by the creation of trusts to hold the business property, with the directors as trustees.[30] The use of the trust form implied the same fiduciary duties that Chancery was accustomed to applying to trustees in other contexts, and may explain the continuing application of these duties to directors of other corporations. Eventually the Chancery assumed jurisdiction over many common law causes of action, with its reliance on general principles of justice and its more flexible remedies.[31] Pomeroy characterizes directors as quasi-trustees, because of the power and responsibilities placed on them.[32] He also reports that the common law courts rejected the ancient principles of Roman law, thus leaving Chancery to develop principles of equity and justice for all of English law.[33]

According to Finn, the fiduciary duty concept reached the law reports in the mid-19th century.[34] I was surprised to learn during my research that some authorities claim the concept of fiduciary duties of agents developed not in the Court of Chancery, but in the common law courts.[35] Pomeroy describes suits against directors and officers of

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[27] 3 Paige Ch. 222, 1832 N.Y. LEXIS 72, *20 (1832).
[28] P. D. Finn, Fiduciary Obligations, 1 (1977).
[29] Janni Riordon, A History of Equity, www.jaani.net/resources/law_notes /***equity**_and _trusts/01_**History**.pdf* (2006) (last visited 3/5/2015); Patricia Loughlin, The Historical Role of Equitable Jurisdiction, in Patrick Parkinson, ed., THE PRINCIPLES OF EQUITY, 13-14 (1993).
[30] 6 Geo. I, c. 18. Gary M. Anderson & Robert D. Tollison, The Myth of the Corporation as a Creation of the State, 3 Int'l Rev. L. & Econ. 107, 111 (1983); David L. Perrott, Changes in Attitude to Limited Liability - The European Experience, in LIMITED LIABILITY AND THE CORPORATION, 81, 94-95 (Tony Orhnial, ed. 1982); L. C.B. Gower, Principles of Modern Company Law, 29 (5th ed. 1992).
[31] Pomeroy, *supra* note 4 at §§ 32-38; Grigg, supra note 22 at 69-71.
[32] Pomeroy, *supra* note 4, at §1089.
[33] Pomeroy, *supra* note 4, at § 38.
[34] Finn, *supra* note 28.
[35] Oliver v. Court, *supra* note 21 was decided in the Court of Exchequer, not the Chancery. Mark Fortier, THE CULTURE OF EQUITY IN EARLY MODERN ENGLAND, 71-73 (2005). Fortier cites Edward Hake,

corporations as within the jurisdiction of courts of equity as well.[36] Pomeroy also describes directors and managers as being "quasi trustees" who are subject to fiduciary duties.[37] In some cases, involving joint stock companies, they were actual trustees. To avoid the procedural difficulties of having to join all partners or members in any litigation, these organizations often used the trust to hold the company's assets to avoid procedural difficulties.[38] The fiduciary duties developed in exactly the same manner as they did for trustees and administrators of estates, which I surmise happened either because notions of fiduciary duties had become customary law, or because of the jurisdictional competition between Chancery and the common law courts.[39] They were applied to relationships which involved trust, but did not meet the formal requirements of a trust - a deed or indenture.[40] There are three elements to these fiduciary duties: "(1) entrustment of property or power, (2) entrustors' trust of grantees, and (3) risk to the entrustors emanating from the entrustment."[41] The common law courts followed with similar rules for other fiduciaries, such as directors of corporations recognized as chartered by the King.[42] The Delaware Chancery Court plays an active role in supervising

EPLEKEIA: A DIALOGUE ON EQUITY IN THREE PARTS (1953) for the proposition that equity arises in common law from the flexibility of judges to exercise reasonable discretion in applying laws.

[36] IV Pomeroy, *supra* note 4, §1089; V Pomeroy, *supra* note , §1411.

[37] I Pomeroy, *supra* note 4, §157.

[38] Turner, *supra* note 18, at 9.

[39] Fortier argues that the concept of equity permeated English culture in the 17th century. Fortier, *supra* note 35 at 2.

[40] Finn, *supra* note 28 at 1.

[41] Tamar Frankel, FIDUCIARY LAW, 4 (2011).

[42] See Victor Morawetz, MORAWETZ ON CORPORATIONS, 2d ed. §516 (1886), citing, *inter alia*, Hoyle v. Plattsburgh &c R. R. Co., 54 N.Y. 314, 328 (1873) where Judge Johnson wrote:

> Whether a director of a corporation is to be called a trustee or not, in a strict sense, there can be no doubt that his character is fiduciary, being intrusted by others with powers which are to be exercised for the common and general interests of the corporation, and not for his own private interests. He falls, therefore, within the great rule by which equity requires that confidence shall not be abused by the party in whom it is reposed, and which it enforces by imposing a disability, either partial or complete, upon the party intrusted to deal, on his own behalf, in respect to any matter involved in such confidence.

It is revealing that none of the cases cited involved corporate directors. Two of the cases were in the High Court of Chancery, and only one in the law courts. Ex parte Lacey, 31 Eng. Rep. 1228, 6 Vesey 625 (1802), involved the purchase of a bankrupt's property by the trustees in bankruptcy. Gibson v. Jeyes, 31 Eng. Rep. 1044, 6 Vesey 266 (1801), involved an attorney with a power of attorney to sell a client's securities purchasing for himself. ("Every principle applying to trustees applies equally to attorneys.") Greenlaw v. King, 49 Eng. Rep. 19, 3 Beavens 47 (Rolls Court, 1840), involves a loan by a bishop charged by statute with supervising the financing of a parish rectory furnishing money to the rector in exchange for an annuity. In setting aside the transaction, the Master of the Rolls stated:

"The simple question, however, ... is, whether such a transaction as this is can, consistently *with the rules of law*, be allowed to stand. I am of opinion that it cannot, because it is a clear violation of those rules which have been established for the defense of those whose interests and property have been committed to the protection of persons placed in a fiduciary situation. . . ." 3 Beavens at 62. (Emphasis added.)

the internal affairs of corporations incorporated there.[43] This court, in response to management's defense that it had acted in a manner authorized by the statute, stated that "[t]he answer to that contention, of course, is that inequitable action does not become permissible simply because it is legally possible."[44]

This broad charge to courts of equity left chancellors free to ignore laws where to enforce them would lead to fraud or injustice. When law and equity merged, this concept was available to all judges. It led to activist judges, who felt free to do justice regardless of law. I have criticized the Delaware courts for their aggressive use of this power.[45] Civil codes in Europe eradicated the concepts of trust, or holding for the benefit of another, that influenced English law - the German *Salman*, and the French *uese*. Because the civil codes were both rule-based and presumably exclusive and comprehensive, the concepts of trust and fiduciary obligations did not exist in the absence of a statute.[46] Consequently, civil law judges felt constrained by specific rules, and not at liberty to "do justice" in the same manner.[47]

II. The Historic Role of the Sovereign in Corporate Chartering

A. Treatment of Entity Status as Privilege

We turn from the dominant mode of judicial review of the actions of actors in trusts and business enterprises, which even governs relatively new U.S. forms such as the Limited Liability Company,[48] to the evolving role of the sovereign in England and the United States.

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43 For a critical discussion of the Delaware Chancery Court's active role in supervision, *see* William J. Carney & George B. Shepherd, "The Mystery of Delaware Law's Continuing Success," 2009 ILL. L. REV. 1.

44 Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

45 Carney & Shepherd, *supra* note 37.

46 Richard B. Cappalli, Open Forum: At the Point of Decision: The Common Law's Advantage over the Civil Law, 12 Temp. Int'l & Comp. L. J. 87 (1998); John A. Lovett, Another Great Debate? The Ambiguous Relationship Between the Revised Civil Code and Pre-Revision Jurisprudence as Seen Through the Prytania Park Controversy, 48 Loy. L. Rev. 615 (2002); John E. C. Brierly, The Civil Law in North America: The Civil Law in Canada, 84 Law Lib. J. 159, 160-163 (1992) (observing the absence of notions of trusts in Quebec civil law).

47 There is one (minor?) qualification. Many civil codes state the principle of equity and good faith. David Schmid, (Do) We Need a European Civil Code (?), 18 Ann. Surv. Int'l & Comp. L. 263, 280-81 (2012) citing the German Civil Code, but arguing that implementation of such open and general language will vary widely from nation to nation, depending on cultural habits and values. This appears to be the only survival of the concept of *Aequitas* from Roman law. I Pomeroy, *supra* note 4, §2.

48 Szto, *supra* note 2. The U.S. Limited Liability Company (hereinafter "LLC") is not based on forms with similar names in civil law countries, but was an artifact of U.S. tax laws in the 1970s and 1980s. *See* William J. Carney, Limited Liability Companies: Origins and Antecedents, 66 U. COLO. L. REV. 855 (1995) (hereinafter "Limited Liability Companies").

Much of English commerce was accomplished through the joint stock company, which was not an incorporated entity, but essentially a partnership structured by contract in a corporate form of management and control. This meant personal liability for shareholders.[49] One particular problem was that the law did not recognize these companies as separate legal entities. They could not sue and be sued in their own names. All partners were indispensable parties to suits on behalf of partnership. It was generally necessary, in suits on a contract, for plaintiffs to join all partners, since liability was joint, not joint and several.

"Corporation" had a somewhat different meaning in 16th and 17th century England. There were municipal corporations such as the city of London, charitable and educational corporations (Oxford University, etc.), corporations sole (bishops in their office, who held title to church property by virtue of their office) and finally, trading corporations (or so-called private corporations). Note the mixed uses of the corporation - public, private, religious, and charitable.[50]

The unique feature of the corporation was that the law recognized it as a separate legal entity. It could sue and be sued in its own name. It could hold and convey property in its own name. At the same time the Crown wanted to monopolize power over business. Lord Coke, when he was Chancellor of England in early 17th Century, asserted that only the Crown could create a corporation. He wasn't bothered by evidence that law recognized as corporations some ancient entities for which there was no evidence of a royal charter. He made up the "lost grant" theory to explain this.[51]

Early private business corporations were usually given a monopoly privilege, in exchange for performing colonizing and governance services for the crown. The British East Indies Company was given a monopoly on trade with India, in exchange for administering government in conquered lands. Hudson's Bay Company was given similar privileges in trade with Canada. Many American colonies were founded by royally chartered companies. Thus two kinds of companies existed at the same time in England and in the colonies - unincorporated joint stock companies, and royally chartered corporations.

In 1719 the Crown chartered the South Seas Company, with a monopoly on trade with South America. Other unincorporated joint - stock associations were created at the same time for many of the same purposes. They competed for capital with the South Seas Company, and a speculative bubble developed. Stock in the South Seas Company was originally offered for £ 125 per share; within 6 months it was trading at £ 1,000; six

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49 William J. Carney, Limited Liability, in ENCYCLOPEDIA OF LAW & ECONOMICS, 661-62 (1999) (hereinafter "Limited Liability").

50 William Blackstone, COMMENTARIES ON THE LAW OF ENGLAND, Book I, Chap. 18, pp. 457-459 (1765).

51 *Id.,* Chap. 18, at 460-61.

months later it was back to £ 125. This was called the "great South Seas Bubble." To prevent such speculation, and to protect the position of royally chartered corporations, in 1720 Parliament passed the "Bubble Act," which prohibited trading in shares of joint stock companies.[52] But trading never stopped; the law was never obeyed, but it wasn't repealed until 1825.

Parliament acted in 1844 to recognize the separate legal personality of joint stock companies. This act only required companies to register & publicize their members. It wasn't until 1855 and 1856 that Parliament gave shareholders limited liability.[53] The important difference here was that England simply recognized that the incorporated partnership was a separate legal entity. But English law still thought of its origins in contract and partnership law. Thus, it took two or more persons to incorporate a company. This was similar to the Civil Law concept of a company.

In the U.S. colonies, Blackstone's Commentaries on the Laws of England stated that only the King could create a corporation, in contrast to civil law countries.[54] American lawyers, who often only had Blackstone as authority, apparently took this literally. Thus American lawyers thought that only the sovereign could create a corporation, with a separate legal personality. The result was that during the 17th and most of the 18th century all corporations were created either by Parliament or colonial legislatures, as agents of the sovereign.[55] Most chartered corporations were given monopoly powers - toll roads, canals, bridges, mills. Industrial businesses generally weren't incorporated, but used the joint-stock company form.[56] (American Express remained a joint-stock company until the 1960s.)[57]

In 19th century, as industries grew during the industrial revolution, they began to seek charters from the state legislatures. The annual session laws of the states were filled with these charters.[58] Since a corporate charter granted the special privilege of limited liability,

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52 6 Geo I, c 18.

53 Carney, Limited Liability, *supra* note 49, at 663-64.

54 Blackstone, *supra* note 50, Chap. 18, at 462.

55 Of the 317 special charters granted from 1780 to 1801 in the states, nearly two-thirds were for transportation enterprises, 20 percent for banks and insurance companies, 10 percent for local public service enterprises such as water supply, and less than 4 percent for general business enterprises. James Willard Hurst, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970, at 17.

56 The presumption of a grant of monopoly power inherent in a special charter ended with Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 536 (1837), where the U.S. Supreme Court held that a grant by a state was to be strictly construed, and no grant of monopoly could be implied from legislative silence.

57 Peter Z. Grossman (1995), "The Market for Shares of Companies with Unlimited Liability: The Case of American Express", 24 *J. Leg. Stud.* 63-85 (1995).

58 Professor Dodd reported "that by 1830, ... the New England states alone had chartered some 1900 business corporations, of which nearly 600 were manufacturing and mining companies." E. Merrick Dodd, Jr., American Business Corporations until 1860 (1954) at 123. Hurst indicates that of the 317 special

corruption developed in many legislatures, where bribes were required to get a charter.[59] In the 1840s and 1850s many states passed general incorporation statutes, so special legislation was no longer required.[60] These laws were intended to attract new capital investment into local businesses in the states.

American law took the grant from the sovereign as the source of corporate powers, rather than the notion of contract. Perhaps because of this, limited liability was accepted more readily in the U.S. The New England states retained personal liability for shareholders until Massachusetts repealed it in 1830 (the last state to do so). The earliest American corporate law treatise, by Angell and Ames, in 1836, described limited liability as the general rule.[61] The American attitude that corporate characteristics could only be obtained from the sovereign, which was more freely granted by state legislatures, explained why limited liability was more common. In other ways English law was more flexible than American, because of its contractual and partnership origins.[62] In contrast, because of the evolution of the joint stock company in England and in civil law countries, the consent of the owners (analogous to partners) was seen as the source of power. Thus American statutes have generally granted boards of directors exclusive power over the management of the business, in contrast to both British and civil law, which allow shareholders at the general meeting to take action on business matters.

American law viewed the creation of the corporate person as a privilege, to be surrounded by whatever requirements the legislature thought appropriate. But in *Trustees of Dartmouth College v. Woodward*, 17 U.S. (Wheat.) 518 (1819), Chief Justice Marshall held that the grant was also a contract:

> "This is plainly a contract to which the donors, the trustees, and the crown (to whose rights and obligations New Hampshire succeeds) were the original parties. It is a contract for the security and disposition of property." 17 U.S. (Wheat.) at 643-44.

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charters granted from 1780 to 1801 in the states, nearly two-thirds were for transportation enterprises, 20 percent for banks and insurance companies, 10 percent for local public service enterprises such as water supply, and less than 4 percent for general business enterprises. Hurst, *supra* note 58, at 17. The rapidity with which railroad charters were granted is indicated in Morton J. Horwitz, The Transformation of American Law, 1780-1860, at 137, where he pointed out that while Massachusetts had only chartered two insignificant rail-roads by 1829, in the next six years **it** authorized 15 new lines, while New York, with only two in 1829, authorized 48 more in the next five years.

59 Henry N. Butler, Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges, 14 J. Leg. Stud. 129 (1985).

60 Only three states - New York, New Jersey and Connecticut had passed general corporation laws prior to 1845. *Id.* at 143.

61 Joseph K. Angell and Samuel Ames, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE (11th ed. 1882)

62 L.C.B. Gower, Some Contrasts Between British and American Corporation Law, 69 HARV. L. REV. 1369 (1956).

This meant that the state of New Hampshire could not unilaterally amend a charter. But Justice Story showed the states the way out of their future contractual obligations:

> "Unless a power be reserved for this purpose, the crown cannot, in virtue of its prerogative, without the consent of the corporation, alter or amend the charter, or divest the corporation of any of its franchises, or add to them, or add to, or diminish, the number of its trustees, or remove any of the members, or change, or control the administration of the charity, or compel the corporation to receive a new charter." 17 U.S. (Wheat.) at 675.

This reservation of power to amend is reflected in Model Business Corporation Act §1.02, and in the law of every state.

B. The Shift from Mandatory to Enabling Statutes

Until well into the twentieth century most American corporation laws took a "one size fits all" approach and mandated the relationships among officers, directors and shareholders. These statutes generally had the large publicly held corporation as their model. By mid-twentieth century it became apparent that this model did not fit smaller corporate enterprises, especially those with a few shareholders, most or all of whom were active in the business. Unlike civil law nations, the individual states lacked a separate statute for closely held enterprises. Beginning in the 1950s Professor F. Hodge O'Neal began his landmark work on closely held corporations.[63] His treatise on the special issues raised by closely held corporations was first published in 1956.[64] He focused his early writing on the unique governance and stock transfer issues of these entities, and suggested drafting solutions for some of them.[65] At the same time Delaware recognized the need for special statutory provisions for close corporations, and adopted a special subchapter covering them.[66]

Delaware's provisions were optional: an eligible company had to opt into them by filing with the Secretary of State as a close corporation covered by the statute. It expressly authorized restrictions on the transfer of shares, to emulate the partnership model.[67] It also permitted agreements limiting the discretion of directors, and even permitting direct

[63] See generally Dorsey D. Ellis, A Tribute to F. Hodge O'Neal, 66 WASH. U. L. Q. xi (1988). Professor O'Neal's prolific work in this field can be found in a bibliography at *id.* viii.
[64] F. Hodge O'Neal, CLOSE CORPORATIONS: LAW AND PRACTICE (1956).
[65] F. Hodge O'Neal, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 Harv. L. Rev. 773 (1952); Drafting Arbitration Closes for Disputes in Closely-Held Corporation, 9 Arb. L. Rev. 31 (1954); Resolving Disputes in Closely Held Corporations: Intra-Institutional Arbitration, 67 Harv. L. Re . 786 (1954); Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions, 18 Law & Contemp. Prob. 451 (1953. The full list is much longer.
[66] 8 Del. C. 1953, § 341; 56 Del. Laws, c. 50 et. Seq.
[67] *Id.* at §347.

stockholder management.[68] In intracorporate disputes, which could lead to deadlock in two-shareholder corporations, it authorized court appointment of provisional directors to break such ties,[69] and specifically provided that informal operation that deviates from the corporate norms does not invalidate its corporate status.[70] Finally, rather than require majority shareholder consent to dissolve, the close corporation was permitted to contract about dissolution, so that any one shareholder might be permitted to dissolve, a situation close to that of partnerships, where withdrawal of a partner dissolves the firm.[71]

Many courts struggled with allowing such informality and departures from the prescribed statutory model in the absence of such a special subchapter dealing with close corporations.[72] A close corporation chapter was added to the American Bar Association's Model Business Corporation Act in 1984.[73] It was eliminated in later revisions of the Model Act because it was not being used by practitioners with any frequency. To a civil law observer, that must seem strange. But American statutes had evolved over the years from prescriptive to enabling. Voting provisions could vary from the statutory norms in many cases. These enabling provisions were merely default rules, in the absence of contrary choices by drafters of articles of incorporation and bylaws. In 1989 Georgia's version of the Model Act contained at least 38 instances of express authorization of deviations from the prescribed rule.[74] Even before the introduction of special provisions for close corporations, American lawyers were familiar with ways to tailor articles and bylaws, and draft shareholder agreements that deviated from prescribed norms, and were so comfortable with these methods that many saw no need for a special article governing close corporations.

III. The Collapse of State Monopoly Power in Chartering

I mentioned that states began to enact general incorporation statutes in the middle of the 19th century. These statutes provided general powers for all corporations using the statute, and only required some filings and payment of small fees to incorporate. One must ask why state legislators gave up their power to accept bribes in exchange for a corporate charter and the privilege of limited liability. How could competition develop if each state retained a monopoly?

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68 *Id.* at §§ 350-351.
69 *Id.* at §353.
70 *Id.* at §354.
71 Compare *id.* at §355 with Uniform Partnership Act §31(1)(b) (1916).
72 *See, e.g.*, McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934) (invalidating a shareholder agreement covering election and salaries of officers). In contrast, Delaware allowed such agreements even before the close corporation provisions were enacted. Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 53 A.2d 441 (Del. 1947).
73 American Bar Ass'n, Committee on Corporate Laws, REV. MODEL BUS. CORP. ACT (1984) (Chapter 9).
74 William J. Carney, Changes in Corporate Practice under Georgia's New Business Corporation Code, 40 Mercer L. Rev. 655, 657, fn. 7 (1989).

A. The Real Seat Rule as a Barrier to Competition

Until recently civil law countries generally followed the "real seat" rule of recognition of corporate entities.[75] All European countries, except the Netherlands, Switzerland, Denmark, Ireland and Great Britain,[76] held that the law governing a company's existence and internal affairs is that of its real seat, or siege social.[77] The European rule was that a corporation will be governed by the laws of the state where it has its real location or "seat." Its primary effect, then, was as a rule of nonrecognition of pseudo-foreign corporations. While the real seat rule has been described as the dominant rule in Europe,[78] Buxbaum & Hopt questioned this. They characterized the real seat doctrine as being for the special case of local capital seeking to use foreign corporate statutes – pseudo foreign corporations. That, of course, is the focus of this section.[79]

Under the real seat rule the pseudo-foreign corporation will not be recognized as a legal entity in the state where the real seat is located, with the result that its participants will face personal liability for corporate debts.[80] Some nations characterized the use of a

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75 The following is taken from William J. Carney, The Political Economy of Competition for Corporate Charters, 26 J. Leg. Stud. 303 (1997).

76 John P. Kozyris, Corporate Wars and Choice of Law, 1985 Duke L. J. 1, 43; Leleux, Companies, Investment and Taxation in the European Economic Community, 10 Int'l & Comp. L. Q. Supp. 1, 23, 24, 26 (1961); David Charny, Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities, 32 Harv. Int'l L. J. 423, 428, text at note 16 (1991), citing T. Ebenroth, T. Carsten and Uew Eyles, Die Innereuropatische Verlegung des Gesellschaftssitzes als Ausflusss der Niederlassungsfreiheit, 42 Der Betrieb 363, 366 (1989).

77 Peter Hay, Four Lectures on the Common Market: Trade Provisions - German and French Company Law - Establishment, 24 U. Pitt. L. Rev. 685, 755 (1963).

78 Ferenc Madl and Lajos Vekas, THE LAW OF CONFLICTS AND FOREIGN TRADE, 152 (1952).

79 Richard M. Buxbaum and Klaus J. Hopt, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE: CORPORATE AND CAPITAL MARKET HARMONIZATION POLICY IN EUROPE AND THE USA (1988) at 70 (hereinafter "Harmonization.". The characterization is mine; the authors put it somewhat differently:

> In short, one can make the argument that the law of the state or country of incorporation is normally the law governing the internal affairs of European as well as American corporations. The concept of the siege social is designed for the special case only; and not for the special case of simple corporate mobility in the sense of interstate business activity but for the special case of pseudo-foreign corporate distortion (local capital claiming foreign status).

80 Hay, *supra* note 77 at 755, n. 468 cites Weber c. Societe Generale Anglaise et Francaise, 1907 Journal de Droit International Prive 765, where the Commercial Court of Nancy, France held that the defendant company's incorporation in England was fictitious, since no head office was maintained in England, and that the Company had therefore been created in violation of French law, with the result that the company was not recognized, and its owners were personally liable for its *contracts*. *See also* Bouvet, Laubier & Richard c. Societe anonyme Francaise des mines de fer, 1913 Gazette du Palais (2d sem.), 113. Cf. Union des Polonais c. Societe immobiliere de la Rue Faidherbe, 44 Revue Critique de Droit International Prive 103 (1955), cited by Hay, *id.* Italy departs somewhat from this rule, permitting the shareholders to provide for a foreign central office by charter amendment. Hay, *id.*, text at n. 472, citing Italian Civil Code art. 2437. *See also* Elvin R. Latty, Pseudo-Foreign Corporations, 65 Yale L. J. 137, 171 (1955), citing Caro & Cie

pseudo-foreign corporation by a local business as a "fraud on the law."[81] Italy took a different approach, treating such companies as Italian companies, and requiring compliance with Italian law.[82] Correspondingly, the state of incorporation may hold that since the real seat is now in another state, dissolution should result under the law of the state of incorporation.[83]

The real seat rule has been described by commentators as an effort by French authorities to avoid loss of chartering business to competing jurisdictions - first to England and then to Belgium. England was the Delaware of Europe in the second half of the nineteenth century.[84] French entrepreneurs were apparently attracted by the absence of a requirement of an appraisal of property contributed for stock, and the notion of authorized shares for which no subscriptions were received at the time of organization.[85] One of the companies which attempted to take advantage of English liberality was one of the most quintessentially French enterprises of the 19th century - the Parisian cabaret, Moulin Rouge.[86] The anticompetitive nature of the doctrine is best demonstrated by the French reaction when French entrepreneurs incorporated in England and named

v. Societe Franco-Belge de Panification Integrale, Tribunal de Commerce de Bruxelles, March 2, 1901, 29 Clunet 883 and note (France 1902).

[81] See Hay, *supra* note 77 at 755; Kozyris, *supra* note 76, at 52, citing a landmark German decision treating a U.S. corporation with a board of directors that controlled the company from Germany as non-existent, because it had failed to follow German incorporation procedures. The French take the same approach, calling such a situation "*fraud a la loi.*" *See* E. Rabel, THE CONFLICT OF LAWS: A COMPARATIVE STUDY, 43-44 (U. Drobnig, ed., 2d ed. 195). The argument that use of a foreign corporation to conduct a local business is a fraud on the law was rejected in several U.S. courts. State ex rel. Brown Contracting & Building Co. v. Cook, 181 Mo. 596, 80 S.W. 929 (1904); Demarest v. Flack, 128 N.Y. 205, 28 N.E. 645 (1891); Lancaster v. The Amsterdam Improvement Co., 140 N.Y. 576, 35 N.E. 964 (1894). *See also* 2 J. Beale, J. CONFLICT OF LAWS 775(1935) ("It is no fraud or evasion of the laws of a State for its citizens, intending to act only in their own State, to form themselves into a corporation under the laws of another State").

[82] Richard D. English, Company Law in the Single European Market, 1990 B.Y.U. L. Rev. 1413, 1434, text at n. 175, citing G. Certoma, G., THE ITALIAN LEGAL SYSTEM, 94 (1985).

[83] Hay, *supra* note 77 at 755. *See* Queen v. H.M. Treasury & Commissioners of Inland Revenue, ex parte Daily Mail and General Trust PLC, 1988 E. Comm. Ct. J. Rep. 5483, 5503, where Mr. Advocate General Darmon stated:

> Generally, in most of the Member States, the transfer of the central management of the company, in the sense of its real head office, may take place only through the winding-up of the company and its reconstitution in the host Member State.
>
> That solution, the "legal death" of the company, involves the settlement of its tax position ... [c]apital gains are thus taxed even though no disposition of assets has taken place.

[84] Latty, *supra* note 74 at 166, n. 130.

[85] *Id.*

[86] *Id.* at 166, n. 130.

London as their "statutory" seat of business. France simply required that as to foreign corporations doing business in France, "the nominal seat be real - i.e., French".[87]

One of the difficulties with the doctrine is that location of the real seat can be as difficult as location of domicile.[88] The effect, regardless of how the rule is described, is to prevent local businesses from reincorporating in other jurisdictions. Only in recent years has the European Court of Justice ruled that such exclusion is unlawful under the Treaty of Rome.[89]

This barrier to competition gave European company laws a flavor quite different from their English and American counterparts. European company laws featured much more elaborate protections for interest groups other than stockholders - notably creditors and employees. One can only guess what forms of bribery or political support generated such provisions.[90]

While recent court rulings in the European Union have eliminated many of these statutory barriers, there are still language barriers that prevent lawyers and clients in many member states from freely incorporating under the laws of another member state. Those changes are relatively recent, and the overall shapes of modern laws are subject to path dependence, so change is often glacial.

B. Recognition of Foreign Entities in England and the U.S.

Prior to the 1850s American business corporations were sufficiently local that it was assumed or required that they would confine their activities to the state of incorporation, and that a new entity would be required to do business in another state.[91] As a result, the question of recognition of foreign entities remained a bit murky. In the early 19th century courts generally deferred to the law of the state of incorporation and to its courts when an intracorporate dispute arose.[92] When a Georgia Bank sued an Alabama debtor in Federal Court in Alabama, the U.S. Supreme Court held that if Alabama statutes didn't forbid foreign corporations from coming into the state, Federal courts would presume that Alabama recognized them. This was under general principles of comity among

[87] Buxbaum & Hopt, Legal Harmonization, *supra* note 79, at 69, citing Latty, *supra* note 80 at 169-70 and 2 Rabel, *supra* note 77 at 38 & n. 20G.
[88] Kozyris, *supra* note 78, at 52-53.
[89] Case C-212/97, Centros Ltd. v. Erhvervsog Selskabsstyrelsen, 1999 ECJ CELEX LEXIS 708; Case C-208/00, Uberseering BV v. NCC Nordic Construction Baumanagement GmbH, 2002 E.E.C. 1-9919 (2002) and Case C-167-01, Kramer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art, Ltd. 2003 E.C.R.Il-10155 (2003).
[90] Carney, Political Economy, *supra* note 75.
[91] Butler, *supra* note 59 at 150-51.
[92] Frederick Tung, Before Competition: Origins of the Internal Affairs Doctrine, 32 J. Corp. L. 33, 45 (2007).

nations.[93] But that was not a definitive ruling on whether a state was required to recognize them, or admit them to do business locally. That was not decided until *Paul v. Virginia* in 1869.[94] The direct holding of the case was that the state of Virginia could impose different restrictions on a foreign corporation than on local insurance companies, but the negative implication was that foreign corporations had a right to carry on interstate business within the state.[95] This denial of the right to exclude opened the floodgates to state competition to secure charters for companies that might do business anywhere.

Perhaps the most remarkable feature of American corporate law has been the willingness of the several states to recognize the separate legal entity of corporations chartered by other states. The courts of the various states gradually recognized the power of foreign corporations to bring suit in local courts, to own property, and to enter into contracts.[96] The earliest American treatise took the English rule as given: that once a corporation proves that it has been regularly incorporated, it was entitled to bring suit outside its jurisdiction.[97] It was but a short move from that rule to a conclusion that the logic of the rule applied within the United States:

> "But every argument in favor of entertaining, in American courts, suits by corporations created by the laws of a country not forming part of the American confederacy, applies with still greater force to corporations of the States composing the confederacy. It was with much truth said by Judge Cabell, in a case before him respecting the power of a foreign corporation to sue abroad, "It is rendered doubly necessary by the intimacy of our political union, and by the freedom and frequency of our commercial intercourse."[98]

The judicial response seems to have been consistent during the 19th century, apparently relying heavily on English and early American precedent. In 1813 the Massachusetts Supreme Judicial court rejected an argument for non-recognition of foreign corporations, saying:

> The principle suggested by the plea in this case ... has no foundation in any maxim, or in any argument of public convenience or policy, or in any positive

93 *Bank of Augusta v. Earle*, 38 U.S. (13 Peters) 519 (1839).
94 75 U.S. (8 Wall.) 168.
95 That states could not discriminate against or prohibit foreign corporations from engaging in interstate commerce with citizens of the state was established earlier in Gibbons v. Ogden, 22 U.S. 1, 231-32, 239 (1824) (Johnson, J., concurring).
96 Edwin Merrick Dodd, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, 54-56 (1954).
97 Joseph K. Angell and Samuel Ames, TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE §372, 414-15 (11th ed. 1882). It was also the case that England recognized foreign entities, such as limited partnerships, with origins in the Italian *commenda* used for trading firms that were unknown to English law.
98 *Id.*, §373, at 415.

> provision of any statute. Our legislature recognize [sic] in many instances, and to many purposes, corporations existing by foreign laws, particularly those created by laws of any of the United States...."[99]

There seemed to be general agreement in the early cases that the powers of a corporation extended beyond the boundaries of its state of incorporation, with reliance on English and American treatises.[100] Thus the ruling of the Supreme Court in *Bank of Augusta v. Earle* in 1839, that the federal courts would presume that the states would observe principles of comity among nations, and recognize entities created by other states, in the absence of a contrary expression by the legislature, was simply a recognition of the existing law.[101] Judicial attitudes apparently spilled over to influence legislation. In 1807 the New York legislature proposed to bar foreign insurance corporations from maintaining offices in the state. The Council of Revision, a body composed mainly of judges, objected on the ground that it was beneficial for New York residents if foreign insurers were permitted to compete with local corporations.[102]

Beginning in 1852, the states gradually adopted laws that resemble modern statutes dealing with qualification of foreign corporations to do business locally.[103] These statutes put questions of recognition of foreign entities beyond debate in American jurisprudence, by implicitly recognizing foreign entities upon satisfaction of simple conditions. Typically these laws required a foreign corporation to obtain a certificate of authority to transact business locally, which would issue on condition that the corporation make fundamental disclosures comparable to those of domestic corporations, appoint a local agent for service of process, and pay local franchise fees. These statutes were not adopted grudgingly, but as a means of assuring that local citizens could obtain jurisdiction over such corporations, should disputes arise.[104] Such a rule could be partially explained as interest group legislation to benefit local lawyers, since they would be the most likely candidates to prosecute claims against foreign corporations

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99 Portsmouth Livery Co. v. Watson, 10 Mass. 91, 92 (1813).
100 Bank of Washtenaw v. Montgomery, 2 Scamm. 423-424 (Ill. 1840) (citing 1 Blackstone's Commentaries 475, 2 Kent's Commentaries 277, and Angell and Ames, *supra* note 91 at 209; Bank of Edwardsville v. Simpson, 1 Mo. 184-85 (1822); Williamson v. Smoot, 7 Martin (Old Series) 31 (La. 1819); Guaga Iron Co. v. Dawson, 4 Blackford 202 (Ind. 1836); Savage Mfg. Co. v. Armstrong, 17 Me. 34 (1840).
101 38 U.S. (13 Peters) 519, 588-91 (1839).
102 Dodd, *supra* note 90 at 53.
103 Laurens Walker, Foreign Corporation Laws: The Loss of Reason, 47 N. C. L. Rev. 1, 11-15 (1968).
104 See Walker, *id.* at 12, arguing that the decision in Pennoyer v. Neff, 95 U.S. 714 (1877), requiring local service in order to obtain in personam jurisdiction, accelerated the adoption of these statutes. Prior to the Pennoyer decision, approximately 16 states had such laws. Within 20 years the number was 35. In some states these statutes provided that foreign corporations would be treated as if they were domestic corporations, and thus "domesticated" them, apparently as a means of preventing these corporations from removing litigation to the federal courts on the ground of diversity of citizenship. *See* Comment, Multiple Incorporation as a Form of Railroad Organization, 46 Yale L. J. 1370, 1371-72 (1937) (hereinafter "Multiple Incorporation").

in local courts.[105] Until passage of such laws, foreign corporations had the ability to sue in the local courts, but their liability to be sued there was much more limited.

Frederick Tung takes the position that this recognition of local businesses that choose to incorporate elsewhere is an accident of history:

> When courts first began to articulate the doctrine in the 1860s, firms had little choice about where to incorporate: they incorporated in their home states. Shopping for a corporate charter across multiple states was not an option, since a state typically expected or required its domestic corporations to maintain economic ties with the state. This expectation comported with the local nature of most businesses. Firms transacted primarily if not exclusively in local product, labor and capital markets. A firm typically had an identifiable "center of gravity" in one state, and it incorporated there. Each state legislature effectively enjoyed a captive market for its corporate law, which was restrictive in nature. Courts generally agreed that jurisdiction over corporations' internal affairs lay exclusively with the courts of the incorporating state. This doctrine served as a jurisdictional bar to courts outside the incorporating state and not merely a choice of law rule - though the courts of the incorporating state invariably applied local law to resolve internal affairs disputes. This deference to the incorporating state recognized each state's territorial sovereignty over its corporate entities. Initially, this judge-made rule was consistent with legislators' rent-seeking interests. It assured each legislature that sister states would not interfere with the legislature's existing state monopoly on corporate law. Ironically, the doctrine promoted market-sharing among states with respect to corporate law, and not competition.[106]

The remarkable feature of the development of American law in this area was its openness, and the willingness of the states to permit foreign corporations to enter the state and conduct a local, as opposed to an interstate, business. American corporate laws did not become balkanized.[107] Indeed the typical U.S. corporation law permits any

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105 I can personally attest that such motivations are sometimes used to persuade legislators to allow foreign entities to qualify to do a local business. *See, e.g.*, Ga. Laws 1992, p. 1865 §1 (requiring foreign limited liability companies to qualify to do business in Georgia, but at the same time recognizing their status as entities, and providing for appointment of a local agent for service of process).

106 Tung, *supra* note 86, at 44-45.

107 Professor Conard argues that enterprisers commonly formed local corporations in each state, so that a corporation simultaneously became a corporation of more than one state. None of the literature he cites establishes this proposition. Alfred F. Conard, The European Alternative to Uniformity in Corporation Laws, 89 Mich. L. Rev. 2150, 2157, n. 37 (1991), citing Foley, Incorporation, Multiple Incorporation, and the Conflict of Laws, 42 Harv. L. Rev. 516 (1929) and Comment, Multiple Incorporation, *supra* note . The comment describes multiple incorporation primarily as a device used by railroads in the era of special chartering, and offers an explanation specific to that era and form of chartering to explain it: that forms of

foreign corporation, whether incorporated in another state or nation, to qualify to do business in the state on the same terms as local corporations.[108] This provides support for the hypothesis that constitutional provisions mandating a common market (the "negative commerce clause") constrained the states in this arena.[109]

IV. Freedom to Choose Law: Jurisdictional Competition in the United States.

A. The Internal Affairs Doctrine

For jurisdictional competition to exist, there must be freedom of choice of law for incorporators, regardless of the physical location of the business. The internal affairs doctrine, which honors that choice of law, is thus a necessary condition for competition. The internal affairs doctrine has been defined as involving "relations *inter se* of the corporation, its shareholders, directors, officers or agents".[110] The U. S. Supreme Court has recently defined and stated the rationale for the doctrine as follows:

> The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs - matters peculiar to the relationship among or between the corporation

combination were limited, and took approval by both legislatures, usually in the form of authorization of consolidation of operations. Further, domestication, which was not always a form of multiple incorporation, was a device used by states to deny foreign corporations access to the federal courts on diversity grounds. It is not surprising that railroad corporations may have been chartered in multiple jurisdictions, since this may have been a regulatory requirement of the states involved, and, in addition, may have been required in order to gain local power of eminent domain. Insurance companies, another form of business that operated across state lines at an early stage, also were subject to special regulation that may have required local chartering.

108 See, e.g., MODEL BUS. CORP. ACT ANN. 3, §15.01(c) and Offical Comment, (2016 (hereinafter "MBCA"); Kozyris, *supra* note 74 at 86, citing, *e.g.*, Hausman v. Buckley, 299 F.2d 696, 702-03 (2d Cir.) cert. denied, 369 U.S. 885 (1967); *cf.*, First Nat'l City Bank v. Banco Para El Comercio Exterion de Cuba, 462 U.S. 611, 615 (1983).

109 Erin O'Hara and Larry E. Ribstein, Rules and Institutions in Developing a Law Market: Views from the U.S. and Europe, 82 Tulane L. Rev. 2147 (2008). The reach of and rationale for the negative commerce clause are not entirely certain. *See* Note, The Constitutionality of Multistatute Antitakeover "Schemes" Under the Commerce Clause: Potential Consequences of the West Lynn Creamery Decision, 52 Wash & Lee L. Rev. 1475, 1514 (1995).

110 American Law Inst., RESTATEMENT (SECOND) OF CONFLICT OF LAWS §302, Comment a (1971) (hereinafter "Restatement"). Kaplan, Foreign Corporations and Local Policy, 21 Vand. L. Rev., 436, 438, n. 12, quotes a widely accepted definition from North State Copper & Gold Min. Co. v. Field, 64 Md. 151, 154, 20 A. 1039, 1040 (1885):

> Where the act complained of affects the complainant solely in his capacity as a member of the corporation, whether it be as stockholder, director, president, or other officer, and is the act of the corporation, whether acting in stockholders' meeting, or through its agents, the board of directors ... then such action is the management of the internal affairs of the corporation....

See also Kozyris, *supra* note 70 at 15; 2 J. Beale, J. CONFLICT OF LAWS 893-98 (1935); R. Leflar, AMERICAN CONFLICTS LAW § 255 (3d ed. 1977).

> and its current officers, directors and shareholders - because otherwise a corporation could be faced with conflicting demands.[111]

The doctrine is widely accepted, and has become enshrined in the Revised Model Business Corporation Act as a statutory choice of law rule.[112] Confusion surrounds the question of precisely what local rules are the subject of the internal affairs doctrine.[113] Reese and Kaufman make a useful distinction between those acts which can be performed by individuals, and those which are peculiar to corporations, necessarily involving relations *inter sese*.[114] Latty dismissed it as "a mere misnomer for *forum non conveniens*".[115] The *Restatement* provides a list of those items covered by the doctrine.[116]

In the 19th century some courts took the notion of the chartering state as the source of all authority so seriously that they held they even lacked jurisdiction to decide disputes arising with respect to internal affairs.[117] More recently some courts have used the doctrine of *forum non conveniens* to avoid such decisions,[118] but modern American courts will generally accept jurisdiction over such disputes, applying the law of the incorporating state.[119]

During the second half of the twentieth century choice of law was influenced by new scholarship that suggested that the state with the greater "interest" in a dispute should

111 Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).

112 MBCA, *supra* note 108, §15.01(a), provides that the law of the incorporating jurisdiction governs its internal affairs.

113 Justice Cardozo once stated that to undertake an enumeration of when the doctrine applied "would be a difficult and hazardous venture." Travis v. Knox Terpezone Co., 215 N.Y. 259, 264, 109 N.E. 250, 251 (1915).

114 Willis Reese and Edmund Kaufman, The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit, 58 Colum. L. Rev. 1158, 1120 (1958).

115 Latty, *supra* note 17 at 144.

116 Among the items covered are "the original incorporation, the election or appointment of directors and officers, the adoption of by-laws, the issuance of corporate shares, preemptive rights, the holding of directors' and shareholders' meetings, methods of voting including any requirement for cumulative voting, shareholders' rights to examine corporate records, charter and by-law amendments, mergers, consolidations and reorganizations and the reclassification of shares." Restatement, *supra* note 110, §302, Comment a.

117 Kaplan, *supra* note 110 at 443; Latty, *supra* note 80 at 143-44; 17 William M. Fletcher, CYCLOPEDIA PRIVATE CORPORATIONS §8425 (Perm ed. 1933); Restatement, *supra* note 110, §§ 196-97 (1934); Rogers v. Guaranty Trust Co., 288 U.S. 123, 130 (1933) (courts will leave to the state of domicile suits concerning the internal affairs of a corporation); *but see* Williams v. Green Bay & Western R.R. Co., 326 U.S. 549 (1946), where the Supreme Court rejected the doctrine that when the internal affairs of a corporation are involved, a court must decline to hear the case. It treated the problem in terms of the doctrine of forum non conveniens.

118 Restatement, *supra* note 110, §84 Comment d; cf. Williams v. Green Bay & Western R.R. Co., *supra* note 117; Note, Forum Non Conveniens as a Substitute for the Internal affairs Doctrine, Colum. L. Rev., 58, 234 (1958).

119 Kaplan, *supra* note 110, text at note 24.

apply its law, rather than deferring automatically to the incorporating jurisdiction, introducing the possibility of considerable uncertainty into this area of law.[120] American jurisdictions, with the notable exceptions of California and New York, have rejected the opportunity to change their conflicts rules in light of the new conflicts jurisprudence. While conflict of law doctrines have evolved in a flexible manner in other areas of law, that change has had little impact on the choice of corporate law, although noted commentators suggested during the 1950s that local law should be applied to pseudo-foreign corporations.[121] The new jurisprudence rejected mechanical choice of law rules in favor of an examination of which jurisdiction had the most significant contacts with the transaction, in order to allow that jurisdiction to further its own public policies and provide protection for its citizens.[122] The Restatement invited application of this approach to corporate conflicts questions,[123] but thus far the invitation has not been taken up, whether because of statutory enactments such as the Model Business Corporation Act or the reluctance of courts to ignore a traditionally recognized contractual choice of law.[124] One author notes that no serious attempt has been made to reexamine the internal affairs doctrine in light of the new conflicts methodology, asking:

> Are the constitutional strictures too tight or the merits of the rule so obvious and weighty that a reconsideration would be superfluous? Do commentators find the subject too treacherous and unrewarding or are the courts and legislatures too overburdened or tradition-bound to pursue this demanding and complex task? There is probably some truth in all of these possibilities.[125]

With the advent of modern contractarian approaches to corporate law in the United States that suggest the corporation is a nexus of contractual relationships,[126] there is even

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120 Restatement, *supra* note 110, §§ 302, 303-306, and 309. Section 302(2) provides:

"(2) The local law of the state of incorporation will be applied to determine such issues, except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which event the local law of the other state will be applied."

For a critical view of this provision *see* Larry E. Ribstein, From Efficiency to Politics in Contractual Choice of Law, 37 Ga. L. Rev. 363, 366, 377, n. 51 (2003).

121 Latty, *supra* note 80; Reese & Kaufman, *supra* note 114; *see also* Donald Baraf, The Foreign Corporation - A Problem in Choice-of-Law Doctrine, 33 Brooklyn L. Rev., 219 (1967); Note, Limited Liability of Shareholders in Real Estate Investment Trusts and the Conflict of Laws, 50 Calif. L. Rev. 696 (1962).

122 Eugene Scoles and Peter Hay, CONFLICT OF LAWS, 16-46 (1982).

123 *Restatement, supra* note 110, §§ 302, 303-306, and 309.

124 Kozyris, *supra* note 76 at 17-26.

125 *Id.* at 46.

126 Michael C. Jensen and William Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976) at 310.

less jurisprudential reason for courts to upset the choice of law made by the parties when incorporating.[127]

In England and the United States the subject of foreign corporations was treated quite differently from the civil law, as outlined above. Both England and the United States have recognized foreign entities. In the Anglo-American system, the concept of choice of law was reserved for the issue of what law would be applied to recognized foreign entities. The ability of foreign corporations to do an interstate business with residents of other states is protected by the so-called "negative commerce clause," which prevents discrimination by a state against residents of other states. But that does not necessarily protect a local business that wishes to incorporate in another state.

B. Jurisdictional Competition in the United States

The story of the beginnings of jurisdictional competition starts with the American Civil War (1861-1865). The Northern part of the war was financed by the individual states, which raised their own militia, equipped and paid them. As with any war, much of the financing was with state borrowings, in the form of bonds. New Jersey struggled to pay off its bonds for several decades thereafter. It was only when an entrepreneurial New York lawyer approached the governor of New Jersey that things began to change. It was pointed out that America now possessed many great industries, but that state corporation law had not kept up with the changes. These laws often restricted the amount of capital that a corporation could raise, required legislative approval for mergers, and prohibited corporations from owning shares in other corporations. Tung attributes the change to the great merger movement in the U.S. at the end of the 19th century, which created entities that were national in scope, with no dominant local ties.[128] Lawyers had developed elaborate techniques for coping with these restrictions, mostly involving the use of the business trust to hold shares. But New Jersey adopted the first modern "enabling" corporation law in 1890, which ended restrictions on raising capital, owning shares and mergers, among other things. Most major corporations reincorporated in New Jersey, which was able to charge high franchise fees, enabling it

[127] See Larry E. Ribstein, Choosing Law by Contract, 18 J. Corp. L. 245 (1993); Henry N. Butler and Larry E. Ribstein, THE CORPORATION AND THE CONSTITUTION (1994) (arguing for Contract Clause protection of choice of corporate law). *But see* Harry Henn, The Philosophies of the New York Business Corporation Laws of 1961, 11 Buffalo L. Rev. 439, 451 (1962) (lamenting New York's "recognition of the old 'concession theory' with respect to the foreign corporation, viz., that it is a creature of the law of its state of incorporation and should, even when doing business in New York with New York residents, be governed, so far as regulatory aspects are concerned, by the law of its state of incorporation and not by New York law.") On the other hand, Kozyris notes the choice of law made by the organizers of the corporation as a justification for application of the internal affairs doctrine even under the new conflicts methodology. Kozyris, *supra* note 76 at 49-50.

[128] Tung, *supra* note 92 at 45.

to repay its Civil War debt.[129] Delaware duplicated New Jersey's statute, hoping to capture some of these fees, but New Jersey was the first mover, had captured the lucrative franchising business, and corporations saw no need to move to Delaware.

Woodrow Wilson was a populist governor of New Jersey who abhored the new laws, and saw to their repeal in 1913. The result was a move of most major corporations to Delaware, which then had the most modern and flexible corporate law. Delaware sought to assure that it would never lose this advantage. It assigned jurisdiction over corporate law disputes to its Chancery Court, which enabled a small group of judges carefully chosen from the corporate bar to specialize and become experts in corporate law.[130] Delaware publishes the reports of the Court of Chancery, an unusual occurrence for trial courts, to educate attorneys on the current developments in the law. The Delaware constitution requires 2/3 vote to amend Delaware's General Corporation Law, a bond that it will not radically change its laws to disadvantage Delaware corporations. Delaware obtains 15-20% of state revenues from franchise fees, which is also a bond that it won't change its law radically. Because Delaware is a small state, these revenues are critical to its government in a way they would not be in a larger state. As a result, Delaware has long been the dominant choice for large corporations. Over 50% of New York Stock Exchange firms are incorporated in Delaware.

Officials in other states have frequently complained about the tyranny of Delaware, which leads to the flight of local corporations and the prospective loss of franchise revenues for states that provide greater benefits to interest groups through corporate law.[131] One attempt at uniformity illustrated the power of competitive forces to dictate the shape of state laws. The Corporation Law Committee of the American Bar Association's Section of Corporation, Banking and Mercantile law submitted a draft Model Business Corporation Act in 1946, which followed the pattern of the recently adopted Illinois Business Corporation Act, not the Delaware law.[132] By 1955 it had been adopted by only two states and the District of Columbia, although it is now the

[129] Christopher Grandy, NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW (1993).
[130] Because corporate disputes are often complex, litigants generally prefer a hearing before a judge rather than a jury, and Delaware grants the Court of Chancery jurisdiction over interpretation of corporate instruments, 8 Del. C. §111, and jurisdiction over all matters in equity, 10 Del. C.§341, or where there is no adequate remedy at law, 10 Del. C. §342..
[131] Kaplan, *supra* note 110 at 436, quotes the Governor of Michigan in 1921, explaining to the Michigan Legislature that it was useless to pass a stringent corporation act because "all of our corporations will come back to us as foreign corporations", citing Mich. H. R. J. 37 (1921). *See also id.* at 437, for other writings denouncing this phenomenon.
[132] Benjamin Harris, The Model Business Corporation Act - Invitation to Irresponsibility?, 50 Nw. Univ. L. Rev. 1, 2-3 (1955).

dominant model.[133] During the period 1996–2000, 58% of all publicly held firms and 59% of the Fortune 500 Industrial firms were incorporated in Delaware.[134] During the period 1978–2000, 56% of all initial public offerings ("IPOs") involved Delaware corporations.[135] Delaware's share of IPOs listed on the New York Stock Exchange increased during the 1990s, reaching 73–77% during parts of that decade.[136]

The Model Act itself proclaimed that it was not written to "appeal to a state soliciting corporate business".[137] While there was earlier writing that criticized the development of enabling statutes as the result of competitive pressures from Delaware,[138] it was not until William Cary's famous article about Delaware's race to the bottom[139] that a flood of writing claimed that such a competition had occurred, to the detriment of investors and shareholders.[140] The debate has evolved over the years, after Ralph Winter argued that a state offering a law that was unfriendly to investors would not attract incorporations, because they would be less attractive to investors.[141] Early reincorporation studies were inconclusive, showing, at best, that there were no significant losses from moving to Delaware.[142] The debate generally rejected the race to the bottom hypothesis, because

133 *Id. See* William J. Carney, The Production of Corporate Law, 71 So. Cal. L. Rev. 715, 731 (1998) (142 provisions were adopted by an average of 37.21 states by 1997.)

134 Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 389–91 (2003) (referring to Table 1. Distribution of Firms' Locations Among States and Table 2. Distribution of Incorporations Among States).

135 Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV 1559, 1571 (2002) (referring to Table 2. Market Share of IPO Charters).

136 Id. at 1572 (referring to Table 3. Delaware's Share of All IPOs Listed on NYSE).

137 Model Bus. Corp. Act, x (1953 Rev.) as cited in Harris, *supra* note 132 at 15.

138 *See, e.g.*, Elvin R. Latty, Some General Observations on the New Business Corporation Law of New York, 11 BUFF. L. REV. 591, 609-10 (1962) ("A great barrier to the inclusion of strong protective features in any state corporation law long has been the utter futility of such features in face of the ease of evasion by simply incorporating in a state free from controls and then bringing the resulting 'foreign' corporation into the state to do business as a foreign corporation that is regulated, particularly in its internal affairs, by the law of the state of incorporation."); *see also* Kaplan, *supra* note 110, at 434-36.

139 William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L. J. 663 (1974).

140 *See, e.g.*, Ralph Nader, Mark Green & Joel Seligman, TAMING THE GIANT CORPORATION (1976); Donald Schwartz, Federal Chartering of Corporations, 61 GEO. L. J. 71 (1976); Richard Jennings, Federalization of Corporate Law: Part Way or All the Way, 31 BUS. LAW. 991 (1976).

141 Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEG. STUD. 251, 256 (1977).

142 Peter Dodd and Richard Leftwich, The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation, 53 J. Bus. 259, 277 (1980) (average prediction error on announcement date is -0.01%, although there were significant price increases over the preceding 60 months); Allen Hyman, The Delaware Controversy-- The Legal Debate, 4 Del. J. Corp. L. 368, 396 (1979) (no statistically significant price movement on or after the announcement date, although stock prices rose prior to the announcement date). *But see* Roberta Romano, Law As a Product: Some Pieces of the Incorporation Puzzle, 1 J. L., Econ. & Organization, 225, 271, Table 12 (1985) (hereinafter "Law as a Product"). (statistically significant gains of 3.8% in ten-day window around announcement date); Michael Bradley and Cindy A. Schipani, The Relevance of the Duty of Care Standard in Corporate Governance, 75 Iowa L. Rev. 1 (1989) (significant

these studies do not produce negative price movements. The nature of the debate changed when Robert Daines employed Tobin's Q to measure value in Delaware corporations versus others.[143] He found that incorporation in Delaware added approximately 5% to the value of a firm. Other studies have disagreed,[144] although one study, which found a negative correlation between Delaware incorporation and value employed different samples, time periods, and control variables.[145] The most recent study, by Guhan Subramanian, finds that Delaware firms were worth approximately 3% more than non-Delaware firms in 1991-93, and 2% more in 1994-96. Thereafter, the Delaware difference is statistically insignificant, and even turned negative in 1998-99.[146] The results over twenty-five years of empirical work thus remain inconclusive.[147]

V. Sources of Corporate Law

It has been said that imitation is the sincerest form of flattery. Roberta Romano found that when any state adopted a new and useful provision in its corporate law, it was quickly imitated by other states, and that Delaware was generally an early adopter.[148] State bar committees on corporate law meet regularly in many states to review these innovations, and to recommend what they consider advantageous to their own legislatures.[149] The Committee on Corporate Laws of the American Bar Association, composed of experienced corporate lawyers from across the country, regularly reviews corporate law developments with an eye to amending the Model Business Corporation Act, the most widely followed model. The American Law Institute, a national membership organization of lawyers and judges with the goal of clarifying and improving the law through its Restatements of various common law subjects, such as Torts, Agency, Property and Contracts, to name a few, undertook a similar project for corporate law in the 1980s, which did not have a similar impact.[150] The National Conference of Commissioners on Uniform State Laws ("NCCUSL") has served a similar function on other business entity laws, discussed below.

1% rise on announcement date, following significant rise preceding that date); Jeffry Netter and Annette Poulsen, State Corporation Laws and Shareholders: The Recent Experience, 18, No. 3 Fin. Mgt. 28 (Autumn 1989) (positive returns around announcement date).

143 Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. Fin. Econ. 559 (2001).

144 Lucian Bebchuk, Alma Cohen and Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law?, 90 Cal. L. Rev. 1775, 1784-86 (2002) note that Daines' results are not consistent across the period studied.

145 Paul A. Gompers, et al., *Corporate Governance and Equity Prices*, 118 Q. J. Econ. 107 (2003).

146 Guhan Subramian, *The Disappearing Delaware Effect*, 46 J. L. Econ. & Org. 32 (2004).

147 A recent review of the theory and evidence, arguing that the evidence fails to fit the contractarian theory of the corporation is found in Michael Klausner, Fact and Fiction in Corporate Law and Governance, 65 Stan. L. Rev. 1325 (2013).

148 Romano, Law as a Product, *supra* note 142.

149 Carney, The Production of Corporate Law, *supra* note 133.

150 For a critical review, *see* Carney, Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?, 66 WASH. U. L. Q. 239 (1988).

VI. Types of Business Organizations

A. Partnerships

Partnerships are the most ancient and universal form of organization. Under U.S. law it is the default form: that is, absent formation under a specific statute, individuals carrying on business together as co-owners are partners.[151] The National Conference of Commissioners on Uniform State Laws ("NCCUSL"), a body with representatives appointed by each state, has promulgated a variety of forms of uniform laws for adoption by those states that choose to do so. The Uniform Partnership Act has been widely adopted, and has gone through revisions over time. One of the features of this act is that it contains default provisions, that can be contracted around, but provide an inexpensive set of rules for internal governance that are generally intuitive.[152] Partners are generally subject to unlimited liability for firm debts,[153] and have equal voices in firm governance, with the majority prevailing in disputes,[154] and equal authority to carry on the business in the usual way.[155] Because of the potential for personal liability, new partners can only be admitted by unanimous consent.

One of the benefits of a partnership in the U.S. is that the entity is not taxed on its income - only the partners are, who must declare their proportionate share of partnership income on their individual income tax returns, whether or not they receive their share of the profits in cash. The price for this benefit, of course, was unlimited personal liability. In the late 1970s entrepreneurial lawyers persuaded one state, Wyoming, to authorize a new form of entity which could avoid personal liability, but be eligible for tax pass-through status - the Limited Liability Company, described below (not to be confused with the civil law entity often bearing the same name). In response, lawyers in other states persuaded their legislatures to authorize partnerships to have limited liability for their members - the Limited Liability Partnership, or "LLP." Obtaining this status involves a simple name change to indicate the limited nature of liability to third parties, and a filing with a local official.[156]

B. Limited Partnerships

Limited partnerships were unknown at common law in England, and thus unknown in the U.S. They are derived from the Italian *commenda*, a device used to avoid the usual rules of unlimited liability in commercial ventures. The *en commandite* partnership was legalized in France in 1671, in Ireland in 1782, elsewhere on the Continent and, in a few

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151 Uniform Partnership Act (1916) (hereinafter "UPA", §6.
152 UPA §18.
153 UPA §15.
154 UPA §18.
155 UPA §9.
156 Revised Uniform Partnership Act (1997) §§ 1001 - 1003.

states in the U.S.A. in the early 19th century. The Uniform Limited Partnership Act ("ULPA") was promulgated in 1916 by NCCUSL, with later revisions as the Revised Uniform Limited Partnership Act ("RULPA), with revisions in 1976, 1985, 1997 and 2001, reflecting dynamic changes in the law.

Formation requires a formality - a public filing that identifies who are the general partners. RULPA §201. A general partner has unlimited liability for firm debts, but other partners do not - they are only subject to loss of their capital.[157] The default rule is that the general partner controls the business, but this is subject to variation by agreement to give limited partners more control.

C. Limited Liability Companies

Until Georgia revised its version of the Uniform Limited Partnership Act in 1988, section 7 of the 1916 Act imposed personal liability on a limited partner if he "takes part in the control of the business." The 1976 revision had softened the rule, but had not completely eliminated the risk if the limited partner "participates in the control of the business."[158] The Georgia revision of RULPA §303 provided that "a limited partner does not become liable [for the obligations of the limited partnership] by participating in the management or control of the business." Ultimately the 2001 version of RULPA followed Georgia's lead. [159] But until that time many investors found the limited partnership act unattractive because limited partners had no power over control of the business. In the late 1970s entrepreneurial lawyers in Wyoming obtained passable of a new act allowing creation of limited liability companies - not to be confused with entities with similar names in civil law countries.[160]

This new form of LLC was specifically designed to allow investors to participate in control of the entity while obtaining the advantage of pass-through treatment for income tax purposes. Accordingly, the default rules provided the features that the U.S. Internal Revenue Service found important in distinguishing partnerships from corporations: decentralized management by the members, no continuity of existence when a member died or withdrew, no free transferability of shares, and personal liability of members for firm debts. Under Revenue Service rules in effect at the time, entities could have two of these partnership features and still be treated as pass-through entities. The statute permitted all of these features to be varied by contract, to obtain the most desirable corporate attributes, which always included limited liability for members.

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157 A general partner's liability may be limited by using a corporation as the general partner, subject to some limitations beyond the scope of this article.
158 Revised Uniform Limited Partnership Act (1976) §303(b) in 6B UNIF. L. ANNO. 181-82.
159 William J. Carney, Larry Ribstein's Federalism Scholarship and the Unfinished Agenda, 2014 U. ILL. L. REV. 1603.
160 William J. Carney, Limited Liability Companies, *supra* note 48.

The Revenue Service approved this form in 1986, and other states rushed to adopt similar statutes. Somewhat later, the Revenue Service simply ruled that any non-corporate entity could choose pass-through status, so the original purpose of creating LLCs became irrelevant. What is more important is the freedom to contract out of those fiduciary duties the members may find inappropriate. Delaware's statute express allows such contracting out.[161]Some businesses find this particularly attractive. Orbitz was a joint venture of major U.S. airlines that allowed a search of all their web sites for a complete list of scheduled flights and prices that consumers can use. At the same time, each airline maintained its own web pages that are in direct competition with Orbitz and each other. Orbitz was originally formed as a Delaware LLC in order to contract away from the fiduciary duty of member airlines not to compete with Orbitz.[162] Recently proposed changes in corporate laws will clarify the ability of corporate participants to contract out of the business opportunity doctrine.[163]

D. Corporations

In most respects U.S. corporations are similar to those throughout the world. The great advantage of the corporate form is its ability to raise capital from many investors to allow it to engage in larger enterprises. Shareholders benefit from limited liability, risking only the capital invested in the corporation's shares. The price paid is so-called "double taxation" - the corporation is taxed on its profits (currently at a rate of 35% for larger corporations), and, in turn, shareholders are taxed on dividends when they are paid.[164] When corporate profits are reinvested to grow the enterprise and its profits, thus making the shares more valuable, the capital gains on shareholders' appreciated values are not taxed until the shares are sold. There is no separate statute for organizing closely held corporations with only a few shareholders. Some statutes contain a few provisions that a corporation can elect to be covered by, but in most cases special needs are addressed in a shareholders' agreement. Most corporate statutes contain "default" provisions that can be contracted around, either in the articles of incorporation, bylaws or a shareholders' agreement.

1. Formation

161 Del. Code Ann., Title 6, §18-1101(c).

162 As of February 2015 Orbitz announced that it would be sold to Expedia. Forbes on line, March 4, 2015, http://www.bing.com/search?q=Orbitz+ Expedia&form=PRUSEN&mkt=en-us&refig=7bf362bf58d4422286a371f883d284b7&pq=orbitz+expedia&sc=5-14&sp=-1&qs=n&sk=&ghc=1&cvid=7bf362bf58d4422286a371f883d284b7 (last visited March 6, 2015).

163 See Changes to the Model Business Corporation Act, *infra* note 180.

164 Corporations with a small number of shareholders and a single class of stock may elect to be taxed like a partnership, with corporate earnings allocated to the shareholders whether dividends are paid or not, under Subchapter S of the Internal Revenue Code.

Corporations are formed with a simple filing with the Secretary of State in the jurisdiction chosen for formation. These filings include a copy of the articles of incorporation, and are updated annually to disclose a registered office and registered agent authorized to receive process within the state. There are no minimum capital requirements, and one person can form a corporation and own all its shares. Corporations may be formed for any lawful business purpose, or the organizers may specify narrower purposes if they choose, in the charter. The only limits here are equitable – a corporation may not engage in a business for which it has unreasonably small capital without rendering the shareholders personally liable for its debts - piercing the corporate veil.[165] There are some special purpose corporations that must be formed under special statutes, with banks being a typical example. Most states (except Delaware) provide separate statutes for not for profit corporations.

2. Directors

Like all nations, U.S. law provides for a board of directors to provide centralized management, an essential trait where there are many shareholders. Unlike civil law, U.S. law provides the board of directors with exclusive power to manage the business and affairs of the corporation. This contrasts with civil law, where shareholders have the power at the general meeting to take action on business matters. Shareholder power to remove and replace directors may be limited in several ways. Most states allow the terms of directors to be staggered in two or three classes, with only one class being elected annually. This means it is difficult if not impossible for shareholders to change a majority of the board in any one year. While directors may be removed by the shareholders, there are complications. Under the Model Business Corporation Act ("MBCA") the statute grants shareholders the power to remove directors with or without cause, but the articles of incorporation may permit removal only for cause.[166] Delaware law provides a similar rule, but also restricts removal to "for cause" if the board is classified.[167] While election of directors is generally governed by a plurality vote (recognizing that more than two candidates might compete), activist shareholders in the U.S. have been pressing corporations to require a majority vote for election.

3. Duties of Directors

American corporate laws are not very specific about most duties of directors - many provide simply that directors shall act with the care that a person in like position would act.[168] Delaware law contains no provisions on directors' standard of care. The courts

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165 Carney, Limited Liability, *supra* note 49 at 668-69.
166 American Bar Association, Committee on Corporate Laws, Model Business Corporation Act ("MBCA" or "Model Act") §8.08.
167 DEL. CODE ANN. tit. 8, §141(k).
168 Model Act §8.30(b).

drew analogies from the rules governing trustees and agents, and stated that directors had duties of care. At the same time, the courts developed rules of deference to directors' decisions, even when they turned out badly. Some courts held that they were ill-suited to judge business decisions. Others simply stated that it was unfair to second-guess honest decisions that turned out badly. Finally, at least one judge stated that directors were paid to make risky choices about the future, and should not be punished when these decisions turned out badly.[169] Delaware's courts have held that a plaintiff must show more than ordinary negligence to hold a director liable - the standard is "gross negligence."[170] Collectively, this deference to directors became known as the Business Judgment Rule, and is applied in virtually every state. One writer stated that his research found no cases in which directors of an industrial corporation were held liable for ordinary negligence.[171]

In more recent years there has been pressure from critics for a more rigorous standard of review of directors' decisions, often based on the idea that directors have duties to monitor for law violations by corporate employees,[172] and that directors must affirmatively demonstrate that they had considered what a court views, in hindsight, an adequate amount of information in making their decisions.[173] Some of these decisions have been vigorously criticized, but they have had some influence on the shape of corporate law. In a legislative response to court decisions holding directors liable for breaches of the duty of care, most states responded with statutes allowing corporate charters to protect directors from liability for breaches of the duty of care, carefully leaving directors liable for other breaches of their duties (discussed below).[174]

Directors' duties of loyalty are drawn from the trust analogy. This means directors cannot deal with corporate property for their own profit, cannot take advantage of corporate opportunities,[175] cannot compete with the corporation,[176] or disclose its

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169 Joy v. North, 692 F.2d 880 (2d Cir. 1982).
170 Aronson v. Lewis, 473 A.2d 805 (Del. Supr. 1984).
171 Joseph Bishop, Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers, 77 YALE L. J. 1078, 1099 (1968). But see Federal Deposit Ins. Corp. v. Loudermilk, 761 S.E.2d 332 (Ga. 2014).
172 In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996); Stone v. Ritter, 911 A.2d 362 (Del. Supr. 2006).
173 Smith v. Van Gorkom, 488 A.2d 858 (Del. Supr. 1985); Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. Supr. 1985). In C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust, 2014 WL 7243153 (Del.), the Delaware Supreme Court substantially modified most attorneys' understanding of these two cases, holding that a reasonable effort to secure the best price may involve one-on-one negotiations, followed by announcement of an agreement that provides a reasonable time for others to place higher bids, without an active search by the selling corporation.
174 Model Act §2.02(b)(4); Del. Code Ann. tit. 8, §103(b)(7).
175 Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (1939).

confidential information to outsiders. Strictly interpreted, directors would not be able to set their own compensation, since all directors would have a conflict of interest in doing so. Some statutes expressly authorize this power,[177] and most statutes have "safe harbors" for directors seeking to engage in a transaction that involves either dealing with the corporation or seizing what might be a corporate opportunity. These statutes generally require the director to make full disclosure in advance of the transaction, and to obtain approval either from the disinterested directors or the disinterested shareholders.[178] In the absence of such independent approval, the burden of proof falls on the conflicted directors to show the entire fairness of their actions.[179] Some state laws have authorized advance permission for directors to take advantage of specified business opportunities without bringing them before disinterested directors or shareholders, and the Model Business Corporation Act has been amended to include such provisions.[180]

As previously mentioned, shareholders' voting power in U.S. corporations is quite limited. Most laws simply provide that the business and affairs of the corporation shall be managed by the board of directors.[181] This has been interpreted to give the board exclusive control of these matters. As a result, shareholders can only advise the board on these questions, rather than take direct action themselves or require the board to do so. A recent example involves popular (or populist) concerns that top executives are often overpaid, whether in comparison to lower level employees or in comparison to the performance of the company. In 2010 Congress adopted the Dodd-Frank Act in response to the 2008 financial crisis.[182] This added a new section to the Securities Exchange Act of 1934, which governs disclosures of all publicly traded companies, to require an advisory vote on executive pay.[183] Congress recognized that state laws do not allow shareholders to manage company affairs, so this vote is only advisory to the board of directors.

4. Shares

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176 Cellular Information Systems, Inc. v. Broz, 663 A.2d 1180, 1182 (Del. Ch. 1995), reversed on other grounds, 673 A.2d 148, (Del. 1996); Fender v. Prescott, 101 A.D. 2d 418, 476 N.Y.S.2d 128 (1984), aff'd, 64 N.Y.2d 1077, 479 N.E.2d 225, 489 N.Y.S.2d 880 (1985); Morton v. Rank America, Inc., 812 F. Supp. 1062, 1070 (C.D. Cal. 1993).

177 Model Act §8.11.

178 Model Act §§ 8.60-8.63, 8.70; DEL. CODE ANN. tit. 8, §144.

179 Del. G.C.L. §(a)(3); Model Act §8.61(b).

180 American Bar Association, Committee on Corporate Laws, Changes in the Model Business Corporation Act – Proposed Amendments to Sections 2.02 and 8.70 (and Related Changes to Sections 1.43, 8.31 and 8.60) Permitting Advance Action to Limit or Eliminate Duties Regarding Business Opportunity, 69 Bus. Law. 717 (2014); Changes in the Model Business Corporation Act, 70 Bus. Law. 175 (2015) (announcing approval of the proposed changes).

181 Model Act §8.01(b); DEL. CODE ANN. tit. 8, §141(a).

182 Pub. L. 111–203, H.R. 4173.

183 Securities Exchange Act of 1934, § 14A, 15 U.S.C. §78nA, as amended.

Generally U.S. corporations are not required to authorize any particular number of shares of stock, and there are no upper limits on the numbers that may be authorized in the charter (although state franchise taxes may impose some practical limits). No shares need be subscribed for at the time of incorporation, and shares need not have any "par" or stated value that sets a minimum on the price to be paid for them.[184] A corporation must have what is generally called "common stock," which has full voting rights to elect directors and approve charter amendments, and the right to receive all profits, either in the form of dividends or distributions upon liquidation.[185] Because these shares are the riskiest form of investment in the firm, receiving the residue after all creditors and senior classes of stock have been paid, they must have full voting rights in most states, although the Model Act only provides that some class of shareholders must have these rights, whether alone or jointly with other classes. Shares in U.S. corporations are held of record, rather than in bearer form. Notices of meetings must be sent to all shareholders of record. Even when shares are held by nominees such as brokers or banks, these nominees are required by SEC regulation to pass such notices to the beneficial owners.[186]

Corporations are authorized to issue other classes of stock, generally called preferred stock. If the charter so provides, the board of directors may be authorized to determine the rights and preferences of a previously authorized class, or to create a series within a class, at the time of issuance, rather than in the charter ("blank shares" or "blank check shares").[187] The voting rights of each class are generally a matter of contract - in the form of the charter or the board resolution specifying the rights or a class or series.[188]

Corporations have the power to repurchase their own shares, subject to leaving sufficient assets to protect creditors,[189] or in some cases to leave sufficient capital to cover "legal" or "stated" capital.[190] Such "legal capital" provisions have been disappearing from most statutes, to be replaced by requirements that sufficient capital remain to cover all debts and to continue in business.[191] Some states, notably Maryland, have special statutes that allow shares to be redeemable at the will of the shareholder, to accommodate open-end mutual funds.

184 Model Act §6.01(a); Del. Code Ann. tit. 8, §151(a).

185 Model Act §6.01(b) provides only that some class of shares must have unlimited voting rights, and that some class must have unlimited distribution rights upon liquidation. The author knows of no instance where separate classes have these rights - common stock appears to have unlimited distribution rights in all cases of public corporations. Delaware has no such provision. Del. Code Ann. tit. 8, § 170 simply provides authority to pay dividends "on shares," while §212 (a) provides that each share shall have one vote unless the charter provides otherwise.

186 Securities Exchange Act Rule 14a-13, 14b-1 and -2, 17 C.F.R. §240.14a-13, 14b-1 and -2.

187 Model Act §6.02; Del. Code Ann. tit. 8, §102(a)(4).

188 Del. Code Ann. tit. 8, §151(a); Model Act §6.02.

189 Model Act §§ 6.31 and 6.40.

190 Del. Code Ann. tit. 8, § 160.

191 Model Act § 6.40.

5. Shareholders

Shareholders' liability for corporate debts is generally limited to the amount they commit to pay for shares.[192] There are exceptions for fraud on creditors, which can take the form of confusing creditors about whether they are dealing with the individual shareholder or his or her corporation, where shareholders receive corporate funds that leave the corporation unable to pay its debts, or where the shareholder uses the corporation as an agent to carry on business for the shareholder's benefit at the expense of the corporation.[193]

Most states allow articles of incorporation to provide for preemptive rights of shareholders to buy their proportionate share of any new offering of shares. These provisions are rarely used by publicly held corporations, but can be a useful protection for shareholders against favorable treatment of a controlling shareholder which might otherwise buy new shares at a bargain price and dilute the value of the others' investments. Some statutes codify judicially developed exceptions and modifications of these rights.[194]

One of the unique features of U.S. law is the shareholders' derivative action. This was an innovation of courts of equity. When a board has engaged in wrongdoing that injures the corporation, the board, which normally has full power to manage the business and affairs of the corporation, will not be willing to have the corporation sue the directors to remedy the harm. In these circumstances a shareholder can stand in the shoes of the corporation, generally after making a demand on the board to bring the action.[195] Some controversy surrounds derivative actions, notably whether they benefit and are controlled by the shareholders or principally by the lawyers who bring the suits, and expect to be compensated by the corporation if the suit is won or settled.

6. Shareholder Voting

An annual shareholders meeting for the election of directors is required. Special meetings may be held on the call of a specified percentage of outstanding shares or of the board of directors. Generally statutes require the presence, in person or by proxy, of holders of at least a majority of all shares entitled to vote. These quorum requirements may be increased and in some states reduced in either the articles of incorporation or bylaws. Delaware, for example, allows quorums to be set as low as one-third of the voting shares. [196] The Model Act, in contrast, only permits quorum increases if approved

[192] Model Act, §6.22; Del. Code Ann. tit. 8, §152.
[193] Carney, Limited Liability, *supra* note 49 at 668-69.
[194] Model Act § 6.30.
[195] Model Act §§ 7.40 - 7.48.
[196] Del. Code Ann. tit. 8, §216.

by the greater vote required under the proposed amendment.[197] Supermajority quorum and voting requirements are also permitted, and may be set for specified events, such as votes on mergers.

Statutes authorize cumulative voting for directors. This means that if there are three positions open on the board, shareholders may cast all of their votes for a single candidate, which creates the potential for representation of minority shareholders on a board. Cumulative voting is almost never seen at publicly traded corporations, but it can be a useful protection for minorities in closely held firms, especially if coupled with supermajority voting on some issues, to give the minority a veto power. Federal securities laws require forms of proxies (powers of attorney) be made available to all shareholders of publicly traded companies, to facilitate their participation in corporate governance.[198]

7. Shareholders' Duties

Shares of stock are private property and can be sold by a shareholder at any time and at any price, unless prohibited by a shareholders agreement to which he or she is a party.[199] Similarly, a shareholder is free to vote the shares in his or her own interest, subject to qualifications discussed below. Shareholders may enter into voting agreements in which they agree how to vote their shares. Shareholders may also give a power of attorney ("proxy") to another to vote the shares for the owner. Typically these proxies may be revoked by the owner at any time, although there are occasions where the laws allow a proxy to be irrevocable by its terms, if the proxy holder has a sufficient legal or economic interest in the corporation.[200]

Statutes are generally silent on duties of shareholders. What circumstances should cause courts concern over shareholder voting? Often it is the control of the board of directors by a single shareholder or a group holding a controlling interest. In these circumstances have imputed the board's duties of loyalty to the controlling shareholder.[201] In other cases the courts have not expressed a rationale, except their desire to achieve a fair result.[202]

These circumstances may involve the selective issue of new shares to a controlling shareholder at a bargain price, the payment of dividends on one class of shares and not another, dealings between the corporation and another company controlled by the

[197] Model Act, §7.27.
[198] 17 C.F.R. §240.14a-1 to 14b-2.
[199] Del. Code Ann. tit. 8, §159.
[200] Model Act §7.22.
[201] Sinclair Oil Corp. v. Levien, 290 A.2d 717 (Del. 1971); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (applying Kentucky law).
[202] Perlman v. Feldman, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955).

dominant shareholder, for the benefit of the other company at the expense of the first, a sale of all assets to the controlling shareholder or its wholly owned corporation at a bargain price, or a merger on terms that are more favorable to the controlling shareholders wholly owned corporation.[203]

Statutes deal specifically with only some of these questions. Statutes only require that directors determine in their sole discretion that the price paid for newly issued shares is "adequate," while deferring generally to the good faith judgment of the directors.[204] Charter provisions for preemptive rights can provide protection for minorities, but these provisions are rarely used by publicly held corporations. Accordingly, in the absence of preemptive rights, courts have exercised their equitable powers to impose fiduciary duties on directors to not issue new shares on unfairly favorable terms to controlling shareholders.[205]

Selective dividend payments are not expressly addressed in most statutes. Here courts can hold directors liable for a breach of their fiduciary duty treat all shareholders fairly.[206]

While boards cannot sell all the assets of a corporation without shareholder approval, no statutes prevent a dominant shareholder from approving the transaction itself. Many statutes provide shareholders with the right to dissent from the transaction and demand that they be paid the fair value of their shares.[207] But some, such as Delaware, limit appraisal to mergers, leaving it to the courts in their equity role to impose fairness standards on other such transactions.[208]

Similarly, While boards cannot approve a merger of the corporation without shareholder approval,[209] no statutes prevent a dominant shareholder from approving the transaction itself. All statutes provide shareholders with the right to dissent from the transaction and

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203 *See* generally William J. Carney, The Theory of the Firm: Investor Coordination Costs, Control Premiums and Ownership Structure, 65 WASH. U. L. Q. 1 (1987).

204 Model Act §6.21(c). Delaware only requires that the price equal or exceed the par or stated value of shares. Del. Code Ann. tit. 8, §153(a). Shares without par value may be issued for any price determined by the board. Directors' fiduciary duties require that they not discriminate among shareholders.

205 Katzowitz v. Sidler, 249 N.E.2d 359 (N.Y. Ct. App. 1969).

206 *Cf.* Sinclair v. Levien, *supra* note 195.

207 Model Act §13.02(a)(3).

208 *Cf.* Zahn v. Transamerica Corp., *supra* note 201 (where the controlling shareholder deceived a class of shareholders into redeeming their shares so the controller could liquidate the company and capture the appreciated value of its assets for itself).

209 The exception is the "short form" merger, where a board can approve a merger with a controlled subsidiary. Most states permit such mergers upon parent board approval only when the parent owns 90% or more of the shares of the subsidiary. Del. Code Ann. §253; Model Act §11.05. Delaware, after 2013 amendments, permits such mergers after a tender offer if the merging parent owns over 50% of the subsidiary's shares. Del. Code Ann. §251(h).

demand that they be paid the fair value of their shares.[210] The Delaware courts have added to that remedy a fiduciary duty claim against controlling shareholders if the transaction is deemed unfair.[211]

VI. The Federal Securities Laws

A. The Predecessors: State Securities Laws

Where shares were traded on organized stock exchanges, issuing corporations were always subject to the listing rules of the exchanges, which in some cases required audited financial statements and some reporting to investors. But it was not until the early years of the 20th century that states began to adopt laws governing the sale of securities. These laws were separate from corporation laws, and were known as securities laws, and sometimes as "blue sky laws" from the comment of an early regulator that some sellers were so unscrupulous that they would sell pieces of the blue sky in fee simple to gullible investors.[212] These laws came in three forms. The first were simple laws forbidding fraud in the sale of securities. These laws could be enforced by injunction or criminal prosecution by the attorney general of a state, and some provided civil remedies for defrauded buyers. The second were "full disclosure" laws that mandated full disclosure about the issuer before shares could be sold. The full disclosure requirement was enforced through a requirement that issuers file a disclosure document (a "registration statement") with the state's securities commissioner, who had to approve it before shares could be sold. Like the first type, these laws also provided for enforcement by injunction or criminal prosecution, and provided for civil suits by investors to recover damages. The third type was the "merit" statute, which, in addition to the disclosure and remedy provisions of the first two types, required the state's securities commissioner to approve the prospective offering as "fair, just and equitable" for investors. Enforcement of these laws was sometimes difficult, if the seller operated by mail from another state. Local officials had considerable difficulty establishing *in personam* jurisdiction across state borders.

B. The Securities Act of 1933

The 1929 stock market collapse and the Great Depression that followed aroused the interest of the U.S. Congress. Hearings were held, and much of the blame was mistakenly placed on bankers and brokers ("Wall Street"). Modern financial studies, most notably by Milton Friedman, placed the blame on the U.S. Federal Reserve, which shrank the U.S. supply of money by one-third in the years leading up to 1929. With the

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210 Model Act §13.02(a)(1); Del. Code Ann. §262. There are some exceptions to these appraisal rights not discussed here.

211 See, e.g., Weinberger v. UOP, Inc. 457 A.2d 701 (Del. Supr. 1983).

212 Hall v. Geiger-Jones Co., 242 U.S. 539 (1917), contains the first mention of this phrase by the U.S. Supreme Court.

election of Franklin D. Roosevelt in 1932, there was a call for a federal law protecting the public from fraudulent stock sales, noting the inability of state officials to enforce across state borders. Within the first 100 days of the Roosevelt administration a small group of lawyers and academics drafted the proposed Securities Act of 1933. They drew heavily from state law models, adopting the full disclosure model most common in the states. Issuers would be required to file a registration statement by section 5 of the act.[213] The required disclosures were drawn from the best practices of reputable brokerage firms on Wall Street, which sought to protect their customers by assuring full and candid disclosure of all the strengths, weaknesses and risks of an offering. The penalty for failing to file and to secure regulatory approval of the offering documents was severe - all investors were entitled to damages or a refund of their money,[214] and criminal penalties for wilful violations of this law were available as well.[215] There were some exemptions from this expensive process, such as where a local corporation made an offer exclusively to residents of its own state, which could be governed by state law.[216] Other exemptions existed for small offerings,[217] and for offerings to sophisticated and knowledgeable investors who could obtain the information necessary to protect themselves.[218]

For 63 years Congress left the operation of state laws alone. Section 18 of the Securities Act expressly stated that it did not preempt state regulation. But state regulation was hugely costly in nationwide offerings. Paternalistic merit regulation was contrary to spirit of federal law, which only required disclosure. In 1996 Congress amended Section 18 to preempted state regulation of offerings of nationally traded securities or those that will be nationally traded after an offering. In all other respects state laws remain in effect.

C. The Securities Exchange Act of 1934

The Securities Act was limited to governing offers and sales of securities by issuers and underwriters. It did not address some of the manipulations in trading activities uncovered by Congressional hearings. In 1934 Congress returned to the subject with an act to address these activities. The Securities Exchange Act regulates the trading markets where secondary transactions occur.

1. It regulates stock exchanges, by requiring them to register with SEC, and maintain rules designed to prevent fraud and promote good business practices.[219]

2. It regulates trading by securities dealers, not on organized exchanges.[220]

213 15 U.S.C.A. §78e.
214 15 U.S.C.A. §77*l*.
215 15 U.S.C.A. §77x.
216 15 U.S.C.A. §77c(a)(11).
217 15 U.S.C.A. §77c(b)(2).
218 15 U.S.C.A. §77d(2) and (6). *See also* Regulation D, 17 C.F.R. §230.500 to 508.
219 15 U.S.C.A. §78f.

3. It regulates the continuing disclosures of companies whose shares are traded, so secondary markets have information as complete as initial offerings.[221]

4. It provides rules against fraud in trading markets, including liability rules.[222]

5. It provides some assurance to shareholders that they will be able to participate in corporate governance through the use of proxies to vote their shares.[223]

The general purpose is to provide investors with a constant flow of information about companies whose shares are traded. One result of this is investor confidence in the fairness and general honesty of American markets, and wider investor participation in stock investing than in any other nation. Many non-U.S. companies find it advantageous to list their shares on American markets in order to gain the benefits of this deep and broad market.

The securities laws are administered by the Securities and Exchange Commission ("SEC"), established in 1934.[224] It is a bipartisan independent regulatory agency that enforces these laws, subject only to review by the federal courts for acts in excess of its authority or other offenses of governing laws, such as the Administrative Procedure Act, which governs procedures at virtually all federal agencies.[225]

The SEC has been an active and aggressive regulator over the past 80 years. Its rules are voluminous and complex, leading to the development of a specialized bar with the expertise to advice on compliance and defend against actions brought for violation of its rules. The SEC has developed its own common law, most notably in the area of Rule 10b-5, which has been used to create rules against insider trading that did not previously exist.[226] These rules have been a rich source of litigation in the U.S., and have provided the basis for many criminal prosecutions as well. Other rules have used disclosure requirements to impose pressure on issuers to change their behavior. The Sarbanes-Oxley amendments to the '34 Act require that all reporting companies either have a "financial expert" on the audit committee or provide an explanation for the absence of such an expert.[227] That is effectively a mandate for all companies; explaining the absence of such an expert is like answering the question if you've stopped beating your wife—addressing the question is a fatal admission. Recent amendments require not only full disclosure of executive compensation, but also a comparison with the average

220 15 U.S.C.A. §78e.
221 15 U.S.C.A. §78m and 78n.
222 15 U.S.C.A. §78i and 78j.
223 15 U.S.C.A. §78n.
224 15 U.S.C.A. §78d.
225 15 U.S.C.A. §78y.
226 In the Matter of Cady, Roberts & Co., 40 SEC 907 (1961).
227 15 U.S.C. § 7265 (Supp. II 2002).

compensation of corporate employees.[228] They also require a vote on shareholder approval of CEO compensation at least every six years.[229]

[228] 17 C.F.R. §229.402. As of this writing the SEC has proposed but not yet adopted final rules on this subject. *See* Release Nos. 33-9452; 34-70443 (September 18, 2013).
[229] 15 U.S.C.A. §78n-1.