



FOUNDATIONS OF Corporate Law

Second Edition

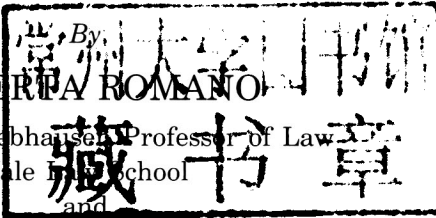
Roberta Romano

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FOUNDATIONS OF CORPORATE LAW

SECOND EDITION

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PREFACE TO THE SECOND EDITION

The revolution in corporate law that led me to assemble the first edition of this reader has quickened in the intervening decade plus years, bringing a far greater sophistication in the use of finance and organizational economics in corporate law scholarship and practice. In the years since the first edition's publication, the field has expanded to confront new substantive issues, and deepened as attention has refocused on corporate governance in the wake of the financial accounting scandals of high-profile firms in 2001–02, such as Enron, Worldcom and Parmalat. Moreover, corporate law scholarship and practice have been extended geographically, both because of the international scope of the scandals and because of a profusion of cross-border transactions and global investments, which have spurred the diffusion of U.S.-type business transactions and legal rules across the globe. The second edition reflects these trends, expanding the original chapter on internal governance mechanisms into three separate chapters on distinctive components of governance: boards of directors and their fiduciary liability; voting and other forms of institutional investor activism; and executive compensation, and adding a new chapter on comparative corporate governance.

Users of the prior edition will find that there is considerable new excerpted material in every chapter but the chapters on limited liability and financing the corporation; still, even those chapters have fully updated notes and questions, as do all the others. This has necessarily made for a considerably longer book. For example, the theory of capital markets section of chapter one includes excerpts on behavioral finance, which provides the theoretical underpinning of new substantive material, such as the Langevoort excerpt on boards of directors in chapter five. More recent debates over the need to increase shareholder power and to rein in executive compensation are excerpted in readings in chapters six and seven. In addition to new debates, there are selections that take fresh looks at ongoing controversies in the first edition, such as whether states compete over charters in chapter three, who benefits from shareholder litigation in chapter five, and the efficacy of the federal securities laws, in chapter nine.

Although I have a point of view on a number of these issues, as the excerpts from my contributions indicate, as in the first edition, I have tried my best to counter my perspective, and that of others, by juxtapos-

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ing differing viewpoints throughout the reader. My belief is that such an approach should make for both a better and more enjoyable educational experience. I have further followed the same editorial approach to the material as taken in the prior edition, favoring accessibility and breadth, by considerable editing of the original articles, along with suppression of most mathematics, footnotes, and references, recognizing that this risks loss of the subtlety or complexity of arguments, and technical or bibliographic precision, and compensating, hopefully, by the inclusion of extensive notes and questions related to the wider literature. If the book serves to pique the reader's interest to delve further into the original material to follow up on theories, evidence and references, then the tradeoff, in my mind, will have been well served. For this edition, I have adopted several formatting rules for improved readability of the excerpts: omission of ellipses, indicating breaks in text, that would otherwise appear at the beginning or end of text paragraphs, and standardized subheading fonts (in italics) across excerpts. As in the first edition, authors' use of italics in text has been retained.

R.R.

New Haven
July 2010

PREFACE

Corporate law underwent a revolution over the past decade. In the midst of an extraordinary period of innovation in business organization and acquisitive activity, legal scholarship was transformed by the use of the new analytical apparatus of the economics of organization and modern corporate finance. This learning has already had, and will increasingly have, a profound impact on corporate practice and, accordingly, on the teaching of corporate law. This book of readings seeks to provide an accessible introduction to the enduring policy debates in corporate law as well as the intuition for the fundamental economic concepts of the new learning that informs the debates. In addition, a concerted effort has been made to provide a realistic sense of the institutional landscape, which is foreign to many students, by extensive referencing of the burgeoning empirical research on corporate governance.

The key feature of the public corporation is Adolph Berle and Gardiner Means' insight concerning the separation of ownership and control: managers of the firm, who run the business, are not the owners. This separation creates a host of organizational problems, because managers' incentives are not always aligned with the owners' interest; such problems are generically referred to as agency problems. Much of corporate law is directed at mitigating agency problems, as selections in the reader illustrate. The readings also indicate how the economic theory of organization as well as corporate finance clarify different facets of the agency problem and suggest ways of mobilizing the legal system to address this master problem.

A word on the reader's format is in order. I have used materials in this reader to supplement casebooks in my courses in corporate law and corporate finance. The reader was crafted with the intention that it be used as a springboard for class discussion in a corporations course, but there are extensive notes and questions to ensure that it is sufficiently self-contained for independent, self-directed use. All of the selections have been extensively edited to facilitate accessibility. Mathematics appearing in original works has been suppressed, although simple numerical examples have been retained or included in the notes to illustrate concepts. A danger with such an approach is that complexities of the literature can easily be lost, and this may convey the misimpression

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that there is no ambiguity to policymaking. I have sought to temper this risk by juxtaposing sharply differing positions in the selections or accompanying notes. In addition, references and most footnotes have been omitted from excerpts. Precision and bibliographic convenience have been sacrificed for the pedagogic benefit of greater readability. Readers who are sufficiently intrigued by an excerpt can follow up on arguments and references by recourse to the original source.

This book would not have been completed without the superb assistance of Cathy Briganti and the unflagging encouragement and support of Albert Romano. I cannot begin to thank them; I can only end by acknowledging that fact.

R.R.

New Haven
October 1992

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Theory of the Firm and Capital Markets

The readings in this chapter provide a framework for understanding corporate law. The selections in part A on the theory of the firm are classic contributions that provide explanations of why individuals organize their economic activity into firms and why certain institutional arrangements are so prevalent. They also suggest that the markets in which firms operate affect their organizational structures. A key market for public corporations is the capital market. This is because one of the explanations for organizing a business as a corporation is its greater access to capital, which, as discussed in Chapter 2, is facilitated by corporate characteristics of free transferability of shares and limited liability. The selections in part B introduce the conceptual building-blocks of modern corporate finance. It is not possible to understand the operation of capital markets, and correlatively the corporations whose securities trade in those markets, without a mastery of those rudimentary ideas.

In neoclassical economics, the firm is a black box, represented by a production function. Although firms have an objective, profit maximization, the neoclassical approach focuses on aggregate firm behavior (markets) rather than the individual firm. The readings in this chapter on the theory of the firm, however, take a more microanalytical approach, delving inside the firm and differentiating the players and their interests.