

CORPORATE LAW

CLARK

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CORPORATE LAW

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To My Mother and Father

PREFACE

Audience. This book is written primarily for law students taking the basic course in corporations. Its style and subject matter coverage are geared to students. Nevertheless, I hope that the book will reward many other kinds of readers. Parts of it should serve as a useful preparation to those who are about to embark on courses in securities regulation, corporate finance, or other specialized areas of study. Moreover, the book presents a distinctive vision of corporate law, and it aims to produce a fresh and unified understanding of basic principles and connecting themes. Consequently, it may prove helpful to lawyers and judges who are searching for new ideas and arguments about familiar topics, or who are trying to synthesize their hard-won stores of knowledge. Finally, the book may be an appropriate and friendly guide for businesspersons, economists, or non-lawyer academics who want to inform themselves about this important area of law. I have tried very hard to write a text that reads easily and forgives a lack of legal training.

Approach. Given its primary audience and focus, this book is not cast as a small encyclopedia. It does not purport to be a compilation of legal authorities that by itself could serve as a complete basis for concrete legal advice. The reasons for not attempting to write a treatise that both teaches and serves as a reference work are fairly obvious, even though they seem to have been forgotten by more than one author of a legal work: too much detail impedes learning, giving real legal advice requires exact knowledge of particular local law that is constantly changing in its details, and today loose-leaf services and computerized data banks often provide the best sources of detailed current information for the practitioner who already understands the basic legal doctrines.

Instead of questing for infinite completeness, this book tries to do what a one-volume introductory work can and should do. First, it explores major topics at length. Second, it gives the subject matter a coherent structure; it shows how all the major parts of corporate law fit together. Third, it examines the rationale of the major concepts and doctrines.

This emphasis on the organization of legal knowledge reflects my view

Preface

of the nature of the expert knowledge possessed by truly competent lawyers. Becoming a good corporate lawyer, or a good lawyer in any field, is an ongoing process that never ends, but it is not a process of just piling up one legal nugget after another. Learning a technical subject is like building a house. If (but only if) the young professional has built a firm foundation and a properly laid out basic structure of understanding, later acquisitions of detailed knowledge or of new developments can easily be put into their proper place, thus letting the occupant move around efficiently. Those who throw up an awkward or incoherent structure in the beginning will later pay the price.

As compared to traditional hornbooks, this book may seem both more and less “theoretical.” On the one hand, it often develops arguments for and against rules and pursues policy analyses, sometimes at great length, and it does so with the aid of economic theory and concepts. On the other hand, it relies greatly on examples, hypotheticals, and extended discussions of cases.

This latter feature of the book is deliberate and reflects its audience and purpose, as well as my beliefs about how students actually learn. The approach has certain risks. For example, some of my extended discussions of cases may be of cases that don’t match those the student reads in her course or that will soon be dropped from casebooks or superseded by later developments. I regard this problem as far less important than the gains in understanding that are likely to come from abandoning the sterilized and deceptively permanent abstract statements of black-letter principles that dominate the pages of many traditional hornbooks. It is better to wrestle with a fleeting historical reality than to dally with an immortal but effete generalization. For the most part, I have chosen to discuss cases that are good vehicles for examining the operational meaning of legal rules and concepts, or of kinds of legal argument. Under this approach, some very old but interesting cases receive significant scrutiny.

The book tries to explain and illustrate a large quantity of rules, doctrines, and cases in a clear, concise, and fair way. Yet my own ideas and recommendations enter in several ways. First, there are explicit analyses of what the law should be, or how rules should be interpreted and related to one another. Examples are the concluding sections of the chapter on corporate opportunities, the concluding pages of the chapter on insider trading, and the first and last sections in the chapter on basic self-dealing. For the most part, these legal briefs are easy to spot and are kept separate from the expositional parts. The student anxiously concerned to learn “only what the law is” will find it easy to detect and skip over these parts if he so wishes. Second, I have made many value judgments in the course of select-

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ing, weighing, and assessing opposing arguments about legal rules. Prime examples are my treatment of the pros and cons of insider trading and the pros and cons of management buyouts. The context should make it clear what conclusions belong to the courts, to the author, to other commentators, or to the general intellectual space of the subject. Third, my own view of corporate law as a whole is implicit in the selection and organization of topics. This viewpoint cannot be excised from the exposition itself. The reader who wants to examine it critically will have to do his own reflecting and cogitating.

Theme. Most of corporate law is concerned with the array of substantive rules and procedural devices that are aimed at controlling managerial slack and diversion while preserving adequate discretion to carry out business operations efficiently. Put in other words, the law displays a constant tension, and a constant striving for a good balance, between the fiduciary duties of care and loyalty on the one hand and the business judgment rule on the other. As is more fully explained in chapter 1, the book is organized around these topics.

Seen in this light, the study of corporate law is a study of the legal system's attempts to control managerial discretion in an important class of large, complex, formal organizations. It is a study that should offer important food for thought to anyone interested in the design of other large organizations in modern societies. The central problem of corporate law — the optimal control of managerial discretion — is a thoroughly pervasive one in all modern societies, whether they be capitalist or socialist in basic design. In all large formal organizations there are people (usually the top executives) who (1) possess a great deal of power to affect the operations of the organization and the fortunes of all of the affected participants, but who (2) are not given this power as something to be exercised principally for their own benefit. This is as true of labor unions, nonprofit hospitals, government agencies, and state-run enterprises as it is of stockholder-owned business corporations. Corporate law's major conceptual contribution to solution of the problem (the fiduciary principle), the major substantive rules it deploys to implement that concept, and its distinctive set of enforcement mechanisms (such as the derivative lawsuit, proxy voting, and the hostile tender offer) should be of great interest as a source of more general reflections about the allocation and control of power in highly organized societies.

Role of economics. Economic theory does not provide the organizing principle of the book. The book is for future lawyers, and the law has its own characteristic categories and ways of approaching problems that the lawyer *must* master on their own terms. Nor is the book immersed in

Preface

economic jargon. On the other hand, it is suffused by a law-and-economics approach. More specifically, parts of the argument and analysis come from microeconomics, financial economics, and law review writing by law-and-economics scholars, or they at least have the flavor of a cost benefit analysis.

Numerous examples can be pointed out. Chapter 1 sketches a functional analysis that looks at the **cost-reducing effects of legal principles**. Chapters 1, 2, 4, 7, 11, and 12 all employ hypothetical contracts reasoning. Chapters 2 and 9 invoke the prisoners' dilemma of game theory. Chapters 8 and 12 present arguments cast as cost/benefit analyses. Chapter 10 uses valuation theory. Chapter 13 reviews economic theories about, and econometric studies of, the effects of tender offers and of defenses to tender offers. It and other parts of the book appeal to a modest version of efficient markets theory. Chapter 14, on dividends and repurchases, borrows arguments about optimal capital structure from the literature of financial economics. Chapter 16 takes a welfare-analytic approach to the functions of government and of corporations. Chapter 17 considers the extent to which information might be analyzed as a **public good**. Throughout the book, reliance is put on arguments about **transaction costs, information costs, risk and uncertainty, and diversification**. Finally, Appendix A is based on a theory about the minimization of types of information costs.

Omissions. Given the kind of book that I have tried to write, it is inevitable that I will have ignored or slighted the beloved topics of at least some professors of corporate law. Many of my silences about standard or semi-standard topics are quite calculated and deliberate; they rest mainly on the belief that it is not wise to try to cover everything, even everything that is arguably of practical importance, in the first pass through a subject. Some of the topics thus ignored or slighted have to do with the particular legal characteristics of different types of securities (bonds versus debentures versus preferred stock), the ALI's Corporate Governance Project, the proper drafting of articles and bylaws, and miscellaneous doctrinal areas such as conflict of law issues, the **de facto incorporation** cases, and state Blue Sky laws. These and similar omissions are obviously matters of judgment and taste, and as to their wisdom I am quite eager to receive feedback from my readers.

Robert C. Clark

April 1986

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In all but the last of these listed items, the previous work has been greatly revised and supplemented.

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SPECIAL NOTICE

SHORT CITATION FORMS

In order to reduce the bulk of the footnotes, the book departs from the formal citation practices of law reviews in a number of ways. The major differences are as follows:

1. Dates. References to statutory sources and securities law rules are usually undated. All such references are to compilations in force in 1985. Dates are used only when the statute has been superseded or the time of adoption is relevant.

2. State statutes. Frequently cited corporation laws are cited in abbreviated form as follows:

MBCA §8.01	Model Business Corporation Act, Section 8.01 (as approved June 1984).
Cal. §300	California Corporations Code, Section 300.
Del. §141	Delaware General Corporation Law, Section 141.
N.Y. §701	New York Business Corporation Law, Section 701.

Other statutes are cited in Blue Book form, except for the omission of dates.

3. State cases. I omit parallel citations and cite only the West regional reporters whenever possible. An unadorned abbreviation of a state's name means the decision was made by the state's highest court. For example, "493 A.2d 946 (Del. 1985)" cites a decision of the Delaware Supreme Court; "460 P.2d 464 (Cal. 1969)" cites a decision of the California Supreme Court. A lower court opinion is indicated by an added abbreviation in the parenthetical part of the cite, e.g., "(Del. Ch. 1985)" or "(N.Y. App. Div. 1969)".

Special Notice

4. Federal sources. References to the federal securities laws and rules under it are given in a short form familiar to practicing lawyers:

Securities Act §5	Section 5 of the Securities Act of 1933, which as a whole is codified at 15 U.S.C. §77a et seq.
Rule 144	Rule 144 under that act. The rules appear in 17 C.F.R. 230.xxx, where “xxx” means the number of the rule.
Securities Exchange Act §10(b)	Section 10(b) of the Securities Exchange Act of 1934, which as a whole is codified at 15 U.S.C. §78a et seq.
Rule 10b-5	Rule 10b-5 under that act. The rules appear in 17 C.F.R. 240.xxx, where “xxx” means the number of the rule.

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