Today’s readings introduce you to US corporate law. Now that you have a basic understanding of US law – its common law roots, its federal structure, and its principal institutions – you are ready to consider the specific topic of corporate law.

You’ll begin by reading two chapters from a study book used by US law students for their course in Corporations or Business Organizations. The first chapter describes the principal attributes of the US corporation, which you should find quite similar to those of Italian and other European companies. It then offers a history of the US corporation, culminating in recent regulatory reforms by Congress. Finally, the chapter explains how corporations are “persons” for many purposes, including under our Constitution.

The next reading, another chapter from the study book provides you an insight to how US corporations are formed, what rules apply to such corporations (under the “internal affairs doctrine” that explains internal corporate governance is to be determined by the law of the state of incorporation), and the powers of US corporations. Much of this will be familiar to you, and you will find ready analogues in Italian and European company law.

The next reading is drawn from a speech I gave a few years ago at the opening convocations of notarial schools in Italy. The speech was way too long! But the text, I hope, is a readable description of some of the peculiar and important aspects of US corporations. I describe six essential aspects: US corporations as creatures of state (not federal) law; US corporate law as enabling, not mandatory; Delaware as the pre-eminent corporate law state; US corporate law’s focus on shareholders, not creditors; the nature of US corporate fiduciary duties; and the dynamism of US corporate law.

Finally, I encourage you to use the link below to browse the corporate statute of Delaware. Is it familiar to you? How does it differ from Italian company law?

**Readings:**
- E&E 01 (Overview of Corporation)
- E&E 03 (Incorporation)
- [Delaware General Corporation Law](please browse)
CHAPTER 1
The Corporation — An Overview

What is a “corporation”? It is a framework by which people conduct modern business. It is a convenient legal entity that can enter into contracts, own property, and be a party in court. It comes in assorted sizes, from a publicly held multinational conglomerate to a one-person business.

The corporation is a creature of law — a legal construct. Nobody (not even your law professor) has ever seen one. The corporation’s existence and attributes arise from state-enabling statutes, which give business participants significant freedom to choose their own customized relationships. But the statutory framework is incomplete, and judicial norms fill the many gaps left by the statutes. Other gaps, particularly those involving disclosure to investors, are filled by federal securities law.

Ultimately, the corporation is an investment vehicle for the pooling of money and labor — a grand capitalist tool. Money capital comes from shareholders and creditors; human capital comes from executives and employees. Both money and labor expect a return on their investment. The corporation defines their legal relationships and mediates their conflicting interests.

This chapter considers the principal attributes of the modern business corporation (§1.1); the history of the U.S. corporation and the sources of U.S. corporate law, including an overview of the Sarbanes-Oxley Act of 2002 (§1.2); and the status of the corporation as a “person” under the U.S. Constitution (§1.3).

§1.1 CORPORATION BASICS
§1.1.1 Five Basic Attributes

Suppose you are asked to make an investment. What would you ask? The paradigm corporation represents a set of answers to the five basic questions that arise in every investment relationship:

• **How long does the investment last?** The corporation has an independent, perpetual existence. It is an entity distinct from those who contribute capital (shareholders and creditors) and those who manage the business (directors and officers). The persons who constitute the corporation may come and go, but the corporation remains. It owns the business assets and is liable for any business debts.

• **Who manages the investment?** The locus of corporate power is the board of directors, which manages and supervises the business. (The board often delegates its power to officers to act for and bind the corporation.) In exercising their management powers, the directors are subject to fiduciary duties. Shareholders have only a limited
governance role. They can vote to elect directors, approve fundamental corporate changes, and initiate limited reforms, but have no power to act on behalf of the corporation.

• **What is the return on the investment?** The corporation establishes a hierarchy to the financial returns generated by the business. Creditors (including bank lenders, bondholders, trade creditors, and employees) are first in line and receive a return based on their contracts. Shareholders are last in line and receive dividends as declared at the discretion of the board. If the business dissolves, creditors’ claims have priority, and shareholders are residual claimants.

• **How can investors get out?** Ownership interests (shares) are freely transferable. Shareholders can realize the value of their investment by selling to other investors interested in acquiring their financial rights. The corporation, however, has no obligation to repurchase these ownership interests. Managers (directors and officers) cannot transfer their positions, but can resign at any time.

• **What are investors’ responsibilities to others?** The corporation is liable for its own obligations, but otherwise creates a “nonrecourse” structure. Corporate insiders (directors, officers, shareholders) are not personally liable to outsiders on corporate obligations. Outsiders (such as contract creditors and tort victims) bear the risk of corporate insolvency. Corporate investors and managers risk only their investment.

In effect, the corporation combines five attributes: (1) separate, perpetual legal personality; (2) centralized management under a board structure; (3) shared ownership interests tied to residual earnings and assets; (4) transferability of ownership interests; and (5) limited liability for all participants.

Of course, there are exceptions. For example, shareholders in closely held corporations can agree to manage the business, pay themselves specified dividends, and limit their ability to transfer their shares. In some circumstances courts use equitable principles to hold shareholders personally liable for corporate debts beyond their investment, or lenders may require shareholders to guarantee personally the corporation’s obligations. The corporation is mostly a malleable set of default rules that specifies the terms of the parties’ relationship unless they agree otherwise. This places a premium on the lawyer’s role as creative planner.
Note on Corporate Nomenclature

There is some confusion about what is meant by “private corporation” and “public corporation.” A “private corporation” generally refers to a nongovernmental, for-profit business that has been incorporated under a state statute. A private corporation can be owned by a few shareholders — referred to as a “closely held corporation” or “close corporation.” Or the private corporation can be owned by many shareholders whose shares trade on public trading markets such as the New York Stock Exchange — referred to as a “publicly held corporation” or “public corporation.” See MBCA §1.40 (Definition 18A). Thus, Apple Inc. is a “private corporation” that is also a “public corporation.” And Mom & Pop Grocery Corp. is a “private corporation” that is also a “close corporation.” To keep things simple, this book avoids the term “private corporation.”

Some corporations are governmental, such as the Federal Deposit Insurance Corporation. The FDIC, a government agency established to insure bank deposits, was created by an act of Congress and is governed by a board of governors whose members are appointed by the president. Although some people might call the FDIC a “public corporation,” it’s clearer to call it a “governmental agency.”

Corporate Constituents

Many persons participate in the joint economic activities that constitute the corporation. Shareholders — whether individual investors or institutions that invest for their beneficiaries (pension funds, mutual funds, banks, insurance companies, endowments) — provide money capital. Managers (directors and officers) oversee the business and its employees. Lenders supply additional money capital as secured bank loans, unsecured bonds, short-term notes, and suppliers’ trade credit. Suppliers provide inputs for the business under long-term contracts and in market transactions. For some, customers are the reason the business exists. Those injured by the business (whether as employees, customers, or strangers) have claims on the business directly or through governmental enforcement — antitrust, banking, environmental, health, product safety, and workplace safety. As an economic actor in society, the corporation pays federal, state, and local taxes.

Corporate law, however, focuses on the relationship between shareholders and managers — the two constituent groups understood to comprise the “internal” organization of the corporation. “Outside” relationships with creditors, suppliers, customers, employees, and government authorities usually are subject to legal norms that treat the corporation as a person — such as the laws of contract, debtor-creditor, antitrust, labor, and tax.
§1.1.2 Theory of the Firm

In the paradigm corporation, investors delegate control over their investment to managers. By separating the finance and management functions, the corporation creates an investment vehicle for raising large amounts of capital and operating large enterprises. This separation between shareholders and managers, however, makes the corporation a breeding ground for conflicting interests—and opportunism.

Ideally, shareholders and managers should want to maximize business returns, but they will have separate agendas. Once shareholders have invested, managers may become lazy, extract exorbitant perquisites (or worse), or be reluctant to take business risks that threaten their job security. Once managers have committed their human capital, shareholders may demand immediate returns, want managers to take high risks, or seek intrusive control powers. Despite these conflicts, the premise of the corporation is that neither shareholders nor managers can exist without the other— the corporation allows them to coexist.

Corporate law allocates risks between shareholders and managers in an attempt to minimize shareholder-manager conflicts and to maximize the firm’s overall success. It creates a structure for business activities and devices to control conflicts of interest among corporate constituencies. These conflicts are often referred to as “agency problems” since they mimic the conflicts in the principal-agent relationship. In some contexts, corporate law assumes legal intervention is too costly and leaves risk with shareholders. For example, the judicially created business judgment rule gives directors broad discretion to run the business without judicial second-guessing (see §12.2). In other contexts, corporate law regulates conflicts. Shareholders, for example, must approve the board’s decision to merge the corporation into another corporation (see §35.2.2).

Over the last few decades, some legal theorists have described the corporation as a “nexus of contracts.” Contractarians view the corporation as a set of voluntary relationships among corporate constituents bound together by formal contracts, statutory norms, implicit understandings, and market constraints. The corporation serves as an organizing tool for their relationships. Corporate law, a collection of rules and mechanisms for specifying the roles of the corporate constituents, reflects the bargain the parties would have struck had they negotiated.
This vision of the corporation contrasts with the traditional notion of the corporation as a regulatory device. To traditionalists, the corporation creates dangerous opportunities for managers to exploit shareholders and other constituents. Traditionalists maintain that in public corporations active managers exercise “control” at the expense of passive shareholder “owners.” In close corporations where no market exists for shareholder interests, the majority can unfairly exploit the minority. Corporate law, particularly corporate fiduciary duties, serves to protect shareholders.

Traditionalists thus place great emphasis on corporate law as a means to control manager opportunism. They urge greater shareholder voting powers, broad disclosure rights, and strong fiduciary protection. On the other hand, contractarians believe that corporate law embodies the terms the parties have chosen. Combined with market forces, these terms are enough to restrain manager opportunism. For example, contractarians argue that if managers act opportunistically, investors can sell their shares; falling market prices of corporate shares will make it harder for managers to raise capital and to compete in product and service markets; and, eventually, any corporation in which managers disregard shareholders will become a takeover target or go bankrupt.

<table>
<thead>
<tr>
<th>Traditionalists</th>
<th>Contractarians</th>
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<tbody>
<tr>
<td>The corporation is a creature of law; no real bargaining occurs in the modern public corporation.</td>
<td>The corporation (like a contract) is a device, recognized by law, to organize specialized business activity.</td>
</tr>
<tr>
<td>Managers can use “control” to exploit shareholders and other constituents.</td>
<td>Managers cannot exploit “control” because market constraints align their interests with shareholders’.</td>
</tr>
<tr>
<td>Shareholders can be exploited because they are unsophisticated or uninformed.</td>
<td>Public shareholders act in sophisticated markets; close corporation participants can protect themselves by contract.</td>
</tr>
<tr>
<td>Capital (and other) markets are not always efficient; markets act slowly and unevenly to discipline poor managers.</td>
<td>Capital markets operate efficiently so stock prices of public corporations reflect all available public information.</td>
</tr>
<tr>
<td>Corporate law should mandate rules to promote fairness and efficiency.</td>
<td>Corporate law should seek to infer the parties’ bargain, whether explicit or implicit.</td>
</tr>
<tr>
<td>Judges should actively enforce managers’</td>
<td>Judges should intervene with caution, only to fill gaps in the</td>
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§1.2 SOURCES OF CORPORATE LAW

§1.2.1 Historical Sketch of the Corporation

The modern corporation did not happen in one blazing moment of inspiration. Instead, we can trace its current attributes to various earlier times and forms. The idea of an amalgamation of persons forming a separate juridical personality moved from Greece, to Rome, to the Continent, and to England. Originally, perpetual separate existence in England was reserved for ecclesiastical, municipal, and charitable bodies whose existence was conferred by sovereign grant. The idea of common ownership by a body of passive investors originates from joint-stock trading companies, such as the East India Company (a monopoly franchise) in the early 1600s. A combination of continuity of life, centralized management, financial interests in profits, transferability of shares, and limited liability for private business existed in the 1700s in the form of complex deeds of settlement — an unincorporated association!

These concepts came to the American colonies. At first corporations, like political municipalities, had to receive a special charter from the state legislature. Legislatures granted charters on a case-by-case basis to noncommercial associations (such as churches, universities, and charities) that wanted the convenience of perpetual existence and to commercial associations (such as banks, navigation companies, canals, and turnpikes) with special public purposes and large capital needs. As the needs for capital (and thus incorporation) increased during the early 1800s, states began to enact general incorporation statutes for specified, usually capital-intensive, businesses. From the beginning, many feared the concentrated economic power inherent in the corporate device. Eventually, the U.S. corporation evolved in the mid-1800s into a legal form available to all, though subject to significant statutory restrictions.

During the late 1800s two major trends, leading in opposite directions, shaped modern U.S. corporate law. The first trend led to restraints on business activities. In the 1880s Congress created the Interstate Commerce Commission to regulate the railroad monopolies. In 1890 and 1916 Congress passed antitrust legislation (the Sherman and Clayton Acts) to combat concentrations of corporate economic power. In the early 1900s states enacted “blue sky” laws to deal with fraud in the sale of corporate securities. In the 1930s Congress passed a series of securities laws aimed at abusive management practices in national securities markets.

The other trend led to a liberalization of state corporation statutes. In the late 1800s, to attract incorporation revenues, some states amended their statutes to lift limits on the

| fiduciary duties to shareholders. | parties’ bargain and protect markets. |
| Managers will abuse incentives, such as by manipulating financials or taking excessive compensation. | Managers can be given incentives, such as stock options, to motivate them to make the business more productive. |
amount of capital that a corporation could raise, to permit corporate ownership of other corporations, and generally to increase the flexibility available to corporate management. Eventually Delaware won this race of laxity, which some have called a scurrilous "race to the bottom" and others an efficiency-producing "race to the top." Today most large, publicly traded U.S. corporations are incorporated in Delaware.

§1.2.2 Modern State Business Corporation Statutes

The corporation statutes of each state describe the basic corporate attributes. The MBCA is typical in that it details

- how to form a corporation (MBCA Chapters 1, 2, 3, 4, 5)
- the financial rights of shareholders (MBCA Chapter 6)
- the governance roles of shareholders, directors, and officers (MBCA Chapters 7, 8)
- the transferability rights of shareholders (MBCA §6.27)
- limited liability for shareholders (MBCA §6.22)
- structural changes such as charter amendments, mergers, and dissolution (MBCA Chapters 10, 11, 12, 13, 14)

Some of the statutory terms are mandatory, such as the annual election of directors and shareholder voting on dissolution. Others, such as the removal of directors without cause or shareholder action without a meeting, are default terms that apply unless the parties choose different terms. Contractarians often view corporate statutes as providing standardized "off-the-rack" terms that apply unless the parties (usually in the charter) choose different, firm-specific terms. Under the internal affairs doctrine, the law of the state of incorporation governs all shareholder-manager matters in multistate corporations (see §3.2.1).

Although no two state corporation statutes are identical, there has been a trend toward greater uniformity and modernization. In 1950 the American Bar Association’s invitation-only committee on corporate laws published the first model business corporation act. This model act, and its many revisions, served as the basis for corporation statutes in most states. In 1984 the ABA committee substantially reorganized and rewrote the model act, which follows the enabling structure of Delaware’s corporate statute. The model act has since been revised on a number of occasions. The 1984 revisions, first referred to as the Revised Model Business Corporation Act (RMBCA), have become simply the Model Business Corporation Act (MBCA). Significant revisions since 1984 include provisions on directors' conflicting interest transactions (1992), director standards of conduct and liability (1998), and shareholder rights in fundamental transactions (1999). A majority of states (32 as of 2011) have enacted corporate statutes based on the 1984 MBCA.

Not all states, however, have enacted a corporate statute based on the model act. In fact, the most prominent corporate law states — Delaware, California, and New York — have their own idiosyncratic corporation statutes. Delaware’s statute is particularly important in U.S. corporate law because of the leadership of its legislature in being the first to enact corporate law reforms, the sophistication of the state’s corporate bar, and the expertise and influence of its judiciary — and because most large, public corporations are incorporated in
State corporation statutes generally treat all corporations the same. Corporations with numerous, widely dispersed shareholders (publicly held corporations) generally are subject to the same statutory rules as corporations with a small group of shareholders who do not have a public market for their shares (closely held corporations).

§1.2.3 Role of Judge-Made Law

Corporation statutes are not all-encompassing; court decisions clarify and fill in the gaps of the statutes and the corporation’s constitutive documents. The most important judicial gap-filling involves the fiduciary duties of directors, officers, and controlling shareholders. Common-law fiduciary principles that regulate abuse by those who control the corporation’s decision-making machinery lie at the heart of corporate law. See Chapter 11 (introduction to fiduciary duties). Lately, many fiduciary rules have turned on the disinterestedness and independence of outside (nonmanagement) directors in making corporate decisions.

§1.2.4 ALI Principles of Corporate Governance

In 1977 the American Law Institute embarked on a long-term project to describe and unify the basic standards of corporate governance and structure, particularly in those areas not addressed by state corporation statutes. The project was controversial, often pitting contractarians against traditionalists. In 1993, after more than 15 years, the project came to a conclusion when the ALI approved a final version of the Principles of Corporate Governance. The ALI Principles have not received the same reception as other ALI documents, such as the ALI restatements. Although some courts have embraced portions of the ALI Principles as useful statements of corporate law, other courts have given them little attention, and some have openly rejected them.

§1.2.5 Federal Law

There is no federal corporation statute, despite regular calls for a uniform national law applicable to some or all aspects of publicly traded corporations. Despite the absence of a federal law of corporations, federal statutes add a significant layer of corporate regulation. The Securities Act of 1933 regulates the disclosure when corporations raise capital in public markets, whether by selling stock or taking on debt (see Chapter 5). The Securities Exchange Act of 1934 imposes periodic reporting requirements (see §21.2) and proxy disclosure rules on corporations whose stock is publicly traded (see Chapter 9). In addition, the Exchange Act regulates the trading of securities in public and private markets, including insider trading — that is, the use of material, nonpublic corporate information to buy or sell stock (see Chapters 22 and 23).

Nonetheless, the landscape of corporate governance (the relationship between corporate managers and shareholders) has been significantly altered by two important pieces of federal legislation. In 2002, responding to a spate of corporate and accounting scandals, Congress passed the Sarbanes-Oxley Act — sweeping legislation that federalizes specific aspects of corporate law for public corporations. Among the Act’s reforms are limits on corporations hiring their audit firms to do nonaudit work for the corporation, rules governing the composition and functions of the board’s audit committee, provisions
requiring forfeiture of executive pay when companies correct their financials, bars on individuals from holding corporate office if they have committed securities fraud, prohibitions on companies making personal loans to their executives, mandates for companies to institute and disclose systems of internal controls, and SEC rules governing professional conduct of corporate/securities lawyers. Sarbanes-Oxley is described more fully in §11.5.1.

In 2010, responding to the financial crisis of September 2008 and perceived gaps in financial regulation, Congress passed the Dodd-Frank Act — massive legislation principally concerned with banking reform and securities regulation, but also having major implications for public corporations. Among other things, the Act mandates that compensation committees be composed entirely of independent directors, requires that shareholders have a “say on executive pay,” requires corporations to adopt “clawback” policies when executives profit on false financial disclosures, mandates a new SEC program for employees who report securities violations to receive “whistleblower” bounties, and authorizes the SEC to pass rules giving shareholders the ability (at corporate expense) to nominate directors to the board. Dodd-Frank is described more fully in §11.5.2.

Note on Securities Regulation

In keeping with the traditional demarcation of corporate law and securities regulation in the United States, this book considers the aspects of Sarbanes-Oxley and Dodd-Frank that deal primarily with corporate governance. Those reforms that address disclosure to investors — securities regulation — are left to other sources. See Alan R. Palmiter, Securities Regulation: Examples & Explanations (6th ed., Wolters Kluwer Law & Business 2014).

§1.3 CORPORATION AS A CONSTITUTIONAL PERSON

The corporation as “person” is a powerful metaphor. Corporate personality facilitates the aggregation of capital and labor with the attributes of a single entity capable of contracting, owning property, and being a party in court — just like a natural person. For commercial purposes, state and federal law largely respects the corporation-as-person metaphor. Most commercial statutes either specifically define corporations to be persons under the statute or have been so interpreted.

But there are many noncommercial contexts in which the law does not treat the corporation as a natural person, such as laws on intestacy, adoption, and political voting. This makes perfect sense. It would be ludicrous if a corporation could be an adoptive parent (except in the movies) or the political rule were “one corporation, one vote.” When does the corporation have rights under the U.S. Constitution that normally are associated with natural persons?

§1.3.1 Broad Commercial Rights
According to the Supreme Court, the constitutional status of the corporation varies depending on the constitutional right at issue. The Supreme Court has had no trouble treating the corporation as a constitutional “person” when constitutional provisions can be seen as protecting commercial interests of the business.


Corporations have First Amendment rights to express themselves as to commercial matters — such as advertising their products. Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748 (1976). And corporations have a First Amendment right to not be associated with certain speech, thus permitting them to refuse to distribute state-mandated information to customers. Pacific Gas & Electric Co. v. Public Utilities Commission, 475 U.S. 1 (1986).

The one (and largely superceded) exception to the commercial-interest analysis was the Supreme Court’s refusal to treat corporations as “citizens” protected by the Privileges and Immunities Clause of Article IV. Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1868). In theory, this allows states to regulate “foreign” corporations (those incorporated in another state) doing in-state business differently from their own “domestic” corporations, though in practice the differences in regulation have been minor and the equal protection afforded corporations under the Fourteenth Amendment essentially ensures nondiscrimination.

§1.3.2 Limited Noncommercial Rights
As to the corporation’s noncommercial interests, the Supreme Court has been less willing to extend constitutional protection. For example, corporations cannot claim a Fifth Amendment privilege against self-incrimination. Bellis v. United States, 417 U.S. 85 (1974). Yet when the corporation’s interests are closely linked to an individual’s interests — such as in a one-person corporation — some lower courts have suggested that the individual’s privilege against self-incrimination may extend to the corporation. And corporations have only a limited Fourth Amendment right to be free from unreasonable searches and seizures, since business privacy is less compelling than personal privacy. G.M. Leasing Corp. v. United States, 429 U.S. 338 (1977).

Nonetheless, a corporation has significant free-speech protection under the First Amendment — even as to noncommercial political matters. For example, a state cannot forbid a corporation from expressing its views on a state referendum involving individual tax rates, even when the referendum did not materially affect the corporation’s business. First National Bank of Boston v. Bellotti, 435 U.S. 765 (1978). Corporations can communicate with the legislative and executive branches by lobbying and commenting on proposed laws and rulemakings and can seek to sway the legislative branch in amicus briefs. Corporations can also set up their own political action committees (PACs) funded by voluntary contributions from their shareholders, managers, and employees — thus to speak on
political issues and to contribute (subject to limits) to candidates and political parties.

More recently, the Supreme Court has held in a controversial 5-4 decision that a corporation cannot be prohibited from spending its own money to support or oppose a candidate for political office. *Citizens United v. Federal Election Comm’n.* 558 U.S. — (2010). Central to its analysis, the Court in *Citizens United* overruled an earlier 1990 decision that held a state could prohibit corporations from making campaign contributions to state candidates. *Austin v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990). The Court in *Citizens United* rejected that there were compelling justifications to ban political expenditures by corporations that had “amassed” resources in the marketplace because wealthy individuals could not be banned from spending their money to speak out for or against candidates. Thus, although corporations (like individuals) can be limited with respect to their direct *contributions* to political candidates, corporations (like individuals) cannot be limited with respect to *expenditures* — on their own or through independent PACs — for speech that supports or opposes political candidates.

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**Note on Conception of “Corporation”**

As you can see, the Supreme Court’s conception of the corporation has different faces. The Court has variously viewed the corporation (1) as a creature of state law (a “concession” theory), (2) as a distinct legal entity separate from the incorporating state and its shareholders (a “natural rights” theory), and (3) as a set of voluntary relationships among its participants (an “aggregation” theory).

The “concession” theory is reflected in an early decision by the Supreme Court that disallowed states from unilaterally changing the corporate charter, viewing the corporation as a binding contract between two parties — the state and corporation. *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819). The “natural rights” theory, under which corporations are viewed as constitutional persons, was in vogue during the late 1800s when the Court protected corporate persons (and their economic interests) from discriminatory and burdensome state regulation. The “aggregate” theory has been used by the Court — most recently in *Citizens United* — to extend to the corporation the rights that individuals (and thus groups of individuals) have against government overreaching. In the end, though, the Court has never really articulated why the corporation is a “person” or the kind of “person” it is.
CHAPTER 3
Incorporation — How, Where, and What

Forming a corporation under modern state corporation statutes is quick and straightforward. The process creates a public record of incorporation; it binds the parties (with rare exceptions) to the corporate law of the incorporating state; and it documents any optional terms the parties may have chosen. For the corporate planner, there are three significant questions:

• What provisions must be included in the articles of incorporation?
• What optional provisions can be included in the articles?
• In what state should the corporation be incorporated?

This chapter describes how the incorporation process works (§3.1), the choice of where to incorporate and the choice-of-law rules that apply to the incorporation decision (§3.2), and what powers the corporation has and what happens if the corporation exceeds its powers (§3.3).

Other chapters in this part discuss the financial rights of corporate investors (Chapter 4) and the informational rights of new investors when the corporation sells securities (Chapter 5).

§3.1 PROCESS OF INCORPORATION

Corporate existence and the attributes of “corporateness” begin with the filing of articles of incorporation. Forming a corporation involves three essential steps:

• preparing articles of incorporation (in some states called the charter or the certificate of incorporation) according to the requirements of state law, MBCA §2.02; Del. GCL §102
• signing of the articles by one or more incorporators, MBCA §1.20(f); Del. GCL §103(a)(1)
• submitting the signed articles to the state’s secretary of state for filing, MBCA §2.01; Del. GCL §106

These steps are often carried out by a lawyer, who when acting for multiple parties acts as a “lawyer for the situation.” Under professional ethics rules, a lawyer acting in such a capacity must consult with the parties about the pros and cons of multiple representation, including the loss of any attorney-client privilege among the parties, and must obtain each party's informed consent. See ABA Model Rule of Professional Conduct 1.13 (Organization as Client). A lawyer who helps organize a corporation may be seen as representing the corporate entity, not the individual investors. See Jessie by Reineche v. Danforth, 485 N.W.2d 63 (Wis. 1992) (holding that lawyer who organized a corporation for 20 physician-investors did not represent individual investors, thus permitting lawyer’s firm to represent another client in a malpractice suit against two of the physicians).

§3.1.1 Articles of Incorporation

Modern corporate statutes prescribe the standard information the articles must contain.
Name of the Corporation

The articles must state the corporation's complete name and include a reference to its corporate status — a word such as “Corporation,” “Incorporated,” or “Inc.” The name must also be different from other corporate names in the state. How different? Some statutes say it must be “distinguishable upon the records” of the secretary of state from other names already in use or reserved for use. MBCA §4.01; Del. GCL §102(a)(1). See Trans-Americas Airlines, Inc. v. Kenton, 491 A.2d 1139 (Del. 1985) (accepting “Transamerica Airlines, Inc.” even though confusingly similar to existing “Trans-Americas Airlines, Inc.” because both names were distinguishable). Some statutes require the name not be “deceptively similar” to existing names. See Cal. Code Reg. 21002. While the “distinguishable upon the records” test simply assures each corporate name will be unique and easy to identify, the “deceptively similar” test has a further aim to prevent deception or unfair competition.

Many states allow businesses to reserve a corporate name (for a fee) during the preincorporation process. MBCA §4.02 (nonrenewable reservation for 120 days); Del. GCL §102(e) (initial and renewable reservations for 120 days). In some states a corporation incorporated in another state (a “foreign corporation”) may register its name with the secretary of state to keep local firms from using it. MBCA §4.03 (registration renewable annually); Del. GCL §102(e) (renewable every 120 days).

Registered Office and Agent

The articles must state the corporation's registered office for service of process and for sending official notices. MBCA §2.02; Del. GCL §102(a)(2). Often the articles also must name a registered agent at that office on whom process can be served. MBCA §§2.02, 5.01; Del. GCL §102(a)(2). Changes in the registered office or registered agent must be filed with the secretary of state. MBCA §5.02; Del. GCL §133.

Capital Structure of the Corporation

The articles must specify the securities (or shares) the corporation will have authority to issue. The corporation will raise capital by issuing its shares. The articles must describe the various classes of authorized shares, the number of shares of each class, and the privileges, rights, limitations, and preferences of each class. MBCA §§2.02(a)(2), 6.01; Del. GCL §§102(a)(4), 151(a). The corporation cannot issue more shares than are authorized, unless the articles are amended. No share price need be stated, and the requirement (once prevalent) of an initial minimum capitalization has virtually disappeared in the United States.

Purpose and Powers of the Corporation

The articles may (but need not) state the corporation’s purposes and powers. With the decline of the ultra vires doctrine (see §3.2.1), a “purposes” clause is far less important than it once was. The modern presumption is that the corporation can engage in any lawful business. MBCA §3.01; Del. GCL §101(b). A limited purposes clause may be beneficial in a closely held corporation where an investor who lacks control wishes to restrict the corporation’s lines of business. See Chapter 25.

Most state statutes also contain an all-inclusive list of the activities in which a
corporation may engage. The articles need not state these powers. MBCA §3.02 (corporation has “same powers as an individual . . . to carry out its business and affairs”); Del. GCL § 122 (enumerated powers).

Size/Composition of Board of Directors

Many statutes no longer require that the articles name the initial directors. MBCA §2.02(b)(1) (permitting naming of initial directors); cf. Del. GCL §102(a)(6) (requiring names and addresses of initial directors, if power of incorporators terminates on filing certificate of incorporation). Likewise, most modern statutes have abandoned requirements that the board be composed of at least three directors or that the articles specify the number of directors. MBCA §8.03 (requiring board composed of “one or more individuals”); cf. Del. GCL §141(b) (one or more “natural persons”).

Optional Provisions

The articles can contain a broad range of other provisions to “customize” the corporation. MBCA §2.02(b); Del. GCL §102(b). Such provisions are often important in closely held corporations where the participants want specific protections. “Opt in” provisions allow the parties to choose additional provisions defining their corporate relationship; “opt out” provisions allow the parties to avoid provisions that would otherwise apply:

- **voting provisions** that call for greater-than-majority approval of certain corporate actions, such as mergers or charter amendments (see §26.1.1)
- **membership requirements** that directors be shareholders or that shareholders in a professional corporation be members of a specified profession (see §26.3)
- **management provisions** that require that shareholders approve certain matters normally entrusted to the board, such as executive compensation (see §26.4)
- **indemnification provisions** that specify when the corporation will pay for the liability, settlement, or costs of defense if directors or officers are sued in their corporate capacity (see §15.1)

Corporate law is not fully enabling. In some situations, provisions that deviate too far from corporate norms may not be enforceable (see §§26.4, 39.3).

§3.1.2 Incorporators

The role of incorporators, as such, is purely mechanical. They can be an office assistant, a lawyer, an owner of the business — almost anyone. They sign the articles and arrange for their filing. If the articles do not name directors, the incorporators select them at an organizational meeting. After incorporation, the incorporators fade away and need not have any continuing interest in the corporation. Under some statutes the incorporators must be natural persons, though the trend is that a corporation may act as an incorporator of another corporation. MBCA §§2.01, 1.40(16); Del. GCL §101(a).

Comparison of Incorporators and Promoters

Incorporators, as such, carry no legal responsibilities. But when a person acts on behalf of a business during the incorporation process, such a “promoter” can become liable on
preincorporation contracts. See §§29.1, 29.2.

§3.1.3 Filing Process

Filing the articles is today a simple task. Older statutes, reflecting a time when the legislature chartered corporations, gave the secretary of state significant discretion to reject articles of incorporation for technical or other perceived defects. Modern statutes, particularly the MBCA, remove much of that discretion. The MBCA requires state officials to accept articles for filing if

- they contain the minimal information required by the statute
- the document is typed or printed
- sufficient copies are submitted
- appropriate filing fees and franchise taxes are paid
- the corporate name is distinguishable on the secretary of state’s records

MBCA §1.25; Del. GCL §103(c). In some states the filing fee is a flat amount; in other states (including Delaware, see Del. GCL §391) it depends on the number of authorized shares or the aggregate legal capital of the corporation (see §31.2.2).

Once the articles are filed, they become public documents. Those interested in confirming the corporation’s existence can obtain a certificate of existence from the secretary of state (MBCA §1.28), a receipt returned by the secretary of state when the articles of incorporation are filed, a copy of the articles with an original acknowledgment stamp by the secretary of state (MBCA §1.25), or a certified copy of the original articles obtained from the secretary of state for a nominal fee (MBCA §1.27; Del. GCL §105) (certified copy of “certificate of incorporation”).

§3.1.4 Organizational Meeting

Filing the articles merely brings the corporation into existence. It is the first step in its formation. For the corporation to function, the corporate planner must create a working structure. This is done at an organizational meeting of the incorporators or the board of directors named in the articles. The meeting, called upon written notice, usually follows a script already devised by the corporate planner.

The first item of business at the meeting — which need not take place in person, but instead by written consent — will be to elect directors unless the initial directors named in the articles are to remain in office. Once the board is constituted, other items on the agenda will include approving bylaws to govern the internal structure of the corporation, electing officers, adopting preincorporation promoters’ contracts (including the lawyers’ fees for setting up the corporation), designating a bank for the deposit of corporate funds, authorizing the issuance of shares, and setting the consideration for the shares. MBCA §2.05; Del. GCL §108.

Bylaws

As corporate articles have become more cursory and the statutes more open-ended, the bylaws have assumed greater importance under modern corporate practice. The bylaws
typically describe such matters as the functions of each corporate office, how shareholders’ and directors’ meetings are called and conducted, the formalities of shareholder voting (including voting by proxy), the qualifications of directors, the functions of board committees (such as executive or audit committees), and procedures for and limits on issuing and transferring shares.

State law does not require the bylaws be filed. The bylaws must be consistent with the articles. MBCA §2.06; Del. GCL §109(b). Like the articles, the bylaws are not enforceable if they deviate too far from the traditional corporate model (see §§26.4, 39.3).

§3.2 CHOOSING WHERE TO INCORPORATE

In the United States a corporation can be formed in any state, no matter where it does business. That is, the parties can choose the governing law for their corporate relationship. The question of where to incorporate requires balancing the benefits of incorporating in a state that provides flexibility in managing the business against the costs of incorporating elsewhere and then qualifying to do business as a foreign corporation (see §3.2.2) in other states where business is to be conducted. The decision often comes down to a choice between the business’s home state and Delaware.

The incorporation choice will determine how much in franchise taxes the corporation pays to the incorporating state. See Del. GCL §503 (based on authorized shares or capital). But business taxes will depend on where the corporation actually conducts business.

§3.2.1 Internal Affairs Doctrine

In the United States the law of the state of incorporation, with limited exceptions, governs the relationships among the parties in the corporation. This choice of law rule, known as the “internal affairs doctrine,” permits the parties through the incorporation process to fix the law that applies to their corporate relationship, wherever litigation is brought. The corporation’s “internal affairs” are those that relate to the legal relationships between the traditionally regarded corporate participants — including the rights of shareholders, the fiduciary duties of directors, and the procedures for corporate action.

Under the internal affairs doctrine, state courts are bound to accept the corporate law rules of the incorporating state, even when those rules are different or inconsistent with rules of the forum state. See McDermott v. Lewis, 531 A.2d 206 (Del. 1987) (applying Panamanian law that permitted parent corporation to vote shares of subsidiary, even though such voting is prohibited under corporate law of Delaware and all other U.S. states).

A few states have modified this choice of law rule and purport to regulate the internal affairs of corporations that have substantial operations in the state but are incorporated in another jurisdiction — sometimes called “pseudo-foreign” corporations. For example, California subjects foreign corporations to California corporate law if more than 50 percent of the corporation’s property, sales, payroll, and outstanding voting shares are in the state. Cal. Corp. §2115; see also Wilson v. Louisiana Pacific, 187 Cal. Rptr. 852 (Cal. App. 1982) (applying California cumulative voting provisions to Utah corporation because majority of shareholders resided in California and California has “greater interest”).
The validity of these statutes is questionable. The Supreme Court has suggested that the certainty fostered by the internal affairs doctrine may have constitutional dimensions for publicly held corporations. *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987) (see §39.4.1). There the Court said, "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations."

### §3.2.2 Qualification of Foreign Corporations

A business incorporated in one state may conduct *intrastate* operations in another state (such as manufacturing or other regular business activities) if "qualified" to do business in the other state. To "qualify" the corporation must file a certified copy of its articles, pay a filing fee, and appoint a local agent to receive service of process in that state. MBCA §15.01; Del. GCL §371. But corporations that conduct only *interstate* business within other states (such as online-order companies) need not qualify because of the constitutional prohibition against interference with interstate commerce.

What are the penalties for doing business without being qualified? Some states fine the corporation and its officers for failing to qualify. Others treat the business as unincorporated, thus subjecting corporate officers to individual liability for contracts made in that state. Until a foreign corporation is qualified, it generally cannot bring lawsuits in local court. MBCA §15.02; cf. Del. GCL §383 (Court of Chancery can enjoin nonqualified foreign corporation from transacting business in state).

### §3.2.3 Why Delaware for National Businesses?

Generally, a business that will operate locally will be incorporated locally because doing so is easier and less costly. If the business will operate throughout the United States, the corporation will be incorporated in one state and qualified as a foreign corporation elsewhere.

Most large publicly held corporations (and nearly three-fourths of companies that become public in an initial public offering) have chosen Delaware as their state of incorporation. There are a number of explanations for this:

- Delaware’s statute is designed to give management flexibility in structuring and running the business
- the Delaware courts and corporate bar are highly experienced and sophisticated in corporate law matters
- a large body of case law interprets the Delaware statute, thus providing certainty to corporate planners
- the Delaware legislature is a leader in corporate law reform and regularly amends the Delaware corporations statute as new needs and problems arise

Some academics have criticized Delaware for having a pro-management slant and engaging in a chartering “race to the bottom.” Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 88 Yale L.J. 663 (1974). Others, observing the prevalence of Delaware corporations and the willingness of shareholders to invest in them, have argued that Delaware is engaged in a “race to the top.” Winter, *State Law, Shareholder Protection, and*
*the Theory of the Corporation, 6 J. Legal Stud. 251 (1977).* Empirical studies suggest that reincorporating in Delaware does not adversely affect (and may even raise) a corporation's stock prices. Moreover, the many Delaware court decisions favoring shareholder interests cast doubt on a "race to the bottom" thesis.

Nonetheless, the Cary/Winter debate continues — on new fronts. Recent scholarship has questioned whether a "market for corporate charters" produces optimal corporate law. Although nearly 60 percent of publicly traded U.S. corporations are incorporated in Delaware, whose antitakeover statutes are less protective of management than other states, many public corporations remain incorporated in their home states. This home-state protection suggests that states compete to insulate management from financially beneficial corporate takeovers, at the expense of shareholders. In fact, non-Delaware corporations are more likely to incorporate and remain incorporated in their home state when the state offers relatively greater antitakeover protections.
Example:

Xenon, Yentl, and Zeb want to incorporate their palm-reading business. They file articles in New Columbia, an MBCA jurisdiction. Are these articles sufficient?

<table>
<thead>
<tr>
<th>ARTICLES OF INCORPORATION</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>First</strong></td>
</tr>
<tr>
<td>The name of the corporation is XYZ, Inc.</td>
</tr>
<tr>
<td><strong>Second</strong></td>
</tr>
<tr>
<td>The corporation’s registered address is 13 East-West Hwy, North Point, New Columbia; the registered agent at that address is Abner Zeb.</td>
</tr>
<tr>
<td><strong>Third</strong></td>
</tr>
<tr>
<td>The corporation is authorized to issue 3,000 shares of common stock.</td>
</tr>
<tr>
<td><strong>Fourth</strong></td>
</tr>
<tr>
<td>Any shareholder of the corporation must be a cosmologist certified by the Universal Association of Cosmologists.</td>
</tr>
<tr>
<td><strong>Fifth</strong></td>
</tr>
<tr>
<td>All voting by shareholders must be unanimous.</td>
</tr>
<tr>
<td><strong>Sixth</strong></td>
</tr>
<tr>
<td>The corporation will have a term of ten years.</td>
</tr>
<tr>
<td><strong>Seventh</strong></td>
</tr>
<tr>
<td>The incorporator is Abner Zeb, 13 East-West Hwy, North Point, New Columbia.</td>
</tr>
</tbody>
</table>

Yes. The articles are sufficient. MBCA §2.02 requires only a name for the corporation (Article First), a description of its capital structure (Article Third), a registered address and agent (Article Second), and the incorporator's address (Article Seventh). Further, the articles are signed by the incorporator, and one incorporator is enough. MBCA §1.20.
§3.3 CORPORATE POWERS AND THE ULTRA VIRES DOCTRINE

In the nineteenth century, state legislatures chartered corporations for narrow purposes and with limited powers. Likewise, early courts, concerned about the economic power of this capitalist invention, fashioned the "ultra vires doctrine" to invalidate corporate transactions beyond the powers stated in the corporation's charter.

As corporations became an accepted part of the economic landscape, state enabling statutes came to authorize "general purpose" clauses and virtually unlimited powers. See MBCA §§3.01, 3.02; Del. GCL §122 (see §3.1.1 above). Today the ultra vires doctrine applies only when

- the articles specifically restrict corporate activities
- the corporation engages in activities not directly related to profit seeking, such as excessive charitable giving
- the board of directors takes actions that undermine shareholder power (see §39.7)

§3.3.1 Early Common Law

Early corporations were formed to run capital-intensive businesses such as canals, railroads, and banks. To attract investors and obtain legislative approval, business promoters drafted the articles of incorporation to limit the scope of the business. Early courts applied the ultra vires doctrine with vigor. Whenever a transaction was beyond the corporation's limited purposes or powers, either party to the contract could disaffirm it, even after the other party's full or partial performance. The ultra vires doctrine thus invited parties to weasel out of contracts whenever a deal went sour — thus limiting the attractiveness of the corporate form.

§3.3.2 Erosion of Doctrine

Around the turn of the last century, courts recognized the commercial uncertainty created by the ultra vires doctrine and modified it in three respects. First, courts permitted an ultra vires defense only if the contract was still executory and had not yet been performed. Second, courts interpreted charter provisions flexibly to authorize transactions reasonably incidental to the business. Third, most courts held that the ultra vires defense could be barred by unanimous shareholder approval, unless a creditor would be injured.

At about the same time, state legislatures passed "general incorporation" statutes that authorized a wide variety of corporate purposes and powers. Drafters of corporate articles accepted the invitation, enumerating multiple business purposes and specifying powers for virtually every imaginable business transaction.

Later, legislatures passed modern enabling statutes that authorized "general purpose" clauses and specified a long laundry list of corporate powers. Today detailed drafting is no longer necessary. In many jurisdictions, the articles need not recite even that the corporation has the purpose of engaging in any lawful business or the power to engage in
any lawful transaction — both are implicit. MBCA §§3.01, 3.02; cf. Del. GCL §102(a)(3) (requiring articles to set forth “nature of the business or purposes to be conducted or promoted”).

§3.3.3 Modern Ultra Vires Doctrine — Limited Planning Device

Modern statutes, including the MBCA, seek to eliminate the vestiges of inherent corporate incapacity. Neither the corporation nor any party doing business with the corporation can avoid its contractual commitments — whether executory or not — by claiming the corporation lacked capacity. MBCA §3.04(a); Del. GCL §124.

But if the articles state a limitation, the MBCA protects the expectations that arise from the limitation and specifies three exclusive means of enforcement:

- **Shareholder suit.** Shareholders can sue to enjoin the corporation from entering into or continuing in an unauthorized transaction. MBCA §3.04(b)(1); Del. GCL §124(1). A court can issue an injunction only if “equitable” and only if all of the parties, including the third party, are present in court. MBCA §3.04(c); Del. GCL §124(1). An injunction is equitable only if the third party knew about the corporate incapacity. See Official Comment, MBCA §3.04.

- **Corporate suit against directors and officers.** The corporation, on its own or by another on its behalf, can sue directors and officers (whether current or former) for taking unauthorized action. The officers and directors can be enjoined or held liable for damages. MBCA §3.04(b)(2); Del. GCL §124(2).

- **Suit by state attorney general.** The state attorney general can seek involuntary judicial dissolution if the corporation has engaged in unauthorized transactions. MBCA §§3.04(b)(3), 14.30; Del. GCL §124(3). This authority harkens back to the “state concession” theory of the corporation. See §1.3.

The modern ultra vires doctrine thus provides only limited assurance that charter restrictions on the scope of the corporation’s business will work.

§3.3.4 Distinguishing Ultra Vires from Corporate Duties

The ultra vires doctrine, which concerns corporate powers, is sometimes confused with corporate duties — specifically, the corporation’s duty not to engage in illegal conduct and managers’ fiduciary duties. Consider a couple examples:

- **Illegality.** An incorporated manufacturing business dumps toxic wastes in violation of state and federal environmental law. If the corporation has a general purpose clause, has it acted ultra vires? Although courts once described illegal behavior as ultra vires, the doctrine is no longer used to enforce external norms. As a matter of modern corporate law, the corporation has the power to engage in business activities, including the dumping of toxic wastes, but as a matter of environmental law it has a duty not to. (Take note that directors who approve illegal corporate behavior may be liable for breaching their duty of good faith. See §12.3.1.)

- **Fiduciary breaches.** The corporation enters into a contract with a director on terms that significantly favor the director. Unless the articles disable the corporation
from entering into self-dealing transactions, the corporation has the *power* to do this; the transaction is not ultra vires. The corporation, however, may avoid the transaction if its terms are unfair and the director has breached her fiduciary *duties*.

§3.3.5 Ultra Vires Doctrine and Corporate Largesse

A for-profit corporation’s primary purpose is to make money for its constituents. Does such a corporation have the power to give away its profits by making charitable contributions? In particular, can the corporation give money to the founder’s orphans or the chief executive’s favorite art museum? Are these acts of largesse ultra vires?

Courts generally have accepted that corporations have implicit powers to make charitable gifts that in the long run may arguably benefit the corporation. See *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969); but see Fisch, *Questioning Philanthropy from a Corporate Governance Perspective*, 41 N.Y.L. Sch. L. Rev. 1091 (1997) (studies fail to find a conclusive link between charitable giving and corporate profitability). Most state statutes specifically permit the corporation to make charitable donations. See MBCA §3.02(13); Del. GCL §122(9). Gifts cannot be for unreasonable amounts and must be for a proper purpose. In general, if the gift is tax deductible, corporate law treats it as a reasonable exercise of corporate powers. See I.R.C. §170(b)(2) (deduction for corporate giving limited to 10 percent of the corporation’s taxable income).

If corporate largesse is demonstrably unrelated to corporate benefits — as when a gift is excessive — the transaction may be attacked as ultra vires. Such corporate altruism may also constitute corporate waste (see §12.3.2).
THE US CORPORATE ELEPHANT (2005)

Alan R. Palmiter

ABSTRACT

Drawn from a speech at the opening convocation for a notarial school in Italy, this is a story of modern US corporate law. Unlike the statist nature of the corporation in many other countries, the nature of the US corporation is essentially private. It is based on state corporate law – chosen by the parties. Federal law, though regulating disclosure to public investors, mostly avoids a role in the management of the corporation.

The corporation rules of state law are largely enabling, not mandatory. The parties have wide latitude in choosing their own structures. The preeminent provider of state law is Delaware, whose preeminence comes from offering a balanced package of legislative responsiveness, legal expertise, judicial expertise and efficiency, comprehensive case law, and assurances of being non-political.

Corporate law in the United States provides only basic creditor protections, assuming that most protections will come through markets and contracts. Significant emphasis is placed on fiduciary duties of corporate directors – to the corporation and shareholders. Fiduciary duties are dynamic, adapting to new governance and market circumstances. Also dynamic are other aspects of corporate law, as illustrated by the legislative, administrative and judicial responses to recent corporate and accounting scandals.

Some aspects of corporate law, fundamental to the legitimacy of the corporation, remain unaddressed. The role of the corporation in politics, the place of institutional investors in corporate governance, the responsibility of the corporation for social and environmental practices not mandated by law – these are the current questions for corporate law. Will the corporation be up to the task?

* * *

INTRODUCTION

Company law is everywhere in tumult. Reforms in Italy. High level reports and EC communications in Europe. Enron and Sarbanes-Oxley in the United States. What does it mean? My purpose is to offer some perspective - an American perspective - on corporate law and corporate reform.

In thinking about how to tell the story of US corporate law, I am reminded of the parable of the six blind men and the elephant. The story is told, perhaps by the Buddha, that six wise men of Indostan went from their village to observe an Elephant. Though blind, each wanted to satisfy his curiosity, to understand the nature of the strange being so much discussed.

The First approached the Elephant, and came on his broad and sturdy side. "Oh, my," he said, "The Elephant is a wall!" The Second, feeling the tusk, said, "So round, smooth and sharp, this Elephant is a spear!" The Third approached and found the moving trunk in his hands, "I now know the Elephant. It is a snake!" The Fourth felt about and found the leg. "It is plain, the Elephant is a tree!"
The Fifth touched the wide ear, “This marvelous Elephant is a fan.” The Sixth grabbed the swinging tail, “The Elephant is a rope!”

The six wise men of Indostan then returned to their village and began to discuss the nature of the Elephant, each from his own observation. You can imagine the debate! Although each was right, each was wrong!

Now all parables have a moral. In one version of the story, the one I prefer, the parable ends with another, a seventh, blind man who listens to the arguments of his six friends and discerns from them the whole and true nature of the Elephant. Observation is not enough; there must also be objectivity and synthesis.

This I see as my task. To describe the US corporation - the Elephant of the American economy, if not the global economy. This is a daunting task since US corporate law has so many dimensions.

One approach might be to describe our corporate law’s resolution of specific problems, problems common to developed company law systems everywhere - such as how US corporations are capitalized, how powers are allocated between our monistic board and shareholders, when corporate actors have the authority to represent the corporation, how creditors are protected by judicial doctrines that disregard limited liability, what the role is of institutional shareholders in US public corporations, what the status is of shareholder agreements in our close corporations, and so on.

These would be the details. And just as the majesty of any company law lies in the details, this is the case of the Elephant - of our US corporate law. But I fear that in describing the details, some of them esoteric to even us American lawyers, I would create an incomplete impression. I would be both right and wrong.

Instead, I propose to describe the basic aspects, or characteristics, of US corporate law. Like the wise men of Indostan, I make six fundamental observations. I invite you to synthesize them and “see” the organic whole.

1 US CORPORATE LAW IS (MAINLY) STATE LAW, NOT FEDERAL

In the United States, corporate law is fundamentally a matter of state law. From the beginning, this has been true. In 1819, our first and perhaps greatest Supreme Court Chief Justice, John Marshall, made clear: “Corporations are creatures of [state] law.”

Each state has its own corporate legislation, which specifies the essential rules of the corporation: how the corporation is formed, its purposes and powers, its registered agent, how it is capitalized, the limitations on distributions to shareholders, the meetings of shareholders and their voting rights, the management authority of the board of directors and officers, the annual disclosure of company finances, the procedures for amending the articles and the bylaws, the merger into another corporation (or other entities), the process of dissolution, the treatment of corporations incorporated outside the state. The essential topics and language of state corporate statutes would be very familiar to any Italian lawyer or notary.
But what state’s corporate law applies when a business operates throughout our national economy? The system of state corporate law is made coherent by the US choice of law rule: the internal affairs of every corporation are governed by the law of the state of its incorporation. This is a judicial doctrine with more than 150 years of uniform adherence. What is the internal affairs doctrine? According to the case law of every US jurisdiction and now embodied in state statutes, any questions involving shareholder rights, management duties and perhaps creditor protections (to the extent these are specified by corporate law) are resolved by only one law: the corporate law of the state of incorporation. Why do state courts accede to other states’ law? Early in the history because of the legislative nature of the corporation; later because of the commercial importance of certainty in corporate law; today because of long habit that has assumed constitutional dimensions.

In 1987, our US Supreme Court explained, “No principle of corporation law and practice is more firmly established than a State’s authority to regulate domestic corporations.”

This system gives great weight, and respect, to the parties’ choice of where to incorporate. Philosophically and practically, choice is at the heart of the system. There is choice at the time of the corporation’s original formation by the initial investors and entrepreneurs. There is choice each time that new investors, new creditors and new managers join the firm - they implicitly accept that the operative rules will be based on the state of incorporation. There is choice whenever the parties reincorporate – this accomplished by merging into or converting to a corporation in another state, upon the initiation by the corporation’s board and approval by a majority of its shareholders.

Lately choice in US corporate law has mushroomed to encompass the type of business entity that parties (advised by their lawyers) can select. Lawyers are usually involved, but need not be. Notaries, as known in the civil law tradition, have no role. The array is breath-taking. Where only a generation ago the choice was between a partnership and corporation (your società in nome colletiva and società per azioni), today there are limited partnerships, limited liability companies, limited liability partnerships, limited liability limited partnerships - all sharing some level of corporate-type limited liability, but modifying one or more aspects of the governance rules. Like corporations, all of this new alphabet soup of entities is subject to the parties’ agreement, along with a perfunctory filing with the state. For my purposes and of US corporate lawyers, I treat these entities as part of our US corporate law.

These corporate forms – all arising under state law – offer great flexibility. They are each a malleable vessel into which can be poured the world’s largest private organizations - corporations like Exxon/Mobil and Microsoft, or the most humble ones (but collectively the most important in our economy) - corporations that run a family-owned corner gas station or software companies whose only assets are an idea and a PC connected to the Internet.

State corporation statutes make almost no distinction between the rules governing corporations whose shares trade on public stock markets - public corporations, as we call them - and corporations that have no trading market - close corporations. The text of the statutory rules on incorporation, capital formation, shareholder voting, management authority is the same whether a public or close corporation. Instead, the differences arise in how courts interpret the statutory rules, and apply the judge-made law of fiduciary duties. Let me give an example. Public corporation shareholders have no right generally to demand that the corporation buy back their shares - their only liquidity is to sell in public stock markets. The statutes are clear. But minority shareholders in
a close corporation who claim that their fiduciary rights or reasonable expectations have been violated by an oppressive majority can in most state courts insist on a corporate buyout or even a court-imposed dissolution. Same statute - two different results.

What is the role of federal, national law? Federal law, which applies uniformly and with supremacy, has only a supportive role. There is no federal law of corporations, and the practice of federal courts to articulate principles of corporate law ended in 1938 with the demise of federal common law. Historically, federal securities laws passed in the 1930s only specify the informational rights of investors, and the concomitant disclosure duties of managers, in companies whose securities are listed on national stock markets or whose size suggests that public trading is occurring.

These public companies are subject to a set of mandatory rules administered by our Securities and Exchange Commission when companies sell securities to public investors, when they seek shareholder votes through our American proxy voting, when bidders seek to acquire corporate control through mergers or tender offers. And public companies must periodically – and today almost continuously – inform public markets and investors of their ongoing business and its prospects.

Failure to disclose honestly triggers governmental enforcement and, more important, private litigation under our famous antifraud rule 10b-5. The rule, which forbids the making of materially false or misleading statements in connection with securities trading, is the basis for a monumental body of judge-made law in private securities enforcement cases. Best known are our terrifying securities class actions brought against public companies and their executives (both in the US and abroad) for issuing false press releases, misleading SEC filings or manipulated financials.

In short, in the United States, state corporate law defines corporate structure and governance; and federal law requires disclosure to public shareholders. Federal cases abjure any desire to use disclosure rules to create standards of fair conduct. State corporate law, until now, has mostly acceded to this bifurcation of roles. The most disclosure that state statutes require is the filing of an uninformative annual statement stating the corporation’s business and the names of its principal officers. And state courts require disclosure, in shareholder voting cases, along the same lines as their federal counterparts under Rule 10b-5.

2 US CORPORATE LAW IS ENABLING, NOT MANDATORY

The word “law” to describe US corporate law is somewhat of a misnomer. US corporate law is not law in the sense we are accustomed to thinking of positive law - that is, state-created and enforced rules that dictate private behavior. Instead, US corporate law is mostly a series of default rules - that is, background rules that apply unless the parties specify otherwise. It is an enabling system that fosters private choice, private rules and private relationships.

For example, corporate statutes specify that shares normally carry voting rights, but the articles of incorporation can create non-voting shares. Or in a close corporation, parties can agree to assign their voting rights in an irrevocable proxy to another person. Another example. The full board of directors is normally elected each year, but the articles can specify staggered terms in which only one-third of the board is elected annually. Or again in a close corporation, the corporate statutes
permit agreements among all the shareholders on board composition. Such shareholder agreements can even do away with the board of directors.

That is, voting rights and annual board elections (and most corporate law rules) are default terms. In its enabling character US corporate law specifies the rules that seem to fit most corporations, what most corporate parties would choose, but the parties have broad flexibility to make their own arrangements.

The remarkable result is that only a handful of our corporate law rules, at least in the statute books, are mandatory in the sense that the rules are ones on which the parties cannot come to a different agreement. For example, each public corporation must have a board of directors with authority over the business, there must always exist a class of shareholders with voting power; shareholder meetings must occur annually; distributions to shareholders cannot occur if the business is insolvent; the board must propose (and the shareholders must agree) to amend the articles or merge with another corporation. Most everything else is subject to agreement.

In a study comparing the company law rules of the EC directives (which I have the impression cover a good deal of company law in Europe) and US corporate statutes of the 50 states, Professor William Carney (at Emory law school) compared the nature of European and American company rules. He counted a total of 131 EC rules, of which 67 were mandatory - no possibility for the parties to agree otherwise. He then searched US corporate law and found only 14 of these 131 rules existed in all the US states, he found that another 22 of these EC rules existed in some states, and (quite remarkable) he found that 95 EC rules existed nowhere in the United States - at least in the statutes. He then looked at the 67 mandatory rules in the EC. Only 4 of these 67 mandatory provisions existed in all US states, 9 others had been adopted in some states, and the remaining 54 mandatory rules had not been adopted in any US state.

Let me give you an example of this non-mandatory nature of US corporate law. There is no requirement that US corporations file or give public notice of who may act as representative on behalf of the corporation. A few companies do provide this notice, most do not. Imagine a furniture business in my home state of North Carolina. The business plans to purchase 1000 sofas from an Italian manufacturer. Is the president of the North Carolina corporation authorized to make the purchase? No statute, no corporate filing, no corporate rule will answer your question. Instead, corporate authority is a private matter for the corporation’s board of directors to decide. Any outsider will have to ask for internal documentation from the corporation - the articles of incorporation (to confirm the board’s powers have not been changed), bylaws that specify the general powers of the corporate president, a resolution of the board authorizing the president to make the purchase, and a certificate of the corporate secretary verifying the authenticity of these internal documents.

Who stands behind this private system of law? In the example of corporate authority, the Italian buyer could request that the North Carolina seller provide it with an opinion from a reputable law firm. The law firm would identify the corporate documents studied and state that the papers appear to be authentic and valid, would confirm that the person who purports to be the corporate president is in fact that person, and would opine that the president has been authorized by the board to enter into the sales agreement. What if it is a fraud?
The third party buyer could claim the corporation created the appearance of authority – appearances that themselves become binding according to US judge-made law. And the private law firm - assuming the function of a notary in Italy - would be responsible for the conclusions in its private opinion concerning the corporation’s internal delegation of authority.

3 DELAWARE IS PREEMINENT

Observers of US corporate law, particularly in Europe, are immediately struck by the importance of Delaware, a tiny state on the Atlantic coast bordered by New Jersey, Pennsylvania and Maryland. In 1787, it was the first state to ratify the US Constitution, recognizing immediately the value of being part of a larger commercial union.

Today more than 50% of our largest US corporations are incorporated in Delaware; more than 80% of new public corporations choose Delaware when they sell stock to the public. And both numbers continue to grow. When policy makers debate issues of corporate law - for example, whether state corporate law provides adequate corporate governance - they focus on Delaware law. Not only do public corporations (and their legal and financial advisers) choose Delaware, a large number of sophisticated closely-held businesses choose Delaware for its corporation, limited partnership and limited liability company statutes.

Delaware has not always had this leading role as incorporator for the United States. In the late 1800s the role was assumed by New Jersey. It had an early enabling statute, which among other things permitted corporations to own the shares of other corporations - thus making possible the famous monopolistic holding company structures known as “trusts.” But in the early 1900s New Jersey committed a grievous competitive error. Its governor, the idealistic Woodrow Wilson, urged the New Jersey legislature to reform the state’s corporate law to make it more regulatory. Less flexibility for unscrupulous corporate actors. The result was that businesses re-incorporated in Delaware, which had in 1899 borrowed much of the earlier New Jersey statute as its own.

But other states, you might think, could copy the Delaware statute. How has Delaware achieved its prominence? How might an EU member, after the Centros and Uberseering decisions, mimic Delaware’s success? There is no one answer. Instead, there is a blend of explanations for Delaware’s preeminence:

First, Delaware is a leader, a first mover, in revising its statute to reflect technological and business innovations. For example, its statute was the first to allow shareholders to act (without a meeting) by mailing their written consents, the first to permit boards of directors to meet by telephonic communication, the first to permit shareholder voting on the Internet, the first to permit corporate charters that exculpate directors who make good faith errors. Statutory reform is a constant, ongoing process in Delaware. Proposed legislation comes from the Delaware corporate bar association - composed of the state’s prominent corporate lawyers, in theory representatives of management and investor viewpoints. Although the Delaware constitution requires that any corporate legislation pass by a two-thirds vote, the legislature readily and quickly adopts revisions proposed by the state bar association.

Second, Delaware has an experienced and expert group of corporate lawyers. It is a learned, proud,
and insular community. In such a small state, everyone knows everyone else. Law review articles and practical treatises by senior members of the corporate bar, as well as judges, constitute what you would call the "doctrine" of Delaware law.

Third, Delaware has a court system designed to respond quickly, efficiently and expertly to corporate litigation. All corporate law cases are brought before the Delaware Court of Chancery, which hears cases without a jury. The Chancery Court judges, appointed by the state governor for 12-year terms, are selected on the basis of their corporate law expertise - typically mid-career stars of the Delaware bar. Appeals from Chancery Court decisions are made directly and as of right to the Delaware Supreme Court, whose 5 members are also appointed for 12-year terms on the basis (in part) of their corporate law credentials. It is an efficient court system. Important corporate cases - particularly involving takeovers - can be heard and decided by the Chancery Court, then appealed to the Supreme Court, in less than a month. Most Chancery Court decisions that are appealed are affirmed; most decisions are not appealed. To avoid any political tensions, the ten members of the Chancery and Supreme Courts must include an equal number of Democrats and Republicans.

Fourth, the Delaware judges have created a deep and broad body of case law - what you would call "jurisprudence." Delaware decisions cover all of the interstices of the Delaware statute: what constitutes a quorum for a shareholders' meeting? what are the standards for reviewing parent-subsidiary dealings and mergers? what are the responsibilities of a board seeking to protect a negotiated merger agreement? what are the methods to value corporate shares in appraisal? what are the responsibilities of directors defending against an unwanted takeover? In great detail, Delaware cases answer (and update earlier answers) to the questions. On most corporate law topics, there are more Delaware court decisions than all of the decisions from other states combined. Lawyers and state courts outside of Delaware regularly refer to Delaware decisions for guidance.

Fifth, Delaware is a small state. A significant part of its public budget (about 20%) comes from filing and franchise fees. Even more comes indirectly from the business generated by transaction services, litigation and counseling performed by Delaware law firms. This means that Delaware cannot lightly change its corporate law - to prefer a particular company, a particular management agenda, or a particular investor movement. Its financial dependence on being an independent provider of corporate law keeps Delaware from acting impulsively. For example, on the difficult question of takeovers, while other states quickly adopted antitakeover statutes in the 1980s when requested by local managers, Delaware deliberated for more than three years before adopting one, one of the mildest antitakeover statutes adopted by any state.

What about competition from other states? There really is none. The other states have been content to provide corporate law for their closely-held businesses and preferential rules for the public corporations that have stayed home. In the 1980s Kansas and Nevada sought to make corporate law a new business - by copying the Delaware statute and even formally adopting its case law - but hardly anybody was interested. Even though more expensive, Delaware offered a better product.

But Delaware has competition, not from other states, but instead from the looming federal government that periodically threatens to intervene and supersede Delaware law if the state fails in its unique role. In fact, two of the periods of greatest activism in the Delaware courts - which
resulted in an expansion of shareholder protections in takeovers and the strengthening of accountability for corporate boards - coincided with heightened federal awareness. The first in the mid-1980s when Congress debated whether to intervene in the explosive takeover market. And more recently last year, as Congress rushed forward with the Sarbanes-Oxley law to respond to the corporate scandals of Enron, Worldcom, and other major US companies.

The US corporate law landscape, however, is not an expansive Delaware surrounded by a chaotic array of other states. States have chosen relative uniformity in their corporate law rules, without any federal direction. Most states (about 38) have adopted a version of the Model Business Corporation Act. Others, such as New York and California, have statutes with mostly standard provisions, only a few surprises. The MBCA is a model statute prepared by the Business Law Committee of the American Bar Association. Many of its provisions are adaptations of Delaware provisions - though often better organized and more clearly written.

Revised with some regularity, the MBCA was first promulgated in 1949. Its most significant revision was in 1984. Like Delaware, states that have adopted the MBCA rely on their state bar associations to draft and propose revisions. There are some differences between the Delaware statute and the MBCA, but they are few. In some respects the differences only highlight the many similarities and uniformity of US corporate law. For example, the MBCA has much simpler legal capital rules on proper payment for corporate shares and on distributions to shareholders - although the Delaware scheme in this area is easily manipulated and achieves the same results as the MBCA. Another example are the procedures for shareholders to bring litigation - but in the end both Delaware and the MBCA permit independent directors, under some circumstances, to terminate an unwanted shareholder suit.

But there is a growing divergence between Delaware and the MBCA today. Delaware’s leadership as corporate law reformer has been brought into question. Two recent MBCA reforms offer innovative and challenging steps forward - away from Delaware law. Changes that may impose greater corporate discipline and rebalance corporate governance. One set of MBCA amendments creates statutory standards of conduct and liability for corporate directors - particularly concerning independence and monitoring of corporate legal compliance. They thus seek to codify through statute the contours of fiduciary duties of corporate directors. Another set of MBCA amendments deals with the voting and appraisal rights of shareholders in fundamental transactions, such as mergers, sales of assets and tender offers. The MBCA amendments impose uniform treatment, regardless how a transactions isstructured, thus rejecting the formalism of Delaware law in which artful planning can be used to alter and even eliminate shareholder rights.

Will states adopt these innovative MBCA provisions? How will Delaware respond? Time will tell.

## 4  US CORPORATE STATUTES ARE THIN ON CREDITOR PROTECTION

Creditor protection, a centerpiece of European company law, is largely absent from the mandatory structure of US corporate law. By and large, we have no minimum capital requirements for beginning an incorporated business, no fixed requirements of capital reserves, only porous (almost empty) rules on accounting limits for making shareholder distributions, no liability for directors whose good faith actions cause their company to become insolvent.
This has not always been the case. During our early corporate history and through the middle half of the twentieth century, creditor protection was important to US state legislatures. Minimum capital requirements were a basic aspect of US corporate law. So were rules on par value and capital reserves, which were seen as creating an inviolate trust fund or equity cushion for the protection of creditors. Directors, particularly of banks and other savings institutions, who made risky decisions for a bank in financial trouble faced the threat of personal liability. And shareholders of banks were liable for up to three times their investment if the bank failed - a de facto insurance fund for bank depositors.

Over the last half of the 20th century these formal protections have been dismantled, not because of a conscious reform movement, but through a slow process of attrition. Today it is possible to incorporate a business without any capital, rewrite assets and capital accounts on the balance sheet, gamble on the business while the company faces insolvency - all in the name of maximizing shareholder returns. The statutory rules of corporate law generally only mandate that distributions to shareholders, whether the payment of dividends or repurchase of shares, occur when the corporation is solvent, based on a manipulable balance sheet and the business's ability to pay its existing, foreseeable debts. Rules that prohibit corporate loans to finance the purchase of company shares or rules that prohibit promises of future services to acquire company shares each year disappear, even more, from the statute books. That is, the ex ante rules imposed by corporate law for the protection of creditors are few and each year fewer.

This may seem appalling, even barbaric. What happens if corporate actors, through risky undertakings or sloppy (or corrupt) handling of cash, leave a business insolvent - unable to pay legitimate creditor claims? The American answer is peculiarly American. We leave the matter to private protection through ex ante contracts and markets. And for those understandings that did not find their way into a contract, we rely on courts to protect ex post reasonable expectations. Ultimately, our reluctance to aggrandize creditor rights comes from our enthusiasm for shareholder primacy. After all, we Americans are capitalists.

First, we expect voluntary creditors who are concerned about corporate transactions or activities that might undermine their claims to insist on contractual protections. For example, banks that extend credit to an incorporated business often demand personal guarantees from the corporate owners. The banks also impose contractual stipulations on business activities - choice of manager, amount of salaries, timing of distributions, accounting ratios for new debt, and so on. That is, the banks write their own creditor protections. Another example. Corporations that issue bonds, another form of lending, make various creditor protection promises in an indenture – a set of corporate promises whose terms offer bondholders standardized protections. Less strong creditors, such as suppliers or employees, will insist on frequent payment schedules or will increase their prices to take into account the risk of corporate insolvency. As for involuntary creditors, such as tort victims injured by corporate activities, we require insurance for certain business activities and otherwise (at least for now) we assume involuntary creditors will have their own insurance.

Second, we rely on courts to impose ex post relief against abusive corporate actors. Under a metaphoric and purposefully vague judicial doctrine, "piercing the corporate veil", creditors can obtain direct, personal recovery from corporate shareholders and managers who abused the
FIDUCIARY DUTIES ARE THE BINDING CEMENT

Power in the US corporation resides in the board of directors - not the shareholders' annual meeting. This, the Delaware judges, frequently remind us is THE fundamental principle of US corporate law. The board, in reliance on the corporation's officers, has authority over the business and affairs of the corporation - whether publicly traded or closely held. The board chooses the corporate executives, sets dividends, initiates mergers, makes changes to the business. The shareholders? They elect the directors and can veto only specified fundamental transactions.

With power comes responsibility, accountability. The main legal accountability in the corporation arises not in legislated corporate rules, which we have seen are largely enabling not regulatory, but from fiduciary duties enforced by courts. Shareholders have rights to bring lawsuits to enforce these fiduciary duties, subject to significant procedural controls.

The animating principle of US fiduciary law is that the business judgment of directors (and those to whom they delegate corporate authority) should not be questioned. The business judgment rule. A famous case involving the early Ford Motor Co. stated this principle clearly: “Judges are not business men.” In our 150 year history of corporate fiduciary duties, no more than a handful of cases have imposed liability on directors who made good faith, well-meaning business decisions, no matter how flawed or unfortunate the outcome. Given the business judgment rule, the directors’ “duty of care” is symbolic, aspirational.

Courts intervene only when directors ignorance is outrageous or inexcusable given the circumstances of an important decision - a violation of the “duty to be informed.” Or when directors fail completely to supervise corruption in the corporation (private or public) - a violation of the “duty to monitor.” Or when directors act in their own self-interest contrary to corporate interests - a violating of the "duty of loyalty."

In fact, if one were to observe the most significant matters addressed by corporate law in the United

- Corporate privilege. If creditors (either voluntary and involuntary) identify that a corporate insider misrepresented the corporation's solvency or business size, or that the insider de-capitalized the business at the expense of creditor claims, courts will disregard the rule of limited liability. In fact, piercing the corporate veil – though it occurs only in close corporations – is the most frequent type of corporate litigation in the United States. In the end, this ex post doctrine (applied case by case) imposes a set of corporate obligations for the protection of creditors.

An example of a piercing case illustrates. An owner of a fleet of taxis in New York City incorporated 10 separate corporations, each owning two cabs. Operating without any minimum capital requirements, the companies maintained only the insurance required by state law. When one of the cabs injured a pedestrian, the New York state court decided that separate incorporation and under-insurance were not reasons for imposing individual liability on the owner. That is, corporate law imposed no ex ante creditor protections. But the court decided there was ex post protection. In post-insolvency litigation, the owner could be individually liable if there was evidence he had taken cash (through dividends or otherwise) from the companies, leaving them insolvent or near insolvency.

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In fact, if one were to observe the most significant matters addressed by corporate law in the United
States over the last 25 years - they all involve court cases that interpret (and sometimes reformulate) corporate fiduciary duties. Let me give some examples.

Corporate groups. The transactions between companies in a corporate group - stock issuances, payments of dividends, intra-group contracts, even mergers - are regulated mostly by fiduciary law. Although the parent has power over the subsidiary, fiduciary law limits that power. Some complain that the fiduciary rules are too lax in this area, but their existence affects (if not dictates) how corporate groups allocate profit centers, choose dividend policy, engage in intra-group transactions, and structure intra-group buyouts and mergers.

Takeovers. The defenses that incumbent corporate executives may use to prevent shareholders from selling to an unwanted, outside bidder - are regulated mostly by fiduciary law. Federal law imposes some inconvenient disclosure and timing impediments; and state antitakeover statutes (outside of Delaware) sometimes present difficult, but usually, surmountable obstacles. But any lawyer advising on what can and can’t be done in a takeover (particularly of a Delaware corporation) refers to a venerable line of fiduciary cases dating from 1985.

Compensation of executives. The methods by which executives are compensated (and the strong, lately perverse incentives that some stock-based compensation can create) are regulated by fiduciary standards. Federal tax law has a minor role; federal securities regulation requires that the compensation be disclosed; state statutes are almost completely enabling. Only courts using process-based fiduciary rules, with Delaware once indifferent and now taking a harder look at the issue, create a potential limit.

Internal controls - corporate monitoring. The principal rules on how boards monitor financial disclosure systems, construct legal compliance programs, and approve executive loans are all derived from fiduciary principles. That US public boards are composed of independent directors, and what constitutes independence, largely derives from principles articulated in fiduciary duty cases.

In some areas, fiduciary law is silent - and thus corporate law is silent. Our fiduciary standards are largely empty with respect to the duties of institutional shareholders when they vote shares. Our fiduciary law does not regulate corporate political activities or contributions, or charitable giving. Our fiduciary law accepts, but does not require, that corporations voluntarily promote social and environmental practices not mandated by law. In these sensitive areas, without meaningful fiduciary standards or parameters, there is a legal vacuum.

6 US CORPORATE LAW IS DYNAMIC

The last, and perhaps most revealing, characteristic of US corporate law is its dynamism. With reforms coming in a regular stream from state and federal legislatures, state and federal courts, federal regulators, and capital markets, change in US corporate law is inescapable. This has been particularly true during the last 20 years.

The questions today sweeping through Europe have been asked, many of them answered, by the US corporate law system since the mid-1980s: the relationship of shareholders and other corporate
constituencies; the possibilities for mergers and takeovers; the role of institutional shareholders; the functions and relevance of outside directors. Some were answered by Delaware courts applying state fiduciary law, some by state legislatures that passed antitakeover statutes (these, a bizarre exception to the enabling nature of US corporate law), some came from new SEC rules that empower shareholder communications, some by federal courts that imposed duties of transparency on corporate executives, some by practices (new norms) among directors on corporate boards.

Then over the last two years, the collapse of Enron and the series of corporate scandals that resulted in a 35% overall decline in the US stock markets – a 7 trillion dollar loss from the markets' height – presented a wake-up call. The corporate scandals – which we have come to refer to simply as “Enron” – exposed inadequacies, maybe fundamental flaws, in the US corporate law system. And certainly with our corporate governance. How could Enron, the company voted by Fortune Magazine for five years in a row as “the most innovative company in America,” have gone bankrupt in less than six months? What was its board doing waiving the company's ethics code to allow insider profiteering? There were other companies. How could Tyco agree to pay an executive an extra multi-million dollar severance if convicted of a felony? How could Worldcom treat its purchases of telecommunications capacity as an asset, rather than an expense – ultimately forcing it to restate earnings by 11 billion dollars, and causing shareholder losses of $200 billion?

Overnight our magnificent corporate law system suddenly seemed terribly wrong. Enron was not an isolated abnormality. Across the system, corporate managers driven by the promise of stock option wealth greedily and dishonestly had played the confidence of investors and the market. Accountability had collapsed. Auditors, taking on new roles a consultants urging their corporate clients to take risks, abandoned their role of certifiers auditors of financial truth. Wall Street analysts were paid to create an atmosphere of ebullience, whatever their better judgment said. Corporate lawyers had become transactional engineers, no longer voices of wisdom and conscience. Regulators had become complacent, happy to boast that US stock markets (and the roaring economy) were the envy of the world.

The US Congress response to Enron was Pavlovian - bell rings, dog salivates. Congress heard stories of an inept, passive auditing committee at Enron, and mandated that audit committees of public corporations be composed exclusively of outside directors, tasked with selecting and supervising the company's outside auditor, and required at least one member be a financial expert. Congress heard stories of auditor complicity, and mandated a new accounting board to supervise the auditing profession. Congress heard stories of conflicts in accounting firms between auditing and consulting functions, and barred such dual service. Congress heard stories of excessive loans to corporate insiders, and forbade them. Congress heard stories of lawyers assisting company misbehavior, and mandated new SEC rules on lawyer whistle-blowing. Congress heard stories of executives dumping their company stock, while employees in the company pension plan were frozen, and banned the practice. Congress heard stories of oblivious, witless corporate executives, and mandated that CEOs and CFOs certify their company's financials and internal reporting systems. And, as you know, Congress extended many of these new rules to companies outside the United States, including in Europe, if their stock is traded on US markets.

Today, after Enron, US corporate law is at a crossroads. The Sarbanes-Oxley Act, by federally
codifying a new set of best practices in public corporations, raises questions about the centrality of state corporate law. In addition, new rules by the stock exchanges and norms urged by institutional investors create a set of new guidelines – apart from state corporate law – for the independence and role of outside directors, such as committee composition, multiple service on boards, and executive sessions of the board without management present. The SEC has proposed new rules requiring companies to disclose how directors are nominated to the board, as well as a new rule that the corporation-funded nomination process be opened to long-term 5% shareholders. The increase in securities fraud lawsuits in federal courts, lately settled by companies that promise corporate governance reform, make state courts seem less important. Where have the states been? Somewhat late, but now present, state courts have begun to articulate a reformed corporate fiduciary law, particularly in Delaware.

In speeches and remarkably candid scholarly articles, and now in a wave of new court opinions, the Delaware judges have begun to signal that they believe themselves up to the task. According to the latest cases, takeover protections are to be scrutinized more carefully; excessive executive compensation is no longer an open-ended game; the independence of outside directors and their good faith are under intense new scrutiny. Formalism is out; substance seems to be in. And human motivations have retaken center stage in the judicial calculus. As Chief Justice Norman Veasey of the Delaware Supreme Court recently stated, “We did not just fall off the turnip truck … we can tell whether somebody is acting independently.” With a poetic flourish, Veasey went on, “Directors who are supposed to be independent should have the guts to be a pain in the neck.”

But the post-Enron world is hardly revolutionary. The essentially private structure of US corporate law remains intact. Shareholders are still the focus of our corporate law. The board of directors, composed of a majority of independent members, remains at the helm of our public corporations. Outside auditors constitute the principal check on management financial reporting. Reforms by Congress, the stock exchanges, and the SEC only reinforce these central theses. States continue in their primary role, as enablers of this private structure. Even as the new Sarbanes-Oxley rules mandate changes, many already in progress, US corporate law remains largely a matter of state-based private choice, tempered by fiduciary duties molded and enforced by Delaware judges. Is this a legitimate system, one deserving of our confidence and trust? Will our corporate law be up to the task? We will see.

CONCLUSION

So that is the Elephant. The six fundamental, defining characteristics of US corporate law. State corporation law provides the framework, with federal law in a supporting role. Private choice is the engine of state corporation law, which is mostly facilitative, not mandatory. Delaware remains, strong as ever, the preeminent leader of this incorporation-based system of private choice. US corporate law’s animating philosophy of shareholder primary means that creditors must rely on other systems of protection. Meanwhile, shareholders find their protection in a set of judicially-created rules that balance managerial discretion and accountability – fiduciary duties, we call them. Finally, US corporate law is subject to constant change, the latest corporate scandals resulting in a cacophony of voices and reforms. And today that dialogue – the debate about the Elephant – reaches beyond our village.