# CONVERGENCE IN CORPORATIONS LAW-TOWARDS A FACILITATIVE MODEL

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*The following is the Report of the General Reporter on the Law of Corporations presented to the Annual Colloquium of the International Association of Legal Science (the 1995 IALS Colloquium) which was held in Buenos Aires in September 1995. The theme of the conference was "Towards a modern* ius commune*: converging trends in a changing world".*

## 1 *Introduction*

My first impression, when asked to prepare a paper on convergence in corporations law, was that there had been a significant degree of convergence internationally in the general approach of states to corporations law, but rather less at a level of detail.[1] This paper explains that initial impression, asks why it might be true in a field of law which has been the subject of few international treaties or harmonisation exercises, and explores some core areas of corporations law to identify the trends which characterise the perceived convergence.

Because my thesis is that the cause of convergence is primarily an improved understanding of the economic significance of corporations laws, and the insight that brings into the proper function of such laws, I begin by setting out briefly the purpose of corporations laws in a modern economy.

## 2 *The function of corporations law*

The two principal features of the institution of the corporation in a market economy are:

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1 For a general overview, see the discussion in the *International Encyclopaedia of Comparative Law*, vol XIII - Business and Private Organisations, esp chs 3-6.

- division of the ownership interest in an enterprise into a number of readily transferable units - that is, shares;
- limited liability on the part of the owners who have invested funds in an enterprise. They stand to lose the stake they have chosen to commit to the enterprise, but they do not put their other assets at risk.

### 3 *Division of ownership interest into shares*

The fiction of legal personality enables a corporation to continue as owner and operator of a business enterprise while investors come and go. The cost of transfers of the enterprise's assets by the former group of investors to the new group is avoided. Instead, the exiting investor simply sells shares to the new investor. The difference in cost is particularly striking in the case of public listed corporations, where a call to a broker replaces hours spent in lawyers' offices poring over agreements for the sale and purchase of a business. But even in the case of closely held corporations, there are real savings in transferring shares rather than the business assets.

A number of social benefits result from this reduced cost of transfer:

- obviously, reduced transaction costs are in themselves a benefit;
- the reduction in transaction costs enhances allocative efficiency. That is, if it costs an investor less to move funds from one enterprise to another which promises better returns, funds are more likely to flow from worse performing enterprises to better performing enterprises, maximising the overall social benefit from the investments made;
- the reduced transaction cost enables capital to be collected from a huge number of investors to fund a single enterprise. Without a share structure, the co-ordination and transfer costs of large groups of investors would inhibit the aggregation of large sums to fund significant projects;
- the existence of readily tradable fungible units of ownership permits the development of secondary markets, which in turn enhance the enterprise's performance incentives by facilitating control changes, and reduce the enterprise's cost of capital;
- the existence of readily tradable fungible units of ownership also permits investors to diversify their investments at little cost. This is a very important facility, since it enables investors to spread risk across a number of enterprises, in a range of sectors. Limited liability, discussed below, is another significant factor in permitting diversification.

## 4 *Limited liability*

The other very important feature of corporations law is the limited liability of investors in the corporation. A shareholder may lose the stake invested, but other assets are not at risk. Without this protection, very many projects with a positive net present value would never be undertaken.

Of course incorporation is not the only route to limited liability for investors. In theory it would be possible for each contract entered into by the manager of an enterprise to be explicitly non-recourse: that is, the other party could look to the assets of the enterprise in the event of non-performance, but would have no recourse against the manager and the owners of the enterprise personally.[2] But for most enterprises this sort of express contracting is not practical: simply too many contracts are entered into on a daily basis, and the cost of negotiating a non-recourse provision with every trade creditor is prohibitive.

What corporations law does is, in effect, provide a standard form non-recourse contract which those dealing with the corporation enter into.[3]

The economic advancement of society, and especially industrial and technological development, is heavily dependant on the taking of business risks. Provided the net present value of a project is positive, it is (other things being equal) in the interest of society that the project be undertaken. But if it has only a 10% chance of success, few people will be willing to stake all their assets on it. More will be willing to stake a finite sum, and more still will be willing to invest finite sums in a number of such projects, increasing the odds that the payoff will be enjoyed by that investor.

Limited liability also makes the diversification of investments rational. If each new enterprise to which an investor commits funds may result in a total loss of that investor's assets, there is a strong incentive to invest in only one enterprise, or a small number of enterprises, and monitor them very carefully indeed. But the low transaction costs of investment achieved through shares, when coupled with limited liability, enable an investor to spread risk among a number of enterprises of varying risk profiles.

Of course, if an enterprise makes a loss and the investors' liability is limited, someone else must bear the loss. That someone else is the creditor of the corporation who goes unpaid. But those dealing with corporations are also able to price for risk and, with a few

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2 Provisions of this kind are common in major contracts entered into by trustees, in common law countries, especially where the trust is borrowing substantial sums or buying or selling major assets.

3 In some cases, that non-recourse feature of the standard form contract will itself be reversed by a contract of guarantee between the owners of the corporation and the creditor. But normally it is not.

exceptions such as full-time employees, able to diversify their risk by dealing with a number of corporations. So the risk of failure of a project is spread through creditors (who assume it voluntarily and price to reflect it), and in turn through those who deal with the creditors. Limited liability does not make risk disappear, but it is a technique for allocating it across different groups of stakeholder on a voluntary basis, and thus across the community which stands to benefit from the undertaking of the (risk-entailing) enterprises.

### 5 *Risk-taking and risk-bearing are an integral part of corporations law*

It is important to bear in mind, when considering particular rules of corporations law, that one of the justifications of corporations law is that corporations will take risks, sometimes very substantial risks, and that if those risks do not come off the loss should be borne by shareholders first (to the extent of their investment), but then by creditors. Any attempt to prevent risk-taking, or to shift that remaining loss back onto the owners or managers of the business, runs a serious risk of undermining the institution of corporations law, and requires clear justification.

It is also important to bear in mind that investing in corporations, and dealing with them, is a process which is both voluntary and dynamic. This is sometimes lost sight of when the "plight" of small investors in large corporations is debated, or when creditors of an insolvent corporation go unpaid. As Easterbrook has pointed out, the flaw in the Berle and Means approach to corporate control is that people do not just wake up one morning to find that they are managers, or investors.[4] Investors choose to put their funds into corporations in the belief that this will provide a better return than less risky investments: where normal risks not caused by fraud or dishonesty come to pass, they have no legitimate cause for complaint. Where small investors or creditors complain that they were unaware of systemic risk, the first solution considered should be education about those risks, not an attempt to reform the system to reduce risks at the cost of undermining its raison d'être and introducing structural inefficiencies and unnecessary costs.[5] Nor should losses suffered by small investors prompt undue concern about the operation of the market.[6] An attempt to eliminate or even reduce risk in the securities market would be seriously misguided. And as J K Galbraith has pointed out:[7]

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4 See A Berle and G Means *The Modern Corporation and Private Property* (1932); F H Easterbrook "Managers' Discretion and Investors' Welfare: Theories and Evidence" 9 Delaware J Corp Law 540 (1984).

5 In the case of publicly traded securities, ignorance of a small investor as to some of these risks is especially irrelevant, since the expert participants in the market will factor these risks into their trading, which the market price will reflect.

6 Even where large numbers of investors make significant losses, as was recently the case in New Zealand and other countries in late 1987. Such events typically lead to calls for more regulation, with little analysis of the

Regulation outlawing financial incredulity or mass euphoria is not a practical possibility. If applied generally to such human conditions, the result would be an impressive, perhaps oppressive, and certainly ineffective body of law.

## 6 *Some evidence of convergence*

### *A Examples of convergence in corporations law*

There have been almost no truly international harmonisation initiatives in the field of core corporations law - by which I mean the law relating to the formation, internal management and organisation and termination of corporate entities.[8] There has been little activity even in relation to more obviously trans-national issues such as securities markets, the market for corporate control (takeovers, mergers etc) and cross-border corporate insolvency.[9]

### *B Regional convergence*

There are a number of regional groupings within each of which there has been significant convergence in corporations law in the last ten years or so. One obvious example is the European Union. The Treaty of Rome expressly contemplates harmonisation of the corporations laws of member states and the establishment of co-ordinated "safeguards...for the protection of the interests of members and others".[10] A series of Directives issued by the European Council has led to harmonisation of laws in areas including disclosure of information concerning the corporation and its representatives, financial reporting and audit, limits on ultra vires and constructive notice,

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true causes of the downturn and the associated losses. See J K Galbraith *A Short History of Financial Euphoria: Financial Genius is Before the Fall* (Knoxville, Whittle Direct Books, 1990).

7 J K Galbraith, supra n 6, pp 78-80.

8 There are two treaties on recognition of corporations, which address choice of law governing the internal operation of corporations (but not the substantive rules themselves), neither of which have come into force: Hague Convention Concerning Recognition of the Legal Personality of Foreign Companies (1951) reprinted in 1 Am J Comp L 277 (1952); EC Convention Relating to the Mutual Recognition of Companies and Legal Persons (1968) reprinted at 2 Common Mkt Rep (CCH) 6255 (1981). For a brief discussion of these treaties, and why they have not been widely taken up, see P John Kozyris "Corporate Wars and Choice of Law" [1985] Duke Law Journal 1 at 53-55.

9 UNCITRAL is currently exploring the possibility of undertaking some work in the area of cross-border insolvency. For a discussion of other initiatives in this area, see the paper presented to the 1995 IALS colloquium by Professor Jacob S. Ziegel.

10 Treaty of Rome Art 54(3)(g), and see Alfred F Conard "The European Alternative to Uniformity in Corporations Laws" 89 Mich L Rev 2150 (1991) at 2152-5.

allowing single shareholder corporations, minimum capital for public corporations, and mergers and split-ups.[11]

This trend appears to have been slowed by the new emphasis in the EU on the principle of subsidiarity, introduced by the Maastricht Treaty, under which European intervention is restricted to those issues which cannot equally satisfactorily be addressed by national legislation. But the rush of new commercial laws in the post-socialist states of Europe has led to a large number of corporations laws being modelled on the laws of EU states, in particular Germany, which are geographically close to hand, share a common legal tradition, and are a reliable source of expertise and advice.[12]

Another trade group which has harmonisation of corporations law as an explicit goal is CARICOM, the Caribbean community common market.[13] To give effect to this goal a Working Party was established which reported in 1980 with a draft Bill. The work of the working party, and subsequent work by the Caribbean Law Institute, has influenced legislation in Barbados, Trinidad and Tobago and Jamaica but has not brought about a high degree of uniformity among the member nations, or indeed even among those implementing reforms.

### *C Convergence in the United States of America*

The most striking example of convergence - and one that I shall return to later, as it is the best documented and most exhaustively analysed - is the convergence that has taken place since the early years of this century between the corporations laws of the states of the United States of America. Corporations law (as opposed to securities law or insolvency law) is the preserve of the states, and is not the subject of Federal legislation. Yet there is an extraordinary degree of similarity between the laws of the various states, and a change in the law of one of the "leader states" - in particular Delaware - tends to be replicated elsewhere. The principal cause of this convergence is said to be competition for incorporations between states, led by Delaware. Another obvious force for convergence is

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11 See L C B Gower, Gower's Principles of Modern Company Law (5th ed, London, Sweet & Maxwell, 1992) pp 60 - 66; Johan de Bruycker "EC Company Law - The European Company v. The European Economic Interest Grouping and The Harmonization of the National Company Laws" 21 Georgia J Int & Comp L 191 (1991), Conard, above n 10.

12 For a discussion of the approach taken by a number of post-socialist states to commercial law reform, including corporations law, see the fascinating paper by Cheryl W Gray and associates "Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe" World Bank Discussion Paper 209 (1993). The desire to have laws which comply with the relevant EU directives, to facilitate membership at a later date, has also been an incentive to follow existing EU models.

13 Established by the Treaty of the Caribbean Community Common Market (1973). Article 42(1) of the Annexe to the Treaty requires the member states to work towards harmonisation of corporations law.

the American Bar Association's authoritative and hugely influential Model Business Corporations Acts, the first of which appeared in 1950. Successive revisions have introduced changes which have been widely, and relatively swiftly, adopted by states.[14]

### *D Divergence in the British Commonwealth*

The convergence noted above needs to be weighed against a tendency to divergence, at least at a level of detail, among British Commonwealth countries. A pattern of uncritical adoption of the latest English Companies Act in most Commonwealth countries has changed considerably in recent years: I discuss this further below.

## *7 What causes convergence in corporations law?*

### *A Causes of convergence in commercial law*

In an illuminating essay on international harmonisation of commercial law, Professor Roy Goode identifies at least nine methods by which laws are harmonised at an international level:[15]

- a multilateral Convention without a Uniform Law as such;
- a multilateral Convention embodying a Uniform Law;
- a set of bilateral treaties;
- European Community legislation - typically a directive;
- a Model Law;
- a codification of custom and usage promulgated by an international non-governmental organisation;
- international trade terms promulgated by such an organisation;

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[14] For a discussion of this phenomenon see William L Cary "Federalism and Corporate Law: Reflections Upon Delaware" 83 Yale LJ 663 (1974) and Douglas M Branson "Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure" 68 Minnesota L Rev 53. These articles provide a useful summary of the trends that have occurred, although the interpretation offered has been compellingly criticised in eg Ralph K Winter, "State law, Shareholder protection, and the Theory of the Corporation" 6 J Legal Stud 251 (1977); Daniel R Fischel "The Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law" 76 Nw Univ L Rev 913 (1982).

[15] Roy Goode, "Reflections on the Harmonization of Commercial Law" in Cranston and Goode (eds) *Commercial and Consumer Law - National and International Dimensions* (Clarendon Press, Oxford, 1993) at pp 6-7. Professor Goode also notes that harmonisation can occur through colonisation (the foundation of the harmonising effect of English legislation) or adoption by one state of another State's codes, but observes that these are not truly international exercises with the objective of facilitating a common market or inter-State commerce, which is the focus of his essay.

- model contracts and general contractual conditions;
- restatements by scholars and other experts.

Apart from European Community legislation and other regional initiatives, and domestic restatements (including draft legislation prepared by law reform bodies) none of these is applicable to corporations law at an international level. It is interesting to inquire into the reasons for this, and the other possible causes of the convergence I tentatively identify in this paper.

***B Case for harmonisation weak in core corporations law***

The reason for the lack of attention given to international harmonisation of core corporations law is not difficult to identify. As Professor Goode points out, the particular characteristic of twentieth-century harmonisation lies in its motivation, which is to reduce the impact of boundaries - and in particular, to reduce their significance in trade.[16] But trade by corporations is not (with a very few exceptions) affected by differences in the rules which govern their internal operation: this is no more of an issue on the international scene than it is domestically, where many corporations with quite different structures and internal rules trade with each other quite unproblematically.[17]

This issue had to be considered by the New Zealand Law Commission in the course of its recent company law reform project. New Zealand and Australia have entered into ANZCERTA, a treaty aimed at fostering trade in goods and services in the region.[18] There is a memorandum of understanding between the Attorneys-General of the two countries which seeks to harmonise business laws to give effect to the goals of ANZCERTA. The Commission considered whether these international obligations affected the reform process in New Zealand, and concluded they did not. As the Commission said, "much of company law has little impact on trans-Tasman trade. Where it has, as for example in the law relating to company insolvency, we have been particularly conscious of the ANZCERTA implications." The New Zealand reforms bear little resemblance to current Australian corporations law.[19]

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16 Goode, above n 15.

17 It is interesting that the most obvious exception to this generalisation, the ultra vires doctrine (which can have an effect on third parties dealing with a company, and so on trade), was the subject of the First European Council Directive of 1968.

18 Australia and New Zealand Closer Economic Relations - Trade Agreement (1983).

19 See NZLC Report No 9 *Company Law: Reform and Restatement* (1989) paras 36-42, 145-153, 238. Other reasons given for not following the Australian model were its unsatisfactory state, the complexity and difficulty of its drafting, and the pending proposals for reform in Australia which made it an unstable model to say the least.

The New Zealand Law Commission's comments highlight one of the areas of law relating to corporations which does have significant cross-border implications: insolvency law. Recognition of the legal personality of foreign corporations is another area with international trade implications, which has been the subject of some international attention.[20] Other areas are takeovers law, and securities laws generally: these directly affect the existence of international trade in corporate securities, and the ease with which investors in one country can invest in a corporation based in another.

Cross-border investment raises some interesting issues about harmonisation of shareholder rights and obligations. It can be argued that harmonisation is desirable, so that an investor in one country has a better idea of the package of rights incorporated in a "share", and better knowledge of and access to enforcement mechanisms. This raises questions of choice of law, as well as the issue of the non-standard content of corporations laws. But the importance of these issues can easily be exaggerated.

First, most substantial cross-border investment is carried out by investors with access to advice on the legal regime applicable in the corporation's home jurisdiction, and a presence in the recipient country or a specialist knowledge of it. Smaller investors typically invest in "foreign" corporations through a domestic stock exchange on which the foreign corporation is listed: domestic stock exchange rules often go some way towards ensuring that a share listed on that exchange carries similar core rights, whatever might be permitted under the corporation's home law. Second, international capital markets display a considerable tolerance for variation in non-financial rights attached to debt and equity securities. Most investors see their remedy for dissatisfaction with management or the affairs of the issuer generally as lying in liquidity of the securities and their ability to sell, rather than in the exercise of enforcement rights. "Country risk", including any risks associated with the legal regime of the country, is another risk which can be managed to some extent by diversification. Third, and most importantly of all, if an issuer seeks to raise funds in overseas jurisdictions it is in the issuer's interests to attach to its securities terms which are as attractive as possible to investors: in practice this often means that certain topics are addressed in a more or less standardised way. These standard terms need not be imposed by the issuer's home jurisdiction: all that is required is a sufficiently flexible corporations law which enables the issuer to customise the terms attaching to the securities to meet the expectations of investors. That is, the default rules of the home jurisdiction are not a barrier if the issuer is free to depart from them where it is commercially desirable to do so.

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The New Zealand Commission suggested that its work might rather provide the basis for any trans-Tasman harmonisation, an invitation that our larger neighbour has not yet taken up!

20 See above n 8.

Perhaps the most critical issue for those concerned with cross-border investment is removing artificial barriers to raising funds in a number of countries imposed by differing (and often cumulative) disclosure and prospectus requirements in different countries. Considerable work has been done on these issues in regional contexts such as the European Community, and in Australasia. The thrust is normally to ensure that disclosure under one regime is accepted in other countries, or need only be supplemented with a limited amount of additional information, rather than being entirely recast. However I do not intend to discuss this important topic in any detail in this paper, as such disclosure requirements have little to do with core corporations law.

It is not easy to identify any factors apart from facilitating trade and international capital raising and investment, which would justify devoting time and resources to international harmonisation of core corporations law. These factors are not of themselves sufficient, in my view. It follows that attempts to harmonise core corporations laws on an international scale are likely to be of limited value, and the absence of such exercises need not be lamented.

### *C Convergence through use of foreign models*

The task of reviewing and redrafting a corporations statute is a huge one, requiring substantial expertise and resources. This acts as a force for convergence, for it means that all but the most insular or wealthy of countries tend to look overseas for models for reform. These models are either adopted virtually intact, or used as a base for the reform exercise. This tendency is reinforced by the frequency with which smaller or less wealthy countries call on the expertise of consultants from countries whose laws and recent experience appear to be relevant to the reform exercise: such consultants have a natural tendency to take as their jumping off point the laws with which they are most familiar.

I have already mentioned convergence resulting from looking abroad for useful models in the post-socialist economies, where the source has been the EU and in particular Germany.

For many years England was the leader in company law reform for its empire, and also for independent members of the British Commonwealth. As England enacted new companies legislation, the other Commonwealth countries would follow, usually without any substantive review. This approach is summarised rather nicely in the Explanatory Memorandum to the 1933 Bill introducing into New Zealand the English Companies Act 1929, with very minor format changes:

> The Imperial Act on which this Bill is founded is not above criticism. For example, the Editors in their preface to the eleventh edition of Buckley's Law and Practice under the Companies Acts, make the following observations:...

This criticism might be taken to suggest that the Imperial model can be improved upon, and it may further be suggested that if it can be improved upon it should be improved upon. But the view taken by the Advisory Committee, and concurred in by the Government, is that we should as far as possible adopt the verba ipsissima of the Imperial Act. Any attempt at improvements in language or arrangement would in large measure defeat the ultimate purpose of the Bill - namely that there should in this department of law be uniformity, as far as that is attainable, within the British Commonwealth, and that the decisions of the English Courts should be applicable in New Zealand as they are in England.

If the criticisms of the Imperial Act, made in text-books, legal journals, and elsewhere, prove to be well-founded and substantial, they will inevitably be followed by amending legislation in England, and it will then be a simple matter for the New Zealand Legislature in its turn to adopt those amendments. This view has the support of the responsible officials of the Imperial Board of Trade, who administer the Imperial Act and with whom the proposals of the Government in relation to the present Bill have been discussed." (emphasis in the original)

However the influence of EC law on English law, and a view of English law reform in this field as conservative to the point of ossification, and focused on detail rather than underlying principle, has led many Commonwealth countries to look elsewhere for models in the last ten to twenty years. The most influential of the various Commonwealth reform exercises has been the Dickerson report in Canada in the early 1970s.[21] This report, and the accompanying draft legislation, has been the foundation of new or substantially revised federal and provincial corporations statutes in Canada, and has been a major influence on reform in the Caribbean and in New Zealand - and so, indirectly, in Argentina, Sri Lanka, Papua New Guinea and other countries.

The Dickerson report is an example of the importance of restatements by law reform bodies and scholars in the field of corporations law. Another influential restatement I mentioned earlier is the Model Business Corporations Act. It is hard to imagine any law reform body (in the common law world, at least) embarking on corporations law reform without a careful scrutiny of these texts and of the ideas which they embody. Even where a foreign model is not directly drawn on by those responsible for reform, restatements prepared by reformers in other countries are often a source of ideas for change, and challenges to "received wisdom".

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21 Dickerson et al *Proposals for a New Business Corporations Law for Canada* (1971, Information Canada, Ottawa).

### *D Competition for incorporations as a cause of convergence?*

As discussed above, in the USA there has been striking convergence of state corporations laws. This is attributed by commentators to competition between states for incorporation and related business, led by Delaware. The reasons for Delaware's success in attracting incorporations, and setting the agenda for corporate law reform, are said to be the enabling or "facilitative" nature of its laws, the large and stable body of precedent developed in the state, and the large and skilled corporate bar which enable corporations to obtain a higher level of certainty and clearer, more authoritative advice on the transactions which they contemplate.[22] As Professor Roberta Romano points out in a recent article, this competition is more complex than some commentators assume, as it is characterised by:

- significant transaction costs on reincorporation, which lead to limited reincorporations except prior to major corporate transactions likely to be facilitated by the move;
- a significant "first mover" advantage enjoyed by Delaware.[23]

But such competition, or a perceived risk of such competition on the part of lawyers and legislators, is widely acknowledged to be a major force in convergence of US corporations laws.

The question is whether similar competition is an effective force on a wider stage. Certainly countries compete to attract businesses to establish a local presence, employ local staff, export products and so enhance the domestic economy. In order to do so, countries (especially developing countries) frequently establish special programmes to attract foreign investors, involving tax breaks, easy transfer of funds and assets, and simplified administrative and bureaucratic requirements. There is sometimes, though not always, a review of domestic laws to which foreign investors will be subject, to see if these can be

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22 For a discussion of the convergence in US corporations laws, and the debate over whether that tendency is to be applauded or deplored, see Cary above n 14, Melvin A Eisenberg, "The Structure of Corporation Law" 89 Columbia Law Rev 1461 (1989), Easterbrook supra n 13, Fischel supra n 13, Winter above n 13, Ralph K Winter, "The Race for the Top Revisited: A comment on Eisenberg" 89 Columbia Law Rev 1526 (1989), Terence L Blackburn, "The Unification of Corporate Laws: the United States, the European Community and the Race to Laxity" 3 George Mason Independent Law Review 1 (1994), Lucien A Bebchuk, "Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law" 105 Harvard Law Rev 1437 (1992), Roberta Romano "The state competition debate in corporate law" in LA Bebchuk (ed) *Corporate Law and Economic Analysis* (Cambridge University Press, 1990), Easterbrook and Fischel *The Economic Structure of Corporate Law* (Harvard University Press, 1991), chs 4-5.

23 Romano, above n 22.

streamlined, and costs and bureaucratic delays reduced. This process can embrace corporations laws.

The desire to create an attractive climate for foreign investment certainly inclines many countries towards adopting a legal framework for the establishment and operation of corporations which will not appear unduly onerous or strange to foreign investors. An argument often advanced on issues such as capital structures, and takeovers laws, is that certain regimes familiar to investors, such as that of the United States, will be attractive to investors precisely because they are well known internationally. There are often strong counter-arguments, where the foreign model is flawed, or depends on institutional arrangements which are not practical to replicate. But a desire not to be different for the sake of it is certainly sensible.

On balance, however, I do not believe that there is significant competition for incorporations internationally, which has produced or is likely to produce convergence of corporations laws.[24]

Competition for incorporations within the USA is made possible by the ability of a corporation to carry on business and raise capital within that federation regardless of its state of incorporation.[25] That ability in turn is based on the constitutional protection within the USA of interstate commerce, which effectively prohibits discrimination against out of state corporations.

An environment which encourages competition for incorporations does not exist on an international scale, for a number of reasons. First, there are many barriers to a corporation formed in one country carrying on business in another.[26] These are on occasion explicit, as where foreign corporations cannot own land, or pay tax at different rates, or are subject to limitations on access to the courts or to state contracts or licences of various kinds. They may also be implicit, as where foreign corporations carrying on business in a country are required to file financial statements and other forms of disclosure in that country in relation to the whole of their business, in forms and subject to requirements peculiar to that country. The cost of forming a local subsidiary will often be less, in such circumstances.

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24 This is assumed to be true in the US literature on state competition: see for example Bebchuk above n 22, 1507-1508, Easterbrook and Fischel, above n 22, 233.

25 Blackburn, above n 22.

26 The Hague Convention on Recognition of Corporations, above n 8, has had little success, attracting only a small handful of countries as signatories. Many countries impose some restrictions on foreign corporations, going beyond mere disclosure to restrictions on participation in some forms of economic activity, higher tax rates, higher registration fees etc.

Second, the decision whether to trade in a particular country will be driven by a range of commercial factors, of which only one is the cost of complying with legal requirements in that country. In turn, only a small part of legal compliance costs arises from the cost of complying with corporations laws. The decision on whether to form a corporation in a country in which it is proposed to carry on business cannot be easily divorced from the decision whether to carry on business in that country, and will almost never be a major factor in the latter decision. Of the relevant legal issues, tax and employment law tend to be far more significant.

Third, just as Delaware's institutional advantages have not proved easy to replicate in other states, so too they are not easy for other countries to replicate. So this basis for strong competition is lacking.

Fourth, although there are costs involved in transferring incorporation from one state in the USA to another, it is legally possible. International transfers of incorporation are sometimes not permitted by a country's laws, or restricted in various ways, and are likely to be more expensive.[27] Where the vast bulk of a corporation's owners are located in one country, as is often the case, relocation offshore may also lead to a discount in share value for risk (due to ignorance of the new legal environment, and increased information and enforcement costs), which is likely to be unattractive to shareholders and managers.

Fifth, some countries apply a choice of law rule in relation to the law governing the internal affairs of a corporation which focuses on the siËge rÈel of the corporation, not (as under Anglophone law) its place of incorporation. So merely changing a place of incorporation, a legal formality which is likely to cost less than moving a principal place of business, would not be recognised by some countries as effecting a change in governing law. The need to move a corporation's siëge rèel in order to operate under a different corporations law substantially enhances the transaction costs of such competition, making it much less likely.[28]

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27 For example, the Canadian legislation confers "appraisal" or "buy-out" rights on dissenting shareholders of a corporation which resolves to continue under the laws of another jurisdiction: this could impose a significant cost on the corporation (see Canada Business Corporation Act s 188, Ontario Business Corporations Act s 181). In the UK there are significant taxation disincentives to migration of companies: Taxation of Chargeable Gains Act 1992 (UK), s 185.

28 This appears to be the principal weakness in Blackburn's thesis (above n 17) that competition in corporations law is more likely in the EU than in the USA, leading to an accelerated "race to laxity". Relocation of a siËge rÈel seems unlikely simply in order to secure the benefits of a change in governing law. Similarly, the place of establishment of the siËge rÈel of a newly formed European corporation is likely to be driven by commercial considerations other than the legal environment for corporations. And on the increased importance of the law of incorporation, even in continental Europe, see Kozyris above n 8 at 53-55.

### *E The influence of economic theory*

The other cause of convergence in corporations law, in my experience, is an increasing understanding by law reformers and governments of the function of corporations law in the economy, and of the ends which it can and cannot serve.

Those responsible for the reform exercises I have been involved with in the last seven or so years have for the most part proceeded along the following lines:

- corporations laws are seen as providing a form of business organisation which is made up of a set of standard form contracts between the various participants (owners, managers, creditors etc);
- the role of the state is essentially facilitative: it permits the formation of corporations in the least expensive, most efficient manner possible, and provides a set of standard terms which can be varied by the participants to meet their particular business needs. Greater reliance on markets to produce efficient outcomes, and less confidence in the ability of governments to "pick winners" at the level of substantive rules for the operation of the marketplace, has led to a withdrawal of prescriptive law from many areas of corporate relationships;
- the imposition of procedural or formal requirements on corporations needs to be considered very carefully, in the light of the need to facilitate business activity and an awareness that information disclosure and regulatory compliance are not costless;
- the imposition of substantive restrictions on the manner in which corporations are organised, and the relationships between the participants, is difficult to justify and should be rigorously scrutinised;
- the pursuit of collateral objectives through corporations laws (eg "shareholder democracy", worker participation in management, diversified public involvement in the sharemarket) is unlikely to be effective, and entails costs and distortions which need to be justified by something more than warm fuzzy slogans.

One certainly sees these influences at work in the North American legislation, in the proposed reforms in Argentina,[29] and in the reforms in New Zealand and other Commonwealth countries, to take a few examples. They can also be discerned in the lack of progress or abandonment of some of the proposed EU directives, which appear to have fallen victim to the subsidiarity principle precisely because there is no clear and

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29 Proyecto de reformas a la ley de sociedades commerciales elaborado por la Comision designada por resolution MJ 465/91 (Astrea, Buenos Aires, 1993). See the paper presented to the 1995 IALS colloquium by Professor Daniel G Castro Viera.

demonstrable case to be made that the suggested interventions will enhance trade or freedom of establishment within the EU. The result is that individual countries, and within them individual corporations, are left to decide how to address these issues subject to the disciplines of the markets in which they operate.[30]

This theoretical framework encourages convergence towards a generally facilitative model of corporations law, rather than towards identical "default" provisions. This may be seen as a very low level of convergence. But it is the critical level for coherent reform, for once the law in a country is facilitative it is possible for corporations which wish to depart from the standard form to do so (at a cost). Corporations law then ceases to act as a significant handicap to doing business from a base in one country, rather than another.

The precise content of the standard form provided in each country is much less important, and continues to vary considerably. The goal of legislators, from a transaction cost perspective, should be to provide the type of corporate constitution and associated arrangements that the majority of corporations is likely to prefer, since that will reduce the overall cost of departures from the standard form. But a reluctance to change the "default settings" of the past, or a desire to ensure that participants consciously and deliberately choose a lower level of protection in relation to certain corporate transactions, for example, may lead to departures from this approach in some countries. Institutional factors may also be relevant, as discussed below. While there is some convergence in this area of corporations law, therefore, I believe it is weak, and likely to remain so.

### F Tempering theory with institutional reality

One of the significant factors in deciding how to develop corporations law to suit a particular country is the level of competence and resources of its institutions. A certain level of institutional effectiveness is essential if there is to be a meaningful corporations law: for example, there must be a functioning registry from which core information can be obtained about the controllers and owners of the corporation, and about its legal location. This is sometimes overlooked, with the result that a technically excellent and modern law is almost entirely useless in the country which has adopted it.

The question of the appropriate body to carry out supervisory or investigatory functions must also be tempered by reality in each country. The starting point should be to avoid third party intervention in corporate affairs unless there is a genuine problem. But where there is a breakdown of the normal arrangements, there must be ready access to responsive authorities or tribunals with the necessary level of understanding of the issues involved.

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30 This development is touched on by Blackburn, above n 22. See also Frank H Easterbrook, "Federalism and European Business Law" 14 International Review of Law and Economics 125 (1994), esp 131-132.

Two examples may be of interest. First, a belief on the part of those responsible for the reforms in one jurisdiction where I have been working recently that the general courts have insufficient expertise and are too slow to perform commercial dispute resolution functions has led to the creation of a specialist tribunal to hear some disputes, and to replacement of some provisions in the models used which required court intervention with a regime which prescribes a "default" outcome in certain situations, with the ability to go to court or to a tribunal only if that default outcome is not acceptable to a party. Second, when I was drafting the Sri Lankan Companies Act, I included a requirement derived from English and Australian models that any liquidator or receiver of a company must be an experienced insolvency practitioner. The law reform body I was working with politely explained to me that this was a wonderful provision in principle, but as there had never been a receivership in Sri Lanka, and only a few liquidations (most conducted by one person, who had since retired), there were no such persons in the country! The provision had to go.

## 8 *Some likely directions for convergence*

In the remainder of this paper, I consider three aspects of corporations law. I look at the directions for convergence that my thesis suggests, and whether it is possible to discern trends of the kind predicted.

### *A Capital raising, and distributions to shareholders*

#### *1 Capital maintenance*

A feature of almost all common law countries' corporations law has until relatively recently been the requirement that the company specify a nominal capital which it is entitled to issue, and that each share issued have a nominal or par value. This is accompanied by the "capital maintenance doctrine", developed by the courts and only partially set out in the relevant legislation. The capital maintenance doctrine means in practice that:

- a share may be issued at par or at a premium over par. But it cannot be issued for less than par without a special procedure being followed;
- a company cannot pay dividends to its shareholders unless those dividends are paid out of current profits, or out of reserves. But the company need not make up losses of capital in a previous year before it pays current profits out to shareholders as a dividend;
- a company cannot buy its own shares, or return capital to shareholders, without a special procedure to reduce its capital which involves a meeting of shareholders and at least two applications to the Court;

- majority or super-majority shareholder approval is required to increase the company's nominal capital.[31]

If requirements of this kind protect either shareholders or creditors of a corporation from capital dissipation, they do so by chance rather than because they are well fashioned tools for achieving this end. Professor Castro Viera puts it nicely, in describing the principle of capital immutability as providing "a rough, unsophisticated kind of assurance to the general public that the assets of the company exceeded its debts [by] the amount of stated capital."[32] If anything, he errs on the side of overstating the doctrine's value.

Shareholders are not protected from dilution of their stakes in the corporation by restrictions on issue below par, if the company's shares have a market value above par. This lack of meaningful protection is accentuated if the former North American stratagem of issuing shares at low par values and high premiums as a matter of course is adopted. But obtaining capital becomes more costly and difficult precisely when it is most likely to be needed, ie when shareholder funds are depleted.

A creditor who extends credit to a corporation because it has a nominal capital of $1 million is being misled: it may not all be issued. A more sophisticated creditor who relies on a corporation's issued, as opposed to nominal, capital may still find that it has all been lost in previous years and that the expected capital cushion is not there.

In essence, the problem is that neither nominal capital nor issued capital has any necessary relation with net shareholders' funds: it is the latter which is most relevant to the credit risk involved in dealing with a corporation, as well as cashflow and an appropriate risk-weighted assessment of contingencies over the period of credit.

The other problem with the argument that the classical capital maintenance doctrine protects creditors is empirical. Creditors do not in fact go to the public registry and check on a corporation's issued capital before extending credit. Ordinary trade creditors with many customers do not normally carry out credit checks at all: the cost is not justified by the amount of exposure to any one customer, and the risk of bad debts is factored into pricing to all. Major creditors who do care about a corporation's creditworthiness do not rely on searches at the public registry, and the limited historical information which those searches produce. They get credit references, or bankers' opinions, or ask the corporation to provide recent financial information and financial forecasts on which to base the assessment. They may go to other sources of information such as credit rating agencies.

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31 The position was even more extreme in Argentina, as the paper presented to the 1995 IALS colloquium by Professor Daniel G Castro Viera explains. A very rigid principle of "capital immutability" held sway.

32 Above n 31.

They may take security for the credit extended, or rely on retention of title clauses in contracts for the supply of goods.

### 2 *North American "stated capital" techniques*

The approach used in some jurisdictions, such as Canada, replaces nominal capital with "stated capital". Typical stated capital regimes provide that:

- the board of directors decides on the amount payable for shares upon issue;
- the corporation's stated capital is the amount actually received by the corporation for its shares at the time they are issued;
- distributions may be made if the corporation will, after the distribution, be able to meet its debts as they fall due and will have realisable assets in excess of liabilities plus stated capital;
- a corporation may buy back its shares with board approval, and if it does so may reduce its stated capital accordingly. In some jurisdictions voluntary buybacks by a corporation can only take place if a solvency test similar to that for distributions is met. Other buybacks can still take place provided a bare solvency test (ie without the requirement to preserve stated capital) is met;
- a corporation may issue some or all of its shares as redeemable shares, which the holder can require the corporation to redeem, with a consequential automatic reduction of stated capital;
- in some (but not all) jurisdictions, stated capital can be reduced by super-majority resolution, with public notice of the reduction.

This approach avoids the difficulties posed by the capital maintenance doctrine in relation to issue of shares, but is only marginally more focused on the real issues in relation to preservation and adequacy of capital.

The stated capital system does not of itself confer any protection on shareholders. Shareholders' funds may still be depleted by unsuccessful trading or depreciation, for example. If the corporation's net assets fall below the stated capital, no distributions will be permitted: but this is not a protection for shareholders, since they are if anything in a better position where funds have been paid out to them as a distribution.

In any event, to the extent that the restriction is for the benefit of shareholders, it should be able to be waived in the corporation's constitutional documents, or by unanimous shareholder agreement.

For creditors, checking a corporation's stated capital would be as unenlightening as checking issued capital is at present. Even if they do so, they would be none the wiser unless they could also check:

- the current market value of the corporation's assets, which is not ascertainable from the public register in most countries;
- the existence of securities over the corporation's property, which is often recorded on a public register;
- how much is secured under any securities, and in particular under debentures, which is not normally ascertainable from a public register;
- the amount of other unsecured liabilities, which again it is not normally possible to discover from the public register.

It is true that stated capital provides a "cushion", in the sense that distributions which would erode that capital are not permitted - and if such distributions are improperly made, they can usually be recovered from the directors or shareholders. But a creditor who relies on a particular stated capital may also find that it is eroded by trading losses, redemption of redeemable shares or buybacks pursuant to a minority buyout right. This may already have happened before credit is extended, or may occur after the creditor has accepted the exposure.

In addition, experience shows that in the case of closely held corporations in which the shareholders and directors are identical, and all are involved in the operation of the business, even the prohibition on distributions if stated capital cannot be preserved is ineffective. The directors simply pay themselves salaries, rather than taking income through distributions. This is normally quite lawful.

The practical result of these deficiencies in stated capital regimes is that creditors normally either ignore stated capital, or contract to fill the gaps with additional notice requirements and restrictions on use of funds when the cushion is eroded. Such contracts do not depend on a statutory stated capital regime for their effectiveness, and can also be used in countries such as New Zealand without such a regime.

For the reasons canvassed above, there is little to be gained from a stated capital regime. There is a cost to corporations in complying with the requirement. If the cost is not justified, why incur it?

### 3 *Minimum capital requirements*

In some jurisdictions, including Argentina, the EU countries, and some post-socialist countries, certain classes of corporation are required to have a minimum nominal or stated capital.[33] There is nothing similar in most North American jurisdictions, New Zealand or Australia.

It is impossible to specify in advance the amount of capital required to safely carry on all types of business activity. To attempt to ensure businesses are adequately capitalised by such a rough technique, which can only apply to domestic corporations rather than foreign corporations, or even domestic individuals, partnerships or other forms of business association is in my view bizarre. It is increasingly bizarre when one bears in mind that in most countries, closely held corporations are not subject to any such requirement - and yet there is no restriction on the type or scale of business that they can carry on.

This is an example of a well-meaning but poorly thought through requirement which is of no real value to anyone. On the other hand, provided it does not apply to all corporations, it is unlikely to be a significant barrier to efficient conduct of business. So repeal of such provisions is desirable, but hardly urgent. If this kind of restriction applies to all corporations in a country, however, and is set at a level which is meaningful enough to prevent some businesses from being incorporated, there will be real costs and inefficiencies, and some form of reform is more urgent. This can either take the form of removing the requirement, or allowing formation of corporations of different kinds which are not subject to the requirement.[34]

#### 4 *Capital - a summary*

The above discussion of capital raising and distributions illustrates how applying reasonably elementary economic analysis to corporate structures is likely to lead a reformer towards abandonment of a strict capital maintenance doctrine, and to permitting all or at least some forms of corporation to be formed and to carry on business without a minimum capital requirement. Significant moves in this direction have indeed occurred in numerous countries, including Canada, New Zealand, Australia, and Argentina, and seem likely to continue.

### B *Directors' duties to the corporation and its shareholders*

Directors are appointed by shareholders to manage the company. In the case of very small companies, they normally are the shareholders, or most of them. In the case of very

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33 For the position in Argentina, see the paper presented by Professor Daniel G Castro Viera to the 1995 IALS Colloquium. The EU requirement is set out in the Second Directive on Company Law, implemented in the UK by ss 45 and 117-118 of the Companies Act 1985. For the position in selected post-socialist countries see Gray and associates, above n 12.

34 The proposals for reform in Argentina have taken the latter direction: Castro Viera, above n 29.

large companies, on the other hand, it is probably more accurate to say that the company is managed under the supervision and general direction of the board of directors.[35]

At this point, it is worth reminding ourselves that the role of the business corporation is to take business risks. So the job of directors is to manage or supervise the taking of business risks. And it is also worth reminding ourselves of the truism that the board of a company can only achieve above average performance by taking risks greater than those associated with investing in sovereign debt, for example - if there were equally riskless investments which provided a better return, demand for those investments would increase until their price matched that of government paper. If investors want riskless returns, they can buy government paper: they do not need to employ directors to do it for them. So they are looking for a better return - that means risk, and means directors must take risks to do their job.

Because corporations are very diverse, it is not easy for corporations law to specify what is required of directors in detail. But certain general standards can be set: I consider below what those might be.

***1 Limiting directors' duties***

First, however, one important point should be noted. When an investor appoints an agent to carry out any other form of business activity (ie other than to run a company in which the investor has placed funds) it is entirely open to the investor and the agent to agree between themselves on the appropriate level of performance and care to be expected of the agent. In freely negotiated agency agreements, or in trust deeds appointing trustees to manage funds, it is very common to find a wide range of limitations on the agent's or trustee's liability, including provisions which:

- limit liability to recklessness or fraud, or to acts done in bad faith;
- expressly authorise the agent/trustee to act for others in the same market, or to participate in the market on their own account;
- authorise the agent/trustee to take advantage of opportunities or information acquired while acting as agent or trustee.

It is not usually considered appropriate for the law to limit arrangements of this kind - except that exclusion of liability for fraud may be seen as contrary to public policy, and invalid. Such arrangements may reduce the cost of the agency services obtained, or may

35 Compare Model Business Corporations Act 8.01; Companies Act 1993 (NZ), s 128(1) and see Hilmer "Strictly Boardroom - Improving Governance to Enhance Company Performance" (Information Australia, 1993).

make it possible to retain the services of individuals who would not be prepared to act on any other basis.[36]

It is difficult to see why the same reasoning should not apply to corporations and their directors. Whatever the "default" standard of care established for directors, the law should permit this to be varied by the corporation's constitutional documents: in large publicly traded corporations, investors can make their own decision on whether or not this is desirable and the market will price accordingly. In small corporations, each investor can once again make his or her own decision about the acceptability of such a provision, and either participate on those terms or not: but if a partnership can adopt such an arrangement, for example, why not a corporation?[37]

Interestingly, this is not yet a common position in corporations legislation. Most countries take a view on the required standard, and provide for it to be invariable.[38] The first exception I am aware of was the Delaware law permitting a corporation's constitution to limit director liability, which was enacted in 1986.[39] A number of other states in the USA have followed suit.[40] If I had to pick an area of likely future convergence in corporations law, I would see this as a significant change with strong economic justifications, which is likely to spread.

### 2 *The fiduciary duties of directors*

Directors are the archetype of agents whose duties are difficult to specify in advance. As scholars have pointed out, this makes it likely that the law will settle on the type of

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36 This is particularly true in small countries such as New Zealand, where a limited number of skilled intermediaries and agents means that exclusive relationships are often impractical.

37 Certainly there can be no complaint where a corporation is formed with such a provision in its constitution, or where an investor invests after such a provision is adopted. But if such provisions can be adopted by a majority vote, rather than unanimously, there may be investors in small corporations who have such a provision thrust on them, and are unable to sell out easily as their investment is illiquid. The solution depends on how major this change is perceived as being. If it is seen as relatively minor - the view I take - then no special remedy is required: this is just one of a number of business decisions which the investor has agreed to allow to be decided on a majority basis, such as appointment of any other agents of the company, or of a non-director chief executive. If the change is seen as major, the appropriate solution is to allow investors who voted against the change buy-out or "appraisal" rights.

38 See the *International Encyclopaedia of Comparative Law*, vol XIII ch 4 para 113, in which it is also suggested that the trend is toward higher standards. I am not sure that this is as true today as it was at the time this work was completed in the early 1970s.

39 Delaware Act of June 18, 1986, ch 289, 65 Del. Laws. For a discussion of this amendment to the Delaware code see David S Schaffer "Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law" 10 Harvard J Law & Public Policy 665 (1987).

40 Forty states as at 1 December 1994 (Model Business Corporations Act Annotated (3rd ed)).

general duties characterised as "fiduciary" ie duties to act honestly and in good faith, and in what the director believes to be the interests of the corporation. These are indeed the types of duty that one finds set out in many corporations laws.[41] The author of the relevant chapter of the International Encyclopaedia of Comparative Law was able to make the strong statement that:[42]

> Directors owe duties of skill and care and fiduciary duties to the corporation. The standards as to fiduciary duties may vary in detail from one jurisdiction to another, but the basic approach seems to be pretty much the same everywhere.

### 3 *The standard of care expected of directors*

The more difficult question in many ways is the standard of care expected of directors in making business decisions. Should they be liable for losses suffered by the company if they make decisions recklessly? Negligently? Or which are simply wrong? Most commentators agree that where a board is reckless, in the sense that it makes a decision no reasonable person could have made, it should be liable for the consequences. Similarly, most agree that it would be fundamentally inconsistent with the role of directors as takers of business risks to impose liability for decisions which prove to be wrong: directors are not insurers of every corporate project which is undertaken. But there is considerable debate over the question of liability for negligence, and many different solutions have been propounded and enacted. The passage from the International Encyclopaedia of Comparative Law cited above continues, a few lines later:[43]

> The situation is different with regard to duties of care and skill. Here we find a great variety of solutions. The standard liability ranges from slight negligence (West Germany) to gross negligence amounting to fraud (England and, to a decreasing extent, the United States). In some jurisdictions the test is objective, not taking into account the particular talents of the individual director (West Germany), whereas in others the standard is wholly subjective (England). Distinctions tend to be made between inside and outside (United States) or salaried and non-salaried directors (France). Likewise, the scope for discretion given to directors varies from jurisdiction to jurisdiction, the broadest scope probably being granted by the American "business judgment rule". Occasionally members of management may even become personally liable for corporate debts in case of any mismanagement (France).

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41 For a discussion of the imposition of duties of loyalty, or "fiduciary" duties where it is impossible to specify completely the parties' obligations see Easterbrook and Fischel, above n 22; Easterbrook and Fischel "Contract and Fiduciary Duty" 36 J Law & Economics 425 (1993). For examples of legislation to this effect in relation to directors see Companies Act 1993 (NZ) s 131; Canada Business Corporations Act s 102(1); Model Business Corporations Act ß 8.30(a)(1).

42 *International Encyclopaedia of Comparative Law* vol XIII ch 4, para 113.

43 Above n 42.

### *C The New Zealand approach*

In New Zealand, section 137 of the Companies Act 1993 provides:

> A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,-
>
> (a) the nature of the company; and
>
> (b) the nature of the decision; and
>
> (c) the position of the director and the nature of the responsibilities undertaken by him or her.

This is a largely objective standard, in which the performance of a director in particular circumstances falls to be assessed by reference to the standards of an abstract "reasonable director" - itself a concept which it is not entirely easy to pin down, especially outside the context of large listed companies with professional directors.

### *D The Delaware approach*

The law of Delaware, and many other states of the USA, addresses this issue by reference to the "business judgment rule", summarised in one text as follows: [44]

> A decision by a board of directors (i) in which the directors possess no direct or indirect personal interest, (ii) which is made (a) with reasonable awareness of all reasonably available material information, and (b) after prudent consideration of the alternatives, and (iii) which is in good faith furtherance of a rational corporate purpose, will not be interfered with by the courts, either prospectively by injunction, or retrospectively by imposition of liability for damages upon the directors, even if the decision appears to have been unwise or have caused loss to the corporation or its stockholders.

Rather than placing directorial decisions beyond judicial scrutiny, the business judgment rule is in reality a black-letter formulation of the factual and legal issues to be reviewed in determining whether judicial interference with a directorial decision is warranted. Only after the court has concluded - depending upon the circumstances, from either a failure of a challenger to prove otherwise or an affirmative showing by the directors of appropriate disinterest and care - that all the prerequisites for judicial non-interference have been met does the inquiry terminate. On the other hand, if evidence discloses that one or more of the elements underlying application of the business judgment rule is missing - viz, there has been self-dealing, failure to exercise the requisite degree of

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44 Drexler, Black & Sparks *Delaware Corporation Law and Practice* (Matthew Bender, 1995) 15.03.

care, or an irrationality of purpose - other judicial rules come into play to determine whether and to what extent the court will employ its injunctive powers or impose personal liability upon the directors."

The "requisite degree of care" referred to is described in most recent Delaware court decisions as requiring directors to act without "gross negligence". But the difference between gross negligence and simple negligence is not clear, and in the view of many commentators has been eroded by recent decisions.[45]

### *E The position in Argentina*

The objective approach to director liability in Argentina, as described by Professor Castro Viera, is one of the strictest I am aware of.[46] I am not surprised by his observation that able individuals may be reluctant to accept appointment as external directors under such a regime, where an individual director may be liable for a board decision without any personal negligence, let alone the protection of a higher standard of fault.

### *F Directions for the future?*

There is nothing easier than re-evaluation of a risk with the benefit of hindsight. If director decisions are to be reviewable on objective grounds, it seems to me that there is a real risk that directors will be more risk averse than it is in the interests of investors, or the economy, for them to be. It is always safer not to make a speculative investment than it is to make it. The many executives who turned down the opportunity to acquire the right to manufacture plain paper copiers were not by any standard negligent. But the decision cost the companies' investors a fortune. If a board elected by shareholders believes in good faith that a project is viable, it seems to me that the risk should be taken without fear of a subsequent expensive second-guessing exercise on the part of risk-averse professionals and judges who can examine the decision at leisure over a period much longer than that which was available to the board to make it.

My own thinking on this difficult point is still evolving. But I am very nervous indeed about the extent to which the current New Zealand legislation imposes an objective standard on directors. I believe it is more likely to cause systematic risk aversion and underperformance in New Zealand business than to protect investors. And even if it does protect investors, it may be protecting them from the very thing for which they invest in equities. A prudent and diversified investor neither wants nor needs protection from risk

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45 Such as *Smith v Van Gorkom* 488 A 2d (1985), *Cede & Co v Technicolor Inc* 634 A 2d 345 (1993).

46 Castro Viera, above n 29. Note however the strict liability of directors for company defaults in Japan, as described in M Tatsuta "Risks of Being an Ostensible Director" 8 J Comparative Business and Capital Market Law 445 (1986).

in individual ventures. A standard of recklessness, perhaps coupled with "gross negligence" (though I am not sure I know what that means, either) seems more appropriate.[47] I should emphasise, however, that I would be much less troubled about the precise standard of care adopted in a jurisdiction which allowed the corporate constitution to limit or modify director liability, as discussed above.

It will be interesting to see whether there is significant convergence towards any one standard for assessing the level of care expected of directors. My suspicion is that this is unlikely, since allowing director liability to be limited in the corporate constitution - a trend that is likely to spread - enables each corporation to set the standard it requires, reducing the importance of the "default" provision.

### *G Fundamental changes to corporate structure or corporate activities*

The thesis that convergence is driven primarily by a focus on economic efficiency suggests that there might be a trend in modern corporations statutes to increase the power of the majority to determine the use to which the corporation's funds will be put, while conferring on minorities opposed to a fundamental change an appraisal remedy or "buy-out right". The ability of a minority to prevent majority-approved transactions would be reduced, as would the need for judicial or bureaucratic approval of such matters.

It is difficult to see why a majority should ever be prevented from using its investment in the manner it thinks fit, provided change is decided on consistently with the corporate contract. Shareholders are investors in a business. In large corporations, the directors decide how the business is to be run. Major transactions, however, are normally decided on by shareholder vote. In smaller corporations, the shareholders usually are the directors, and they decide all matters. If the relevant controllers - the board appointed by shareholders, or the majority - are dissatisfied with the way a business is run, or wish to redeploy the assets of the enterprise in a new project, it is difficult to see how it can be efficient to restrain them from doing so.

If majority investors run the risk of being prevented from reorganising a business:

- existing shareholders are less likely to spend time and money exploring methods of improving the company's performance, where minority shareholders may not support the change or may demand a disproportionate payment as the price of their support;

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47 This is the standard applied by the Delaware courts, as discussed above. It is also the standard applied by the English courts, and in New Zealand (in a somewhat diluted form) prior to enactment of the 1993 legislation.

- new investors who believe a company's assets are underutilised are less likely to enter the market for control of that company, to the detriment of would-be sellers and at the cost of reduced incentives for all managers.

These problems are aggravated if there is also a risk that the majority will be unable to sell because the market is insufficiently liquid: this is a common difficulty in the case of closely held and mid-sized corporations. The cost of funds for corporations generally is likely to increase as a result of such risks.

On the other hand, if a change in company direction is so great that it cannot fairly be said to have been within the contemplation of the minority investors at the time they bought into the company, they should not be forced to accept the change in rules part way through the game.

It follows that injunctive relief is unlikely to be appropriate to prevent majority-approved action. Nor would damages be an appropriate remedy, since this would give the minority an incentive to wait to see how the majority's plans turned out, accept them if they went well, and sue for compensation otherwise. If a majority is to have the right incentives to use corporate assets in the most productive way possible, meaning by that the project with the highest net present value, the minority cannot be permitted to take a risk-free ride on the majority's coat-tails.

The appropriate remedy for the disaffected minority seems to be an immediate election to exit at a fair price which does not take into account the decision of the majority, for better or worse. Dissolution of the company would achieve a similar freedom for the majority to use its assets as it thinks fit, and cashing out for the minority, but at a much higher cost to all concerned. Dissolution seems to be a sensible remedy only if the company or the majority is not able to meet the cost of simply buying out the minority.

As well as meeting any "fair treatment" concerns in relation to minorities in circumstances of this kind, there are persuasive arguments that the appraisal remedy plays an important role ex ante in ensuring that control transactions increase value.[48]

The economic rationale for providing an appraisal or buy-out remedy is strong, and its spread has been significant. In 1968 the author of the International Encyclopaedia of Comparative Law noted (with approval) the existence of the remedy in Argentina, Italy and the US, and in some limited circumstances in England and Germany.[49] His comment that "it seems to be growing in influence" has proved accurate: these countries have since been joined by many others including Canada, New Zealand, other countries which have

48 Easterbrook and Fischel, above n 22, ch 6.

49 Above n 42, Vol XIII ch 6 paras 4, 106-111.

followed the Canadian model, Poland, and other East European countries. The trend seems likely to continue.

### *9 Final comments*

In this paper I have sought to identify elements of a trend I perceive towards a more facilitative model for core corporations law. Although details of corporations laws differ substantially from jurisdiction to jurisdiction, the direction of reform appears somewhat similar. This can be attributed to a number of factors, but principally to:

- a greater focus by those responsible for reform in this area on the common economic goals served by corporations law in all countries. An understanding of the economic purpose of corporations law sheds considerable light on some longstanding assumptions in this field;
- the influence of reforms in other countries, and restatements by scholars and law reform bodies. Much of this scholarship itself embodies a more rigorous and economically coherent approach to corporations law, reinforcing the first factor mentioned above.

The movement towards a facilitative model of corporations law is, as the second point illustrates, a self-reinforcing process which can be expected to become even more widespread and rapid in years to come.

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### *Vers une harmonisation possible des conceptions du droit des sociétés : Analyse des points de convergence.*

Dans un domaine du droit qui n'a que rarement fait l'objet de conventions internationales, et en postulant néanmoins l'existence effective d'une tendance à l'harmonisation des règles relatives aux droit des sociétés dans chaque droit national pour tenir compte des nouvelles donnes du commerce mondial, l'auteur s'attache à démontrer que l'explication du phénomène réside à la fois dans la prise en compte de la place maintenant dévolue à l'économie dans le droit des société d'une part, et dans la redefinition des fonctions conférées à ces règles d'autre part.

Si l'on ne considère que les seuls fondements actuel du droit des sociétés, deux caractéristiques fondamentales apparaissent: le fractionnement de la propriété du capital dans des actions ou parts sociales, et ensuite la limitation de la responsabilité des propriétaires du capital social de telle sorte que leurs capitaux ne sont que partiellement affectés. Sur ce dernier point, il est important de se rappeler que la notion de risque et sa prise en charge font partie intégrante des fondements du droit des sociétés, de telle sorte que toutes tentatives tendant à empêcher cette prise de risques ne seraient pas sans conséquences néfastes sur l'institution du droit des sociétés.

A défaut de véritable coopération internationale dans le domaine du droit des sociétés, on s'aperçoit cependant que depuis une dizaine d'années, quelques initiatives ont été prises à une échelle régionale. Bien entendu, le meilleur exemple, reste le rappel des dispositions du Traité de Rome ainsi que des diverses directives qui l'on suivies et qui toutes ensemble se réclament ouvertement d'une volonté d'harmonisation des règles régissant le droit des sociétés des pays membres de la CEE.

Deux autres exemples, méritent attention. Tout d'abord la réglementation du CARICOM relative au marché commun des pays de la zone caraïbe. Ensuite, et plus symptomatique des tendances actuelles dans ce domaine du droit, toute la législation nord américaine qui d'un état fédéral à l'autre tend maintenant à être uniforme, suivant en cela les règles préconisées par l'Etat du Delaware dont l'influence s'est faite ressentir sur l'ensemble des Etats Unis d'Amérique.

Par contraste, les pays du Commonwealth britannique échappent à cette logique. Ainsi bien que la New Zealand Law Commission ait relevé que des pans entiers de la législation des sociétés avaient des implications internationales (en matiere de faillite, ou encore d'investissements internationaux notamment), elle a cependant indiqué que cela ne voulait pas pour autant dire que le besoin d'harmonisation soit absolument nécessaire. Dès lors que les règles de fonctionnement des sociétés commerciales sont sans réelle influence sur les opérations commerciales qu'elles réalisent entre elles, le besoin d'une harmonisation au plan internationale ne se fait guère sentir.

Reste toutefois que des raisons objectives militent pour la prise en compte d'une harmonisation. Si l'exemple américain semble conforter cette analyse, il ne faut pas néanmoins en tirer de conséquences trop générales.

En effet l'absence de véritable compétition sur le plan international pour attirer l'immatriculation des sociétés commerciales dans un pays plutôt qu'un autre, limite singulièrement la portée de l'expérience américaine.

Une autre explication de l'harmonisation des différentes règles du droit des sociétés, tient à la prise en compte par le législateur des fonctions remplies par les sociétés commerciales dans l'économie d'un pays donné.

Ceci étant, plusieurs domaines particuliers du droit des sociétés peut être affecté par cette nécessaire harmonisation des règles sur le plan international. On citera notamment la formation du capital de la société, les règles actuelles dans les pays de Common Law ne sont pas aussi protectrices que l'apparence voudraient le laisser croire et un investisseur étranger pourrait être induit en erreur. Une harmonisation avec les législations plus protectrices aux investisseurs doit donc être envisagée. Les règles de distribution des dividendes, tout comme celles relatives aux organes dirigeants de la société et leur responsabilité doivent aussi faire l'objet d'une harmonisation internationale.

Le succès de toutes reformes d'ensemble entreprises dans ce domaine, repose sur la prise en considération deux facteurs fondamentaux:

Le premier d'entre eux est la prise de conscience par le législateur que les sociétés commerciales obéissent au delà des frontières à des objectifs communs. Il s'agira ici d'intégrer le concept de culture des entreprises multinationales dans le droit.

Le second facteur, relève plus de l'ouverture d'esprit nécessaire pour entreprendre de telles reformes. En effet ne devront pas être négligées les expériences similaires déjà entreprises dans d'autres pays, ainsi que les analyses critiques qui en sont faites par la doctrine.