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The Purpose of Corporate Law is to Protect Outsider's Right

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ABSTRACT: The statement that the purpose of corporate law is to protect outsiders' rights is not entirely accurate. Corporate law serves a broader range of purposes aimed at regulating the formation, operation, governance, and dissolution of corporations. While it does encompass protections for various stakeholders, including outsiders, such as investors, creditors, employees, and consumers, its objectives extend beyond just safeguarding their rights. Here are some key purposes of corporate law:

1. Facilitating Business Activity: Corporate law provides a legal framework for the establishment and operation of corporations, which are essential vehicles for economic activity, innovation, and wealth creation. By defining the rights, obligations, and procedures governing corporations, corporate law facilitates investment, entrepreneurship, and commerce.[1,2,3]
2. Protecting Stakeholder Interests: Corporate law aims to protect the interests of various stakeholders involved in corporate activities. This includes shareholders, who are typically the owners of the corporation and have rights such as voting, dividends, and access to information. Additionally, corporate law may protect the rights of creditors, employees, consumers, and the wider community affected by corporate actions.
3. Ensuring Accountability and Transparency: Corporate law promotes accountability and transparency in corporate governance by establishing rules for disclosure, reporting, and fiduciary duties of directors and officers. Shareholders and other stakeholders rely on this information to assess the performance, financial health, and ethical conduct of corporations.
4. Balancing Conflicting Interests: Corporate law seeks to balance the often conflicting interests of different stakeholders, including shareholders, management, employees, creditors, and the public. It establishes mechanisms for resolving disputes, mitigating agency conflicts, and aligning incentives to promote the long-term success and sustainability of corporations.
5. Minimizing Risk and Externalities: Corporate law may impose legal requirements and standards aimed at minimizing risks, protecting public health and safety, and mitigating negative externalities associated with corporate activities. This includes regulations related to environmental protection, workplace safety, consumer rights, and product liability.
6. Promoting Economic Efficiency and Competition: Corporate law plays a role in promoting economic efficiency and competition by fostering corporate governance practices that allocate resources effectively, encourage innovation, and prevent anti-competitive behavior such as monopolies and cartels.

While corporate law does include provisions to protect outsiders' rights, such as investors and creditors, its overarching goals extend to promoting responsible corporate behavior, fostering economic growth, and ensuring the overall welfare of society.

KEYWORDS: corporate, protect, law, outsider's , right, purpose

I. INTRODUCTION

Delaware corporate law requires corporate directors to manage firms for the benefit of shareholders, and not for any other constituency. Delaware jurists have been clear about this in their case law, and they are not coy about it in extra-judicial settings, such as speeches directed at law students and practicing members of the corporate bar. Nevertheless, the reader of leading corporate law scholarship is continually exposed to the scholarly assertion that the law is ambiguous or ambivalent on this point, or even that case law affirmatively empowers directors to pursue non-shareholder interests. It is shocking, and troubling, for corporate law scholarship to evince such confusion about the most important black letter matter in the field. While I am a critic of the "shareholder primacy norm" in corporate governance, I am nevertheless convinced that shareholder primacy is the law. In fact, the critical vantage and reformative program that I have pursued in other writing presupposes that shareholder primacy is currently the law.

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This Article is therefore dedicated both to providing doctrinal clarification on the law of corporate purpose and to vindicating a key presumption in a broader normative agenda

Corporate law scholars are divided on the fundamental question of what boards of directors are supposed to do with the corporations they command. It would be no shock to find disagreement on the normative question of what the law of corporate purpose should be. But corporate law scholars are at odds even on the positive question of what the law is on this most basic doctrinal issue. Many in the field take it as given that corporate boards are supposed to pursue profits for shareholders and that directors have neither the obligation nor the right to pursue other interests. This view seems also to be widely accepted in broader social and political discourse about corporate operations. Readers of corporate law scholarship, however, are continually confronted with the claim, made by some of the field's most accomplished academics, that the law allows directors to steer the corporate ship in service of non-shareholding stakeholders, including employees, consumers, and the public generally, even when shareholder interests are in tension with such pursuits. This is more than an important issue. It is the most important issue in corporate law, and one of the most important questions in contemporary social organization. Scholars, policymakers, and the public at large are all rightly concerned with the question of what corporate law does or might do. Effective deliberation on this issue must be informed by a clear expression of what the law presently requires. The confusion in the literature on corporate purpose is therefore not just embarrassing, it is disempowering. In this Article, I endeavor to clarify what the law of corporate purpose is in order to help advance conver- sations about what the law of corporate purpose ought to be. Scholars who are convinced that the law requires shareholder primacy in firm governance tend to also insist that such a governance norm is desirable.4 Scholars who claim that the law allows for a broader corporate agenda tend to argue that director attention to non-shareholder concerns is a good thing.5 My own view is that shareholder primacy is indeed the law, but I advocate reforms that would impose broader responsibilities on corporate boards. I have developed my normative view in a series of articles.[4,5,6] However, I am concerned that confusion in the academy's positive assessment of corporate law detracts from what might otherwise be a more direct and unified call for reform of the prevailing regime. This Article, therefore, both demonstrates that the black letter law of corporate governance is shareholder primacy and explains the missteps that I believe other scholars have made in interpreting that doctrine.7 I focus exclusively on Delaware law because Delaware dominates the corporate law landscape in the United States.8 The Article is organized as followed. Part II dives into statutory and case law and climbs out with a positive assessment that Delaware demands shareholder primacy in corporate governance. Part III looks beyond formal law and examines extra-juridical statements that Delaware jurists have made about their state's law. It shows that Delaware jurists have not been coy in expressing their view that Delaware law requires directors to advance shareholder interests and permits no other purpose in the boardroom. Part IV examines the academic confusion on this question. Part V concludes the Article with an examination of the normative stakes involved in settling this (I hope no longer) ongoing doctri- Not formed by nature or common law, corporations are creatures of statute. To find the purpose of Delaware corporations, therefore, it would seem appropriate to start with the statute. Unfortunately, the statute provides no crisp declaration on this point. The code states that "a corporation may be incorporated or organized under this article to conduct or promote any lawful business or purposes."9 The code commands that the articles of incorporation of every firm must "set forth . . . the nature of the business or purposes to be conducted or promoted."10 However, this requirement can be satisfied if the articles state "either alone or with other business purposes, that the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized."11 So while the code feints towards clarity by requiring a statement of purpose, it lands with obscurity by allowing the purpose to be stated generally as the intent to pursue "any lawful act." In fact, most business corporations use this "any lawful act" language in the purpose section of their articles of incorporation.12 Once a corporation is formed, the code requires that it be managed: "The business and affairs of every corporation organized under this article shall be managed by or under the direction of a board of directors."13 But how will the directors of corporations formed to undertake "any lawful act" know what they are supposed to do with the firms they must manage? In the absence of a specified beneficiary in the articles of incorporation, is there a default constituency on whose behalf the firm should be managed? Or are directors to undertake lawful acts in a random fashion, without intent to serve any particular interest? Or may they manage the firm with the purpose of serving beneficiaries of their own choosing? Indirectly, the Delaware code makes clear that by default directors owe fiduciary duties to the corporation and its stockholders.14 I say indirectly because the first and only mention of this obligation comes in a part of the statute specifying that corporations may, if they so desire, choose to excuse directors from liability for breaches of that obligation. It states: "the certificate of incorporation may also contain . . . a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty."15 This section also forbids limiting personal liability "for any breach of the director's duty of loyalty to the corporation or its stockholders"16 or "for acts or omissions not in good faith."17 This permissive exculpatory provision, and the limitation on it, indicates that by default directors owe fiduciary obligations of care, loyalty, and good faith to the corporation and its stockholders.18 This is the only language in the Delaware statute that addresses the fiduciary obligations of corporate directors. Of course, to say that a person owes fiduciary obligations to another person can only start a meaningful conversation; it cannot conclude it.

II. DISCUSSION

What is the common structure of the law of business corporations—or, as it would be put in some jurisdictions, company law—across different national jurisdictions? Although this question is rarely asked by corporate law scholars, it is critically important for the comparative investigation[7,8,9] of corporate law. Recent scholarship often emphasizes the divergence among European, American, and Japanese corporations in corporate governance, share ownership, capital markets, and business culture.1 But, notwithstanding the very real differences across jurisdictions along these dimensions, the underlying uniformity of the corporate form is at least as impressive. Business corporations have a fundamentally similar set of legal characteristics—and face a fundamentally similar set of legal problems—in all jurisdictions. Consider, in this regard, the basic legal characteristics of the business corporation. To anticipate our discussion below, there are five of these characteristics, most of which will be easily recognizable to anyone familiar with business affairs. They are: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. These characteristics respond—in ways we will explore—to the economic exigencies of the large modern business enterprise. Thus, corporate law everywhere must, of necessity, provide for them. To be sure, there are other forms of business enterprise that lack one or more of these characteristics. But the remarkable fact—and the fact that we wish to stress—is that, in market economies, almost all large-scale business firms adopt a legal form that possesses all five of the basic characteristics of the business corporation. Indeed, most small jointly-owned firms adopt this corporate form as well, although sometimes with deviations from one or more of the five basic characteristics to fit their special needs. It follows that a principal function of corporate law is to provide business enterprises with a legal form that possesses these five core attributes. By making this form widely available and user-friendly, corporate law enables entrepreneurs to transact easily through the medium of the corporate entity, and thus lowers the costs of conducting business. Of course, the number of provisions that the typical corporation statute2 devotes to defining the corporate form is likely to be only a small part of the statute as a whole. Nevertheless, these are the provisions that comprise the legal core of corporate law that is shared by every jurisdiction. In this Article, we briefly explore the contracting efficiencies (some familiar and some not) that accompany these five features of the corporate form, and that, we believe, have helped to propel the worldwide diffusion of the corporate form. As with corporate law itself, however, our principal focus in this book is not on establishing the corporate form per se. Rather, it is on a second, equally important function of corporate law: namely, reducing the ongoing costs of organizing business through the corporate form. Corporate law does this by facilitating coordination between participants in corporate enterprise, and by reducing the scope for valuereducing forms of opportunism among different constituencies. Indeed, much of corporate law can usefully be understood as responding to three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation's other constituencies, including creditors and employees. All three of these generic conflicts may usefully be characterized as what economists call 'agency problems.' Consequently, Article 2 examines these three agency problems, both in general and as they arise in the corporate context, and surveys the range of legal strategies that can be employed to ameliorate those problems. The reader might object that these agency conflicts are not uniquely 'corporate'. After all, any form of jointly-owned enterprise must expect conflicts among its owners, managers, and third-party contractors. We agree; insofar as the corporation is only one of several legal forms for the jointly-owned firm, it faces the same generic agency problems that confront all jointly-owned firms. Nevertheless, the characteristics of this particular form matter a great deal, since it is the form that is chosen by most large-scale enterprises—and, as a practical matter, the only form that firms with widely dispersed ownership can choose in many jurisdictions.3 Moreover, the unique features of this form determine the contours of its agency problems. To take an obvious example, the fact that shareholders enjoy limited liability—while, say, general partners in a partnership do not—has traditionally made creditor protection far more salient in corporate law than it is in partnership law. Similarly, the fact that corporate investors may trade their shares is the foundation of the anonymous trading stock market—an institution that has encouraged the separation of ownership from control, and so has sharpened the management-shareholder agency problem. In this book, we explore the role of corporate law in minimizing agency problems—and thus, making the corporate form practicable—in the most important categories of corporate actions and decisions. More particularly, Articles 3–9 address, respectively, seven categories of transactions and decisions that involve the corporation, its owners, its managers, and the other parties with whom it deals.[10,11,12] Most of these categories of firm activity are, again, generic, rather than uniquely corporate. For example, Articles 3 and 4 address governance mechanisms that operate over the firm's ordinary business decisions, whilst Article 5 turns to the checks that operate on the corporation's transactions with creditors. As before, however, although similar agency problems arise in similar contexts across all forms of jointly-owned enterprise, the response of corporate law turns in part on the unique legal features that characterize the corporate form. Taken together, the latter seven articles of our book cover nearly all of the important problems in corporate law. In each Article, we describe how the basic agency problems of the corporate form manifest themselves in the given category of corporate activity, and then explore the range of alternative legal responses that are available. We illustrate these alternative approaches with examples from the corporate law of various prominent jurisdictions. We explore the patterns of homogeneity and heterogeneity that appear. Where there are significant differences across jurisdictions, we seek to address both the sources and the consequences of those differences. Our examples are drawn principally from a handful of major representative jurisdictions, including France, Germany, Italy, Japan, the UK, and the U.S., though we also make reference to the laws of other jurisdictions to make special points.4 In emphasizing a strongly functional approach to the issues of comparative law, this book differs from some of the more traditional comparative law scholarship, both in the field of corporate law and elsewhere.5 We join an emerging tendency in comparative law scholarship by seeking to give a highly integrated view of the role and structure of corporate law that provides a clear framework within which to organize an understanding of individual systems, both alone and in comparison with each other.6 Moreover, while comparative law scholarship often has a tendency to emphasize differences between jurisdictions, our approach is to focus on similarities. Doing so, we believe, illuminates an underlying commonality of structure that transcends national boundaries. It also provides an important perspective on the potential basis for the international integration of corporate law that is likely to take place as economic activity continues to become more global in scope in the decades to come. We realize that the term 'functional', which we have used here and in our title, means different things to different people, and that some of the uses to which that term has been put in the past—particularly in the field of sociology—have made the term justifiably suspect. It would perhaps be more accurate to call our approach 'economic' rather than 'functional,' though the sometimes tendentious use of economic argumentation in legal literature to support particular (generally laissezfaire) policy positions, as well as the tendency in economic analysis to neglect nonpecuniary motivations or assume an unrealistic degree of rationality in human action, have also caused many scholars—particularly outside of the United States—to be as wary of 'economic analysis' as they are of 'functional analysis.' For the purposes at hand, however, we need not commit ourselves on fine points of social science methodology. We need simply note that the exigencies of commercial activity and organization present practical problems that have a rough similarity in developed market economies throughout the world. Our analysis is 'functional' in the sense that we organize discussion around the ways in which corporate laws respond to these problems, and the various forces that have led different jurisdictions to choose roughly similar—though by no means always the same—solutions to them. That is not to say that our objective here is just to explore the commonality of corporate law across jurisdictions. Of equal importance, we wish to offer a common language and a general analytic framework with which to understand the purposes that can potentially be served by corporate law, and with which to compare and evaluate the efficacy of different legal regimes in serving those purposes.7 Indeed, it is our hope that the analysis offered in this book will be of use not only to students[13,14,15] of comparative law, but also to those who simply wish to have a more solid framework within which to view their own country's corporation law. Likewise, we take no strong stand here in the current debate on the extent to which corporate law is or should be 'converging,' much less on what it might converge to.8 That is a subject on which reasonable minds can differ. Indeed, it is a subject on which the reasonable minds that have written this book sometimes differ.9 Rather, we are seeking to set out a conceptual framework and a factual basis with which that and other important issues facing corporate law can be fruitfully explored.

III. RESULTS

The legal fiction of the separate legal entity principles enables companies to be bound by contracts entered into with outside parties. However, for the company to be bound by the contract, several "internal" transactions must have occurred. These internal transactions are not necessarily observable to the outside party. First, as a result of registration of the company, the company has been granted contractual capacity, but the scope and limitations on its powers need to be identified. Second, the company will have appointed officers and agents to act on its behalf, but the scope of their authority must be identified. Third, regardless of the scope of authority expressly granted, the general law imposes inherent restrictions on the exercise of authority by corporate agents, for example, they must exercise the company's powers according to the fiduciary constraint to act in the best interests of the company. If the scope of these internal transactions is exceeded or otherwise abused by corporate officers, it has consequences for the contracts entered into with outsiders. To minimise the risk of unenforceability for the outsider, the general law, followed by statutory codification, developed some principles to assist the outsider in enforcing contracts. Sections 128–129 of the Corporations Act1 purport to comprise a statutory adoption of the common law rule known as the Rule in Turquand's case2 or the "indoor management rule." This rule formed the common law basis of the application of agency principles to companies. Its essence was to allow outsiders dealing with a company to assume that the internal proceedings of a company were properly carried out. The Rule in Turquand's case has traditionally struck a balance where officers of a company act without authority. It protects outsiders and enables them to enforce contracts against a company. At the same time the rule was subject to several exceptions that limited its protection to outsiders who act bona fide. In recent

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times this issue of corporate authority has most often arisen in the context of financial transactions where a company has contested the validity of a document executed under the seal of the company. From the point of view of lenders such as banks, the most important issue that has arisen is the scope of exceptions, that is, whether the lender was put on inquiry by the circumstances surrounding the formal execution of the contract. Since 1983, the rule has been codified and set out in the Corporations Act in the form of assumptions representing the various aspects of the rule and limitations that correspond to the exceptions to the rule. These limitations are now contained in s 128(4) of the Corporations Act. Whilst there have been three iterations of the statutory indoor management rule since 1983,[16,17,18] there remains uncertainty as to the scope of protection afforded to outsiders dealing with companies. In particular, the statutory limitations to some 1 See Appendix I, where the current and former provisions in the Corporations Act are reproduced. 2 Royal British Bank v Turquand (1856) 119 ER 886. extent differ from the common law exceptions, especially as the Corporations Act does not explicitly provide for an inquiry exception. However, case law demonstrates that judges may be prepared to interpret the limitations in s 128(4) consistently with the policy behind the common law rules. The most recent statutory reform to corporate contracts and authority of agents occurred with the Company Law Review Act 1998. Operational since 1 July 1998, the Company Law Review Act 1998 inserted new provisions relevant to corporate contracts and agents, dealing with: 1. the role of the corporate constitution and simplification of corporate powers and ultra vires;3 2. the procedures for companies entering into external contracts; and 3. the scope of protection conferred to third parties entering into these contracts.4 It is timely to re-examine the statutory rules for corporate contracts. The reforms superficially appear to be a mere simplification of the prior statutory regime, which itself was subject to some uncertainty in application. This monograph describes the common law rules surrounding the principles of agency law in their application to companies. Central to the common law position is the doctrine of constructive notice and the Rule in Turquand's case and its exceptions. One of the features of agency law in its application to companies was that an outsider dealing with a company was taken to have constructive notice of the company's public documents. In this context, the most important of these documents was the company's constitution, in particular where it contained a restriction on the authority of the company's officers or agents. This doctrine of constructive notice operated in favour of the company and against the outsider by deeming that the outsider was aware of the restriction of authority. Therefore the company as principal was not liable under a contract entered into by an officer or agent who exceeded the authority conferred by the constitution. The Rule in Turquand's case recognised that in some cases, an agent may act without authority, however this would not be apparent to an outsider even after reading the constitution. The rule protected the outsider and operated against the company unless certain exceptions arose which resulted in the loss of this protection. Of course, agents exercise authority within the context of the company as a separate legal entity, with its own contractual capacity. All companies' capacity to enter into contracts has been affected by developments in the doctrine of ultra vires. "Ultra vires" means "beyond power" and when used in company law, refers to corporate capacity, where transactions outside the formal objects and powers stated in a company's constitution were previously void. The corporate debt or finance contract provides a compelling application of the rules of agency and the interaction with the statutory rule. This is due primarily to the prevalence of litigation. Litigation over the last decade shows that lenders, as outsiders, are involved in disputes with companies in enforcing corporate borrowing or securities trans2 Corporate Authority and Dealings With Officers and Agents 3 The Company Law Review Act 1998 inserted new Article 2A – Registering a company, and new Part 2B.1 – Company powers and how they are exercised. 4 The Company Law Review Act 1998 inserted new Part 2B.2 – Assumptions people dealing with companies are entitled to make. actions. The magnitude of such contracts, the degree of formality that surrounds their formation and the degree of scrutiny that lenders are subjected to in relation to borrowers and security providers indicate a need for practical guidelines to maximise enforceability of these types of corporate contracts. Within this framework, the principles of agency law with respect to implied actual authority and apparent authority are applicable to contracts with companies because an agency relationship arises as a result of the appointment of an officer or a holding out that such an appointment has been made. Accordingly, we commence this monograph by reviewing, in article 2, the general principles of agency as they apply to corporate contracts. Following the analysis of the Rule in Turquand's case and its exceptions and limitations contained in articles 3 and 4, article 5 discusses the history and background of statutory reform to the indoor management rule, and related doctrines, such as constructive notice and ultra vires. Article 6 analyses in detail the statutory assumptions in s 129. In a number of respects, these assumptions incorporate the common law agency principles. The primary focus is considering whether the statutory indoor management rule achieves its stated purpose of clarifying and codifying the Rule in Turquand's case. The purpose of the legislation was stated as being to "ensure that a person who deals in good faith with persons who can be reasonably supposed to have the authority of the company should be protected against later [claims] by the company that the persons purporting to act for it lacked authority".5 Whilst article 7 briefly digresses to examine the common law rule against forgeries and the extent to which the Corporations Act now abrogates it, article 8 discusses the scope the limitations to the statutory rule contained in s 128(4). It is suggested that the current statutory limitations do not substantially depart from their common law derivation. As borrowing and security contracts indicate a particular instance of vulnerability, article 9 sets out a number of practical implications for lenders arising from the analysis of both the common law and statutory provisions relating to corporate authority. Finally, article 10 offers our summary and overall conclusions, detailing the scope of legislative reform and suggesting future reforms to the statutory rule and its limitations to reflect the policy of the Rule in Turquand's case with greater clarity than at present

IV. CONCLUSION

At the most basic level a corporate governance problem arises whenever an outside investor wishes to exercise control differently from the manager in charge of the firm. Dispersed ownership magnifies the problem by giving rise to conflicts of interest between the various corporate claimholders and by creating a collective action problem among investors.1 Most research on corporate governance has been concerned with the resolution of this collective action problem. Five alternative mechanisms may mitigate it: (i) partial concentration of ownership and control in the hands of one or a few large investors, (ii) hostile takeovers and proxy voting contests, which concentrate ownership and/or voting power temporarily when needed, (iii) delegation and concentration of control in the board of directors, (iv) alignment of managerial interests with investors through executive compensation contracts, and (v) clearly defined fiduciary duties for CEOs together with class-action suits that either block corporate decisions that go against investors' interests, or seek compensation for past actions that have harmed their interests. In this survey we review the theoretical and empirical research on these five main mechanisms and discuss the main legal and regulatory institutions of corporate governance in different countries. [19]We discuss how different classes of investors and other constituencies can or ought to participate in corporate governance. We also review the comparative corporate governance literature.2 The favoured mechanism for resolving collective action problems among shareholders in most countries appears to be partial ownership and control concentration in the hands of large shareholders.3 Two important costs of this form of governance have been emphasised: (i) the potential collusion of large shareholders with management against smaller investors and, (ii) the reduced liquidity of secondary markets. In an attempt to boost stock market liquidity and limit the potential abuse of minority shareholders some countries' corporate law drastically curbs the power of large shareholders.4 These countries rely on the board of directors as the main mechanism for co-ordinating shareholder actions. But boards are widely perceived to be ineffective.5 Thus, while minority shareholders get better protection in these countries, managers may also have greater discretion[20]

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4. ^ e.g. South African Constitution Art.8, especially Art.(4)
5. ^ Phillip I. Blumberg, The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality, (1993) has a very good discussion of the controversial nature of additional rights being granted to corporations.
6. ^ e.g. Corporate Manslaughter and Corporate Homicide Act 2007
7. ^ In England the first joint stock company was the East India Company, which received its charter in 1600. The Dutch East India Company received its charter in 1602, but is generally recognized as the first company in the world to issue joint stock. Not coincidentally, the two companies were competitors.
8. ^ In England, see Edmunds v Brown Tillard (1668) 1 Lev 237 and Salmon v The Hamborough Co (1671) 1 Ch Cas 204
9. ^ Salomon v. Salomon & Co. [1897] AC 22.
10. ^ Although it did attach to documents within the husband's custody or control.
11. ^ Macaura v. Northern Assurance Co Ltd [1925] AC 619
12. ^ Adams v. Cape Industries plc [1990] Ch 433
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18. ^ Shalfoon v Cheddar Valley [1924] NZLR 561
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