PhD THESIS DECLARATION

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Thesis title:

Assessing Shareholders' Personal Qualities: *Intuitus Personae*, Implications For Corporate Governance and Policies

PhD in	Law of Business and Commerce
Cycle	26
Candidate's tutor	Prof. Lynn Stout
Year of thesis defence	2015

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ABSTRACT

My research analyzes the theoretical effects on business organizations' governance mechanics produced by the shift from an organizational model based on the personal qualities of the equity members and their retention of control rights to business legal entities featuring delegated management and freely transferable shares. This shift results in an inability to control the personal qualities of investors in public corporations. Further complications develop when these investors are able to exercise governance power and participate actively in corporate affairs.

Extensive scholarship focuses on the opportunity to expand a shareholder's franchise. Yet, this literature fails to consider how the collapse of a shareholder's ability to assess personal qualities of equity co-ventures impacts corporate governance.

In this framework, my thesis fills a theoretical gap. It investigates the shortcomings inherent in combining the free transferability of shares with shareholders governance power. Indeed, my thesis discusses the implications of this combination on corporations and suggests policies to address the deficiencies within this governance system—a topic neglected by the literature.

Chapter One analyzes the organization of control rights in joint enterprises and provides a theoretical background to carry out the investigation.

Chapter Two describes the evolution of joint enterprise organizations in ancient Rome from the *societas consensus contracta*—structured around the fraternity between equity members—to the *societas publicanorum*, a business form featuring legal personality and structured to provide continuity and stability.

Chapter Three discusses the key traits of business corporate entities in both the ancient Roman *societas publicanorum* and in modern-day public corporations, noting how the free transferability of shares creates defective corporate governance mechanics whenever shareholders are able to determine corporate actions and decisions without a preliminary assessment of their personal qualities.

Lastly, Chapter Four offers policies to address the defective corporate governance caused by the absence of merit-selection among equity coventurers. Among the solutions addressed, this chapter poses two particularly novel policies: the application of heightened standards of review to corporate actions determined by unselected controllers, and the creation of a regulatory body to oversee shareholder voting.

ACKNOWLEDGEMENTS

Completing this program has been a long and, at times, overwhelming journey; there are many people to thank for their constant assistance and encouragement. I begin with my advisor, Professor Lynn Stout. Her constant presence instilled in me a sense of calm necessary to complete the program. Moreover, our insightful discussions always produced fresh ideas, which created new avenues for analysis throughout my thesis. I truly could not have done this without her. I am also indebted to my second advisor, Professor Federico Ghezzi, who has supported me on this journey from the very beginning.

I owe a great deal to the Bocconi University community, especially to my professors and PhD fellows, for providing a nurturing environment.

I would particularly like to thank the members of the Cornell Law School community for providing me with critical information about the framework of American corporate law, editing suggestions, comments, and insight. I especially wish to thank Professor Saule Omorova and Law Students Sasha Belinkie, Joseph Bruno, Samuel Dahan, Mateo de la Torre, Michael DeNiro, Diogo Magalhaes, Philip Mercadante, Nicholas Nahum, Damien Rose, and Kathryn-Ann Stamm.

Of course, I must also thank my mother for her never-ending support not just in this process, but throughout all of my academic ventures.

Adi Gal deserves thanks for her lovely ability to distract me from writing.

Lastly, I wish to thank Cariplo for providing the grant to pursue my investigation in the United States.

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PHAEDRUS' WARNING AGAINST PARTNERING WITH A LION

In his renowned *fabula* "The Cow, the Goat, the Sheep, and the Lion," Phaedrus cautions that a venture with a heavy-handed partner is never fruitful: "A cow, a goat and a patient sheep were partners with a lion in the forest. Joining together and having taken a large stag, they divided it into parts and over such shares, the lion spoke to them, 'I take the first portion because I am named the lion and addressed as king; the second portion, you will assign to me, since I am your partner; then, because I am stronger, the third will follow to me; and an accident will result, if anyone touches the fourth.' Thereby the ruthless lion carried off the whole prey for himself."[1]

The fable illustrates the problem with joint ventures: when you are partnered with a lion, you may not get much food.[2] Likewise, in business organizations, associating with a fool or knave co-venturer is never beneficial and is often potentially harmful to both fellow-venturers and to the enterprise itself.

In other words, the moral of the fable emphasizes the relevance of careful selection of coventurers based on their personal qualities or, put differently, on the role of *intuitus personae* in the formation of group ventures.

In short, *intuitus personae* is the consideration of personal qualities or "the conception of personal characteristics of a partnership, arising from the fact that a partnership arises from choice of associates."[3]

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[1] "Numquam est fidelis cum potente societas. Testatur haec fabella propositum meum. Vacca et capella et patiens ovis iniuriae socii fuere cum leone in saltibus. Hi cum cepissent cervum vasti corporis, sic est locutus, partibus factis, leo: 'Ego primam tollo nomine hoc quia rex cluo; secundam, quia sum consors, tribuetis mihi; tum, quia plus valeo, me sequetur tertia; malo adficietur, si quis quartam tetigerit.' Sic totam praedam sola improbitas abstulit." Phaedrus, *The Cow, the Goat, the Sheep, and the Lion*, *in* BABRIUS AND PHAEDRUS (Ben Edwin Perry transl, 1965).

[2] In Phaedrus' example, the relationship has a horizontal and supposedly egalitarian geometry, although the lion exercises *de-facto* control: the four animals selected each other to carry out a common venture, contributed their inputs (invested their different skills and committed their time) in the common venture, and expected to joint management over the output. The most overbearing equity member, however, was able to take all of the spoils and entirely exploit the investments that the other animals committed to the venture (and that were specifically tied to that venture), leaving no outputs (nor inputs, which the partnership expended in pursuit of the outputs).

[3] Joseph Taubman, *What Constitutes a Joint Venture?*, 41 CORNELL L. REV. 640, 646 (1956). For a broader description of conception of *intuitus personae*, see generally ALFREDO GALASSO, LA RILEVANZA DELLA PERSONA NEI

Thus, in partnerships, the *intuitus personae* among the partners frames the provisions concerning the formation, the termination, and the transferability of shares *inter vivos* and *mortis causa*, as well as the governance of the association.[4] In short, the law of partnership solves the problem of quality-based selection of coventurers[5].

In contrast, shareholders in public corporations cannot select each other, nor do they entrust qualitative assessment to another body.[6] Thus, no barrier against, or disincentives for, a leonine shareholder is provided to protect other investors and the enterprise.

On this ground, this work is about assessing shareholders' personal qualities in public corporations. It investigates the effects that the lack of *intuitus personae* has on corporations and suggests policies to address the defective corporate governance mechanics it causes—a topic neglected by the literature.

RAPPORTI PRIVATE (1974). *See also* Cass., 20 marzo 1930, FORO IT., 1930, I, 562 (It.); Cass., 27 aprile 1936, FORO IT., 1936, I, 992 (It.); App. Milano, 28 febbraio 1933, in RIV. DIR. COMM., 1933, II, 363 (It.); *and* Angelo Sraffa & Pietro Bonfante, *Società in nome collettivo tra società anonime?*, 1 RIVISTA DEL DIRITTO COMMERCIALE 607 (1921). See *infra* Chapter 1, Part IAxiii.

[4] See Revised Uniform Partnership Act §§ 503, 601, 602, 801. From a different standpoint: "'Choose your partner' has as much significance here as in a square dance. Indeed, it has more. Its corollary in a partnership follows logically. Freedom of choice imports freedom to dissolve the relationship. Damages may result from such a breach, but the decision to end the relationship remains effective." Taubman, *supra* note 3 at 646.

[5] Consider the case of Jane and Joe, who decide to form a partnership. They have known each other since they were children, attended the same high school, and want to develop an entrepreneurial idea they had while Joe was a computer science PhD student and Jane was a geography PhD student. Since the age of fifteen, Jane and Joe have shared their personal, scholastic, and professional issues with each other. Jane is the first person Joe would call when facing an important decision in her life, and vice versa. A bond of quasi-fraternity, as well as genuine professional esteem, ties the two together. They are glad to make decisions concerning the partnership they formed and the business they run jointly.

[6] Now consider the case of Anna and Bill, who are shareholders in a public corporation. Anna lives in Melbourne and Bill lives in Chicago. They have never met, nor do they know of one another's existence. Anna is very active in campaigning for environmental awareness and the rights of minorities and has strong convictions about the economic sustainability of enterprises. Bill is living the American Dream, having risen from rags to riches, and is an investment banker. If they met, Anna and Bill would probably find no common ground on which to converse meaningfully, or even chitchat. Jane and Joe, and Anna and Bill, are all equity holders in business organizations, although the relevance of their qualities played a different role in determining their decisions to become equity members of the two types of business forms. Is it reasonable to state that Anna would be pleased if decisions concerning the corporation she has invested in were made by Bill (and vice versa)?

CHAPTER 1. CONTEXT, SCOPE AND CAVEATS

Introduction

This whole work is developed around two pivotal ideas.

First: assessing personal qualities of coventurers is probably the oldest and still most effective policy to provide both soundness and dynamism to collective ventures—relations intrinsically based on incomplete terms and vulnerable contributors, primarily due to the *ex-post* distribution of the undertaking's benefits and costs.

Second: the legal personality is probably the most relevant invention in organizational law, without which both public law and private law could not have provided government and business institutions with groundbreaking features (in particular, asset and liability partitioning), which have permitted the evolution of the economies and of governmental systems.

The joinder between collective business ventures carrying out activities in the interest of the Roman state and the "*corpus habere*" technology (developed within Ancient Roman governmental law to provide municipalities with the ability to own property) gave birth to business legal entities (of which the first type is arguably the Ancient Rome *societas publicanorum*).

The purest forms of business legal entity are public corporations. They feature the most structured organization of legal entities' attributes: perfect asset partitioning, (and thus) continuity and transferability of the interest in the business without subtraction of the assets to carry out the enterprise as well as delegated (and hierarchical) management with power to act vis-à-vis third parties on behalf of the organization.

When the business is organized as a public (listed) corporation, however, the intrinsic free transferability of shares entails the loss of *intuitus personae* among the equity-coventurers: shareholders do not select one another. Such a characteristic is usually justified with shareholders' relinquishment of control rights over the firm and appointment of delegated management. In other words, in public corporations, the control over the firm is centralized in the hands of the management according to hierarchical structure ultimately based on shareholders' selection of the members of the board of directors and corporations' appointment of the latter to control the firm. Thus, the appointment of those entrusted with the control over the enterprise still takes place through selective mechanics, on one hand, and shareholders can transfer and trade their interest in the business organization leaving untouched the collective and individual characteristics of the controllers, on the other hand. Such a structure is ultimately possible because of the ability of corporations to own property and of shareholders' relinquishment of control rights over the contributed assets, which permit the insulation of the corporate enterprise from fate and will of the shareholders.

In actuality, though, in partial exception to grand design of the corporate governance model based on centralized management and transferability of shares, shareholders are granted with governance franchise and, above all, when they gain an influential position, they can *de-facto* return in control of the firm, leading the management towards their (conflicted or not) personal preferences.

In this scenario, the governance mechanics of public corporations seem defective in assessing (influential) shareholders qualities.

This chapter defines the scope of, and provides a theoretical framework for, this investigation.

A. Organizational Models of Control Rights over Collective Firms

i. Organizational Features of Sole Proprietorships

Sole proprietorships are shaped around retained control rights on business assets and decision-making powers, as well as hired inputs (capital, employees, know-how, etc.).

A sole proprietor makes business decisions concerning her firm, deals with third parties on behalf of the concern, and has the power to manage and (within the limits of bankruptcy law) even dispose of the assets composing the firm. She enjoys free rein over decision-making and, when she needs advice in dealing with specific aspects of her business or help in running the enterprise, she can hire professional advisors and managers.

Sole proprietorships, however, have limits in their capacity to amass capital[7] (i.e. the amount of money that can be raised, equal to the assets of the sole proprietor plus her borrowing capability) in order to afford hired inputs, and in the ability to bond the contracts of the firm credibly (due to the lack of assurance that the capital can be committed beyond the lifetime or attention span of the individual proprietor).[8]

In addition, given the limitations in pooling capital, sole proprietorships have the tendency to structure their productivity on a purely contractual basis, rather than through integration via purchasing factors of production. As remarked by Macneil,[9] however, sometimes the duration, complexity, and uncertainty of productivity relationships require an ongoing administrative authority in order to adjust to all possible contingencies that may arise, as well as to allocate fairly the profit stream. Thus, integration provides a better structure to manage these relations. Moreover,

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[7] *See* WILLIAM A. KLEIN, JOHN C. COFFEE JR., & FRANK PARTNOY, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 7 (11th ed. 2010).

[8] *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 387–440 (2000).

[9] *See* Ian R. Macneil, *Contracts: Adjustments of Long-term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 885 (1978).

where human and physical assets become more specialized to a given productive use (and thus less transferable to other uses), the integration of relations for production within a firm may provide a more suitable pattern to "work things out"[10] in myriad eventualities, as well as more protection of those relation-specific investments. Thus, these factors constrain the size, longevity, and efficiency of firms formed as sole proprietorships.

ii. Organizational Features Characterizing Collective Business Associations

In contrast to sole proprietorships, in all types of collective business organizations, equity members[11] come together to undertake a common goal that requires everyone to make some form of investment in the firm and (to differing degrees according to the type of business form) relinquish their control rights over the (tangible or intangible) assets they contribute.[12] One individual might bring critical technical skills to the table, another managerial talent, and a third money.

When undertaking a joint business, each of the equity members agrees to share the risk of the enterprise, which may or may not (depending on whether the business type provides limited liability for equity holders) be limited to the contribution she made to the firm and over which she has (at least partially) given up her control rights.

Due to the characteristics of their investments (capital at risk) and to the relationship between them, these individuals are called "equity holders", and for the specific purpose of this work "equity members," "equity investors," or "*socii*." Thus, this work uses the terms equity holders, equity members, equity investors, and *socius* rather loosely to refer to all of the parties who

[10] *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 79 (1985).

[11] In short, the equity of someone in a business is the difference between the value of the business and the amount of debt. For a more detailed analysis of the concept of equity, see KLEIN, COFFEE, & PARTNOY, *supra* note 7, at 7.

[12] *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 266 (1999).

enter into an associative business organization holding an equity position (e.g., *socii* in *societates consensu contractae*, *socii* in *societates publicanorum*, partners in a general partnership, shareholders of a business corporation, as well as limited and general partners in a limited partnership, or equivalent parties in foreign business associations).[13]

Thus, equity holders, as distinguished from sole proprietors, to varying degrees, give up control rights over the assets they contribute, over activities carried out through the combined application of those inputs (synergy among the inputs creates additional value beyond that of the stand-alone contributions, but also requires commitment of the contribution to the firm), and over the outputs of the business (which might be reinvested in the enterprise, distributed to the equity holders, or invest alternatively).

Considering that relinquishing control rights puts equity holders in a position of vulnerability—at least to the extent of their contribution—the reorganization and allocation of control rights should take place in a way that minimizes the possibility of exploitation on the one hand, and that allows for effective management of the firm on the other. A quick detour into contract theory is instrumental to better explain this statement.

iii. A Detour into Contract Theory to Explain the Origin of Business Organization Governance Mechanics

When two parties commit assets for a joint productive activity, in theory, they can contractually specify exactly who will control each dimension of each asset in each particular future contingency. In practice, as Williamson and others have remarked, it is too costly, inopportune, inefficient, and sometimes even infeasible to write detailed, long-term contracts, which determine

[13] It is worth noting that under Italian business organization law, the term "socio" indicates the holder of an equity position in any type of business organization, from the società in nome colettivo (the equivalent of a general partnership) to the società per azioni (the equivalent of a corporation).

ex-ante all of the potential issues which may arise over the course of a long-term business relationship.[14]

When the assets under consideration are not isolated or in a static bundle, but rather are dynamic sets of assets and contracts that from time to time compose a firm, the aforementioned difficulties in writing complete contracts become practically impossible to overcome. It might be too costly, if not impossible, to specify a long list of the particular rights over assets under the contract, which are called "specified" control rights.

According to an analysis carried out by Grossman and Hart,[15] as well as the foundations laid by Coase,[16] Williamson,[17] and Klein, Crawford, and Alchian,[18] in a situation in which writing or enforcing complete contracts is practically impossible, the organization and allocation of non-specified control rights, called "residual" control rights, over the assets composing the firm play a determinant role in the way the relationship functions.

Governance of the business relationship is, thus, the organization of residual control rights, which ultimately facilitate the firm's adaptation to unforeseen contingencies.

Grossman and Hart suggest that when it is economically inefficient to specify all of the potential control rights over the assets, it may be optimal to settle the relation via the purchase of all residual control rights by one of the parties. Put another way, instead of organizing their business relationship on a contractual basis in which they know in advance that events will occur and they will have to either (i) revise the contract, (ii) interpret the contract in such a way that the terms may

[14] "A result of this incompleteness is that events will occur which make it desirable for the parties to act differently from the way specified in the contract. As a consequence the parties will want to revise the contract. In addition the parties may sometimes disagree about what the contract really means; disputes may occur and third parties may be brought in to resolve them." Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 138 (Oliver E. Williamson & Sidney G. Winter eds., 1993).

[15] *See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 716 (1986).

[16] *See generally* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

[17] *See* Williamson, *supra* note 10, at 79.

[18] *See generally* Benjamin Klein, Robert G. Crawford, & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

be extended to cover the issue in question, or (iii) put the question to a third party to resolve, the parties instead reallocate all the residual control rights via transfer between the contracting parties.

On this ground, Grossman and Hart concluded that the incompleteness of contracts gives rise to a theory of ownership. To that end, these authors call "ownership" the result of the purchase of all the residual control rights.[19] With this purpose, they rely on the legal definition of "ownership" they solicited from Richard Posner, who in turn referred to Oliver Wendell Holmes' statement, that "within the limits prescribed by policy, the owner is allowed to exercise his natural powers over the subject-matter uninterfered with, and is more or less protected in excluding other people from such interference. The owner is allowed to exclude, and is accountable to no one but him."[20]

Going even further, Grossman and Hart put forth the concept of overlap of ownership and control, and assert that ownership can essentially be defined as the power to exercise control. This seems acceptable, but only to the extent that the relation considered has a purely contractual (and not organizational) basis and that one party purchases the residual control rights. Two further considerations remain. Holmes' definition of ownership[21] does not explicitly consider the owner's power to dispose of the owned asset. Secondly, Grossman and Hart's outline does not describe the process and results of the reorganization of the residual control rights in the case of integration of business relations within collective business forms.[22]

From equity holders' perspective in the business organization context, the concept of ownership gives way to the concept of governance.

[19] Asset ownership is a key power source in bargaining during renegotiations where the contract is initially left incomplete. While the asset owner may bind the asset through contract, the residual control rights characterizing ownership give the owner a stronger *ex post* position where terms are left unspecified.

[20] *See* Grossman & Hart, *supra* note 15, at 694.

[21] *Id.*

[22] According to Hart and Moore, rather, "the key right provided by ownership is the ability to exclude people from the use of assets." Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1150 (1990).

iv. Integration of Initially Contracting Parties within a Firm and Development of Governance

Grossman and Hart advocate for the integration of initially contracting parties to more efficiently organize inputs and to produce more effective outcomes when it would be "extremely costly to write a contract that specifies unambiguously the payments and actions of all parties in every observable state of nature."[23] The organization of such a relationship within a firm would provide a set of benefits. Integration is the organizational answer when parties must make specific investments because of the impossibility of writing detailed long-term contracts to appropriately divide in advance the quasi-renting from these investments.

For the sake of clarity, at this stage of the conceptual path, it seems proper to specify that a firm is an economic *quid*, but not a legal entity. In other words, as mentioned above, assets and contracts organized to carry out the enterprise compose the firm, but the firm cannot own assets or enter into contracts.

A firm can be organized as a sole proprietorship or as a collective association.

In the first case, if the sole proprietor decides to take over the residual control rights, she can purchase them and ultimately exercise them according to the Grossman and Hart integration framework.

In contrast, when a firm is a collective business association, an equity holder can only exercise equity ownership rights over the assets and contracts integrated into the firm via contribution, purchase, or production that the governance of that specific organization provides them.

The various patterns in which those control rights are reorganized and allocated frame the particular governance mechanisms that characterize distinctive types of business organizations.

[23] Grossman & Hart, *supra* note 15, at 695.

Borrowing the well-known words of Lavoisier, residual control rights that are reorganized according to the governance patterns of different business organizations are not created; rather, they are the results of the transformation of control rights that equity holders (and other stakeholders) relinquish over the assets they contribute, which ultimately compose the collective firm together with the assets that the firm purchases or produces.[24]

Following from this, the concept of ownership of firms organized as business associations must be revisited. Although a thorough analysis and definition of the concept of ownership is not within the scope of this work, a general set of observations should be sufficient.

v. Equity Holders' Rights over the Firm

First, the perfect overlap between the use of ownership and control that Grossman and Hart suggest, with reference to the purchase of residual control rights by one party, cannot be applied as is to residual control rights in collective business organizations.

Using a simple logical argument, it seems possible to say that the control rights that equity holders of different types of business organizations exercise over the firm as "owners" are only those that they did not relinquish when contributing their assets to the business organization (according to its specific regulations and policies). We refer to this form of ownership rights as "direct control," i.e., unrelinquished rights over the assets composing the collective firm. Thus, the ownership rights held by the business organization itself limits the equity holder's direct control over the firm.

The degree of the business organization's ownership over the assets composing firm and that of the equity holders' direct control falls along a spectrum. On one end lie American public corporations in which equity holders' property rights are severed upon contributing assets to the

[24] *See generally* ANTOINE LAVOISIER, ELEMENTS OF CHEMISTRY, IN A NEW SYSTEMATIC ORDER, CONTAINING ALL THE MODERN DISCOVERIES (Robert Kerr transl., 1789).

firm, which—from that moment on—belong to the corporate legal entity. On the other end lie the Ancient Roman *societate consensu contractae* (business organizations largely similar to present-day partnerships, but differing by the lack of agency among equity members, the absence of weak asset partitioning,[25] and the obligatory end of the association[26] upon the triggering of one of the causes of early termination) that were distinguished from mere common ownership by the *affectio societatis*[27] among the *socii*.

In the case of corporations, in which entitlement is completely transferred to the legal entity at the moment of contributing an asset, equity members' direct control amounts to approximately zero. Whereas in the *societate consensu contractae*, direct control by equity members over the assets of the firm remained very high during the regular course of business and influenced the development of governance structures such as the option for early termination of the concern and the non-transferability of equity membership.[28]

Second, equity holders are (to different degrees) provided with a return of transformed ownership rights. They take different forms, but ultimately are of either a governance or a financial nature: (i) an option for direct control exercisable, according to the limitations and policies provided for the different forms of business organizations, through the liquidation of the concern; (ii) the entitlement to dividends (after the decision to distribute earnings from the profit stream of the firm) and to residual assets after liquidation satisfies creditors; (iii) a set of governance rights including those concerning decision-making—shaped differently according to the form in which the business is organized (from the veto power in partnerships to corporate voting in public corporations)—-and the power to sue delegated controllers.

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[25] *See* Hansmann & Kraakman, *supra* note 8, at 401

[26] In fact, although typically the death or withdrawl of a partner (including withdrawal due to insolvency) typically ends a general partnership, some partnership agreements ensure the partnership contiues by providing that the remaining partners must purchase the intersts of any partner who leaves. Revised Uniform Partnership Act §§ 31, 38 (2001).

[27] *See infra* Chapter 2, Part I.A.ii.

[28] For an overview of the regulation of *societates consensu contracta*, see *infra* Chapter 2, Part I.

This bundle of rights may be considered "political rights" over the firm and its assets and these rights take different forms according to the type of business organization.

For instance, if an equity holder contributed a car to a business legal entity, from the moment of the contribution the car belongs to the business organization, not to the equity member who contributed it. Nevertheless, after the liquidation of the legal entity, the equity holder will have a claim to the remaining assets in proportion to his shares, which may correspond to the valuation of the car at the moment of contribution as compared with the value of other contributions. This means that, for the entire life of the legal entity, the ownership of the car belongs to the business organization and only when the fictional person is terminated (or the equity holder has the right to withdraw) is the equity member entitled to receive assets of the firm in proportion to his share. As Lynn Stout has remarked, "living corporations are different entities with fundamentally different purposes than dead corporations, just as living horses (which we employ as competitive athletes and family pets) have fundamentally different purposes from dead horses (which we use, if at all, for glue and pet food)."[29] Moreover, a "live" going concern has a much higher value than a bulk of "dead" assets, both to the firm's constituents and to the economy.

Third, direct control and political rights are cumulatively the entitlement that a specific type of business organization provides to its equity holders. These ultimately constitute the "equity ownership rights," which are conceptually distinguishable from the "ownership rights" *tout court*. In other words, equity ownership is nothing but the ownership of rights and duties that holding a certain amount of shares in a business organization entails.

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[29] LYNN STOUT, THE SHAREHOLDER VALUE MYTH 39–40 (2012).

vi. Equity Ownership Rights and Different Types of Business Organizations

Equity ownership rights provide equity members with significantly different degrees of entitlements and controlling powers depending on the specific form of business association. They are a combination of varying levels of direct control with certain sets of political rights allocated and organized according to the structure of a given business form.

The extent and content of equity ownership rights depend on the prioritization of goals of the business organization. As one might expect, when the business form is based on a simple (and ultimately contractually-based) model, equity ownership rights provide a larger bundle of controlling rights, while business organizations with more organizationally sophisticated models further restrict equity ownership rights.

For example, when deciding to organize a firm as a partnership, the primary concerns of the equity holders are maintaining flexibility in decision-making and management, as well as containing costs. Consistently, within a legal framework that allows them to select one another as partners, they retain a high degree of control over the firm while accepting a lack of limited liability.

On the other hand, when chartering a corporation, equity holders want to organize a firm in a way that allows for growth, longevity, a large and dynamic equity holder base, and, within a limited liability framework, are willing to sacrifice their direct control over the assets. Thus, shareholders' rights are not based on the ownership of assets composing the firm, but rather in (political-rights-based) ownership of the shares as a kind of contract with the legal entity, the corporation.[30] Put differently, as Robé explains: "[t]he 'things' (in fact, the 'property rights') owned by the shareholders are not the corporation but the shares; and a share is not a 'fraction of the corporation as a thing' . . . . Owning shares is not like 'co-owning' a corporation. . . . A share is not a fraction of some larger object of property right: a shareholder owning 34 of the 100 shares issued

[30] *See generally* Blair & Stout, *supra* note 12, at 292

by a corporation does not own percent of each share -which would be a co-ownership with the other shareholders- she owns 100 percent of each of the shares. And she does not own 34% of the corporation either; she owns 34% of the shares issued by the corporation." [31]

vii. Control Rights Relinquished by Equity and Non-Equity Members

Given the duration, complexity, and uncertainty of business organizations' productive activities, their legal and conventional frameworks "will often do little more than touch on the most obvious and important issues likely to arise as the exchange goes forward, leaving all else to be decided by mutual agreement between the parties as the relationship unfolds,"[32] and thus these frameworks reside in the relational-contracting category described by Macneil.[33]

In contexts where productive activity requires the combined investment and coordinated effort of individuals or groups of individuals, however, an *ex ante* profit stream distribution invites shirking by members or categories of members; while *ex post* attempts to divvy up economic surplus incentivizes opportunistic rent-seeking, disincentivizing and pushing away virtuous members, as well as harming the productivity of the firm.[34] As Blair and Stout remark, "trying to prevent shirking and rent-seeking by defining individual team members' duties and rewards through explicit contracts can be impossibly difficult, especially when the team production process is complex, continuous, or uncertain."[35] In the absence of specified rights to the profit stream generated from

[31] Jean-Philippe Robé, *The Legal Structure of the Firm*, 1 ACCOUNTING, ECONOMICS, AND LAW 28–29 (2011). Conversely, "even though a shareholder in a corporation is not entitled to extract any of the corporation's assets directly from the corporation, she nevertheless may be able to convert her financial interest in the company into cash by selling her shares to a new shareholder. Although corporate assets are fixed and locked in, investor interests in corporate shares can be relatively liquid. This liquidity finds its most perfect expression in the case of shares of a large public corporation subject to effective antifraud and disclosure rules that is listed for trading on an organized, well-developed exchange." Lynn A. Stout, The Corporation as Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form (unpublished manuscript).

[32] LYNN STOUT, CULTIVATING CONSCIENCE 181 (2010), where the Author also relates Robert Scott's description of these contracts as ones that "appear to be 'deliberately' incomplete." Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641 (2003).

[33] See Macneil, *supra* note 9, at 885.

[34] *See* Blair & Stout, *supra* note 12, at 249.

[35] *Id.*, at 250.

the working assets and of explicit contracts defining individual members'[36] duties, distortions can prevent a constituent from receiving the fair *ex post* return required to compensate for her *ex ante* investment (either too big or too little).

Where completeness of contracts cannot solve these issues, Grossman and Hart's relational contracts solution, i.e., transferring residual rights of control over assets (or over bundles of inputs organized to carry out business activities) to one or more parties who will have the ultimate power to distribute the rewards, appears to be the foundation on which to continue this investigation.

First, it is necessary to identify which members relinquish their control rights over their investments in the firm in a way that requires their protection via the sharing of the advantages of the venture. Indeed, due to vulnerabilities created by the relinquishment of control rights and the incompleteness of contracts—particularly when a party, by virtue of the relationship, makes investments that have a smaller value outside of the relationship than within the relationship (relationship-specific or firm-specific investments) [37]— protecting investments is essential to attracting them.[38]

Second, the geometries and dynamics of the organization and allocation of relinquished control rights are paramount. In fact, as pointed out with reference to contractual allocation (via purchase) of residual control rights, if one party takes over those residual control rights, the residual control rights of the other party are diminished. According to the principle of the symmetry of control, when one party appropriates the residual control rights, the other party loses these rights, resulting in disfunctionality and potential holdups in the business relationship.[39]

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[36] For a definition of the word "members" in the corporate context, see generally Robé, *supra* note 31, and Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

[37] Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q. J. ECON. 387 (1998), at 422; *see* generally Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. Econ. 9 (1962).

[38] *See generally* Blair & Stout, *supra* note 12; Rajan & Zingales, *supra* note 37; *see also* Becker*, supra* note 37.

[39] *See* Grossman & Hart, *supra* note 15, at 716.

viii. Non-Equity-Coventurers

While this work primarily focuses on the risks that shareholders of public corporations bear due to the lack of assessment of their personal qualities, a preliminary consideration of whether other members[40] of collective business organizations experience a position substantially comparable with that which equity holders have vis-à-vis their contribution is instrumental to a better understanding of the presently defective corporate governance mechanics.

In fact, due to the low outside-the-firm resale value of certain investments, although they do not formally qualify as equity contributions, these investments make contributing stakeholders participate in the risk of the enterprise.[41] This work considers these stakeholders as "non-equity-coventurers" because of their participation in the risk of the enterprise and for the nature of their investments.

Thus, collective business organizations, due to the combination of their relational nature with the relinquishment of control rights, entail a degree of vulnerability for both the equity-coventurers and non-equity-coventurers to those entrusted with the transferred residual control rights.[42]

For this reason, the non-equity-coventurers should also receive some portion of the rewards; otherwise, any non-equity-coventurers excluded from the surplus could do just as well by investing their resources elsewhere and exiting the productive coalition. So long as each non-equity-coventurer receives even a modest premium over his opportunity cost (due to the low resale value of their investment), she has incentive to remain part of the firm's productive activity.[43]

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[40] *See supra* note 36.
[41] *See* Rajan & Zingales, *supra* note 37, at 422.
[42] See generally Blair & Stout, *supra* note 12, and Hansmann & Kraakman, *supra* note 8.
[43] Blair & Stout, *supra* note 12, at 282–83.

Both equity-coventurers and non-equity-coventurers make firm-specific investments and agree to participate in the extracontractual productive process within the firm.[44]

On this ground, distribution of the firm's surplus is advantageous to not only the firm-specific investors, but also to the firm itself and represents the only way to attract and retain stakeholders whose investments are essential to the going concern.[45]

ix. Organizational Evolution of a Firm

A firm's primary needs for effective economic production typically change throughout the firm's life, and thus the relevance of non-equity-coventurer investments fluctuate throughout the stages of the firm's life.

Accordingly, governance must also evolve and transform the allocation patterns of residual control rights.

To better understand both foundations laid above, consider two friends, Sally and Steve, who have an idea to create, develop, and market a product (say, a new technology). They begin their venture on a friendly basis[46] without a formal contract, and they eventually list the corporation on the New York Stock Exchange.

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[44] *Id.* at 288.

[45] See Blair & Stout, *supra* note 12, 287-290.

[46] "With respect to the informal types of agreement, the parties often do not consider or even contemplate that the occasion will ever arise making necessary the inclusion of many points in their agreement. For example, A and B agree to share their profits and commission from a given venture equally. They do not contemplate losses, and so fail to provide for any, or else never even raise the matter because the possibility of losses seems so remote. There may be similar omissions with respect to the method of handling expenses incurred or to be incurred by A and B. The net result of such informality is the erosion of many of the familiar landmarks of partnership law and accounting. The terms of the relationship, other than the fact of profit sharing, may be so shadowy that it might easily be considered something else, e.g., a debtor-creditor transaction, a brokerage agreement, an employment contract, an independent contractor agreement, an agency, or a lease."
Taubman, *supra* note 3 at 651.

Initially, they only care about their idea, the desire to realize it, and the potential success they might obtain. Let us say that they have different, but synergetic, backgrounds: Sally has a Master's degree in applied science and Steve has a Master's in Business Administration.

They work elbow-to-elbow, share every advancement in their study, and implicitly agree to make any necessary decision to move their project forward jointly.

During the evolution of their project, the two friends have invested time and skill that will be wasted if the venture fails and, at some point, they both realize that Sally's expertise is more crucial than that of Steve. They also realize that if one of them walks away, they would be unable to sell his or her investment in the project outside the relationship. Thus, they start to consider adjusting profit distribution according to the value of their contribution.

They know that an *ex ante* determination of the profit distribution could encourage shirking and that if they entrust only one of them (say Sally, whose contribution is more crucial) with control over the distribution, the other (Steve) would be reluctant to invest, because Sally could use that power to keep for herself all the rents over and above the minimum reward she must pay to keep Steve involved in the project. Moreover, in this scenario, Sally would lose incentive to invest herself because she could benefit from an advantageous distribution of the profit stream that Steve generates. A shared decision making pattern would not be an optimal option either, however, because it would end up in a stalemate with negative effects on production. [47]

While discussing the associative framework to run their enterprise, Sally and Steve begin experiencing financial strain. They need money to buy supplies and infrastructure. Suddenly, they shift their focus from managing profits to their shortage of money. In theory, they could finance their project with debt or with equity. However, due to difficulties in obtaining credit, they have to

[47] For a better description of similar economic dynamics, see Blair & Stout, *supra* note 12, at 273.

finance their business through equity. Steve convinces Max, his fellow at the business school, to take part in the venture and contribute $500,000.

Sally, Steve, and Max have to set up a business organization to run their production activity in which they will each hold an equity position, but their contributions are difficult to evaluate.

While facing the financial strain of the project, Sally reevaluates the relevance of Steve's contribution in light of his ability to negotiate with Max to provide money to the production activity. Steve also perceived the importance of his role in the enterprise. Max knows how crucial his capital is, for the project would have failed otherwise.

It is clear now that the relevance of each of the three coventurers is strictly related to the particular stage in the life of the enterprise and the specific needs that the firm experiences throughout its evolution.

Moreover, throughout the life of the firm, the relevance of additional money (either equity or debt—a lending bank might soon become a relevant stakeholder, calling for covenants), top-notch management (which might be expensive and challenging to attract), a good research and development department (whose results might require a long-term perspective and on which a technology-based project is strongly dependent), etc., will re-define the prioritization among all the investments of both the equity holders (contributing different assets) and the non-equity-coventurers.

Thus, the project could initially be pursued using a partnership (e.g., with egalitarian shares between Sally, Steve, and Max), providing equity holders with the highest retention of control rights over the firm. As soon as the firm grows and the needs of the enterprise change, however, the relevance of the inputs changes, giving rise to the need for governance patterns that can mediate the shifting balance better than a partnership. The main issue will not be cost reduction (including agency costs), but production organization through multiple members and categories of members who make specific investments—when the enterprise becomes larger, it must operate for long periods of time in uncertain conditions to achieve its business goals[48]. Therefore, the costs (including agency costs) that such business schemes take on become acceptable.[49] This would be a reason to organize the firm as a corporation managed by a mediating hierarchy.[50]

Suboptimal profit distribution among firm-specific investors could be fatal to the venture: opportunistic and inefficient behaviors might plague a business relationship if there are large amounts of surplus to be divided *ex post* and if the *ex ante* contract does not specify a clear division of this surplus among contributing members. The negative effects on investment and, therefore, the production activity that such a phenomenon could cause justifies the willingness to bear agency costs in order to have a third party–a board of directors–work out the decisions over contingencies and profit distribution.

In summary, while the allocation of residual control rights of all the constituencies and an optimal distribution of profits among the constituencies are crucial to providing a sound organization of the production and to attracting the different stakeholder investments (i.e., working capital, know-how, and money), the governance patterns (and so the type of business organization) to better work things out might need to change at different stages of the firm's life. Therefore, as soon as the cost of allocation by one member, or a category of members, with specific investments

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[48] Discussing the optimal business form to organize an enterprise, Bank remarks that "Notwithstanding the corporation's unique ability to lock in capital, the partnership form may still be more attractive to some businesses. Lock-in typically is less necessary in closely held firms, especially those in which shareholder liquidity is limited by a lack of market for their shares or through buy-sell agreements. In those firms, the advantage of avoiding double taxation and gaining immediate use of passthrough losses from accelerated depreciation and other business expenses may outweigh any benefits of lock-in. Similarly, in firms with a lack of firm-specific assets, such as retail operations, the hold-up risk may be less of a concern in the decision between a corporation and a partnership. However, for those businesses with firm-specific assets, long-time horizons, and widely dispersed shareholders -- such as most public companies -- capital lock-in is still most reliably found in the corporation." Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889 914 (2006).

[49] "IBM and AT&T likely incurred very high levels of 'wasteful' agency costs while operating their Big Blue and Bell Labs research divisions during the 1950s and 1960s. Nevertheless, those costs have been repaid many times over by the gains to multiple generations of shareholders (and others) from developing the computer and the transistor". STOUT, *supra* note 32, at 18.

[50] *See* Blair & Stout, *supra* note 12, at 276.

exceeds the (agency) cost of having a third party take care of such activity, the corporate form becomes preferable.

In this context, recalling Rajan and Zingales' consideration seems useful: an allocation of governance power to a third party might absorb the opportunity losses that arise from the specializations of the firm's investments and prevent constituents from using relinquished control rights against each other.[51]

From these observations, two lessons should be taken.

First, the optimal allocation of control rights can vary over the life of the firm and depend on the features of the enterprise.

Second, the personal qualities of the fiduciaries appointed with such transformed residual control rights—the controllers—are paramount.

These two considerations are the subject matter of the following.

x. Appointment of Controllers

A business organization can authorize various constituencies to exercise the transformed control rights.

The appointment of the predominant governance power to workers, managers, equity holders, or other constituencies of a business organization, creates different sets of incentives and risks for the aforementioned stakeholders.[52] Conversely, the allocation of residual control rights, by changing the average investment return, affects the level of investment from a business organization's various categories of members. In addition, according to Rajan and Zingales, "the role power plays within the firm is to foster and protect specific investments . . . in an environment

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[51] *See generally* Rajan & Zingales, *supra* note 37.

[52] *See generally* Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267 (1988); Rajan & Zingales, *supra* note 37, at 387-432. The Authors suggest that appointing a third party with residual control rights is the best choice because it does not have specific investments.

where contracts are incomplete. Thus, the smaller the space of contracts that can be written and enforced, the more important the role of residual rights of control and hence of power."[53]

Without discussing optimal allocation, it should be emphasized that the degree of relinquishment and allocation of control rights depends on a business activity's specific features and varies over a firm's lifetime.

Organizational law has developed different sets of rules to make such residual control right transfers and reorganizations feasible within legal frameworks that provide, on the one hand, risk hedging for equity members of an organization and, on the other, workability of the firm.

If the complexity, size, geographical intricacy, and long-term perspective require locking in investments from multiple equity-coventurers and non-equity-coventurers, the corporate form can provide the firm with legal entity technology and its benefits.

In particular, forfeiting property rights over the members' contributed inputs grants the firm a life independent of its members, and allocates control to an independent governing body.[54] This mediates both the redistribution of a business activity's rewards between equity-venturers and non-equity-coventurers, as well as corporate plans.

In fact, appointing a third party might be more equitable to both the equity holders and non-equity holders (including non-equity-coventurers).[55]

Breaking down the dynamics of corporate control rights allocation, Grossman and Hart say that the shareholders as a group have control and delegate this power to the board of directors. Such a statement, however, seems to gloss over the dynamics within business organizations (or in

[53] Rajan & Zingales, *supra* note 37, at 422.

[54] "The directors are trustees for the corporation–mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together." Blair & Stout, *supra* note 12, 280-81.

[55] *See* Rajan & Zingales, *supra* note 37, 387-432. Blair and Stout point out that "[w]ithin the corporation, control over those assets is exercised by an internal hierarchy whose job is to coordinate the activities of the team members, allocate the resulting production, and mediate disputes among team members over that allocation. At the peak of this hierarchy sits a board of directors whose authority over the use of corporate assets is virtually absolute and whose independence from individual team members . . . is protected by law". Blair & Stout, *supra* note 12, at 251.

organizational law), which strongly differ from those of contracts. In addition, Grossman and Hart fail to emphasize that incorporation is the point at which shareholders (and other potential investors) give up their control rights over the assets composing the firm.[56] In fact, there are two separations of ownership and control in the development of a corporation.

The first is of a legal nature and the second is a practical phenomenon.

The legal separation of ownership and control takes place at the moment of incorporation. Titles of assets are transferred to the legal entity and, upon contribution (in cash or in kind), the agreed-upon title (e.g., ownership) vests in the business organization—leaving the shareholders only with equity ownership rights, which derive from holding shares obtained upon the issuance of stock for "property received.[57]

In short, at incorporation, initial equity holders transfer ownership of their investment to the corporation and entrust a board of directors with control of the assets.[58] With significant consequences, the firm's board of directors manages, and the legal entity owns, the assets. This isolates the corporations' assets from the shareholders' fates, and vice versa.

The practical separation of ownership and control described by Berle and Means in their famous book,[59] "The Modern Corporation and Private Property," takes place if the shares of the corporation are held by the public, due to the absence of a dominant shareholder. Members of the board of directors therefore exercise control over the firm.[60]

In summary, in corporations, according to the allocation of residual control rights to the board of directors,[61] the appointment of controllers has a vertical geometry.

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[56] *See* Grossman & Hart, *supra* note 15, at 694.

[57] *See* David Ciepley, *Beyond Public and Private: Toward a Political Theory of the Corporation*, 107 AM. POL. SCI. REV. 139 152 (2013); ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY 222 (1932).

[58] *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003), at 428

[59] *See* Berle & Means, *supra* note 57, at 112.

[60] *See* Robé, *supra* note 31, at 31.

[61] Blair and Stout clarify that "by suggesting that directors serve at the top of the pyramid of authority that comprises the public corporation, the mediating hierarchy model does not imply that directors actually manage the

xi. Assessing Personal Qualities of Controllers

If the controllers are a (non-equity or equity) member of the productive activity or if they are an independent third party, the risk of shirking or exploiting the inputs of the remaining members gives reason to fear a fool or knave controller.

According to Phaedrus' lesson, in Ancient Rome, the relevance of selection of *socii* in *societates consensu contractae* was so crucial that being ignorant of the imperfections of fellow *socii* was considered a case in which the selectors were themselves at fault for not taking proper care in selecting their coventurers: "people engaged themselves to each other as they were, with their imperfections on their heads."[62]

In fact, the *societates consensu contractae* was a relationship in which each *socius* was a trusted actor, potentially able to benefit himself at the expense of his fellow *socii* by taking advantage of their vulnerability. This is because the allocation of the relinquished control rights had a horizontal, interlocking geometry such that each *socius* was a controller vis-a-vis the other *socii*, on one hand, and vulnerable to the other *socii*, on the other hand.

This mutual subjection made Ancient Romans frame the regulation of the *societas consensu contracta* around the protection created through effective selection based on personal qualities and permanence of those qualities through the association's life span. In such business organizations,

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corporation on a day-to-day basis. To the contrary, we expect that most corporate decisions are made collegially among team members at lower levels. Indeed, the existence of a mediating hierarchy may heighten incentives for team members to work out conflicts among themselves because the alternative is kicking the problem upstairs to a disinterested - but potentially erratic or ill-informed - hierarch. Thus an independent board of directors may be able to encourage shareholders, executives, and employees to invest in corporate production not because these team members expect the board to determine which group gets what portion of the resulting economic surplus, but because the possibility that the board could make that allocation discourages the more egregious forms of shirking and rent-seeking among team members". Blair & Stout, *supra* note 12, 280–81.

[62] MAX RADIN, HANDBOOK OF ROMAN LAW 260 (1927); *see also* DIGEST 3.25.9, *in* 1 THE DIGEST OF JUSTINIAN (Alan Watson ed., 1985). See Phaedrus, *The Cow, the Goat, the Sheep, and the Lion*, *supra* note 1 and accompanying text.

the relationship among the *socii* was so confidential that they referred to it as *fraternitas*.[63] In other words, the *societas consensus contracta* was an association based on the *intuitus personae* among its equity members.[64]

This leads to this work's main topic: assessing personal qualities of those appointed with governance powers.

Regardless of the geometry of the transfer of residual control rights or what members are appointed as controller, given the relational nature of business organizations and the vulnerabilities (of both equity-coventurers and non-equity-coventurers) they entail, controllers must be selected on the basis of their personal *qualities*, or *intuitu personae*. Controllers might be equity members, non-equity-members, or third parties (potentially even a computer software, to use an extreme example). The qualities of the controllers, *in primis* their trustworthiness and *in secundis* their competence and care, represent the chief safeguard for equitability and integrity in the management of the organization.

Therefore, both horizontal and vertical control rights reorganization require an effective selection of fiduciaries entrusted with the relinquished control rights based on their personal qualities.

Moreover, effective qualities-based selection depends on certain major principles.

First, the selection has to be affirmative: the selectors—the equity members—must be provided with the power to individually or collectively choose to whom to grant the transferred residual control rights.

Second, the selection has to actually determine who the controllers will be. The appointed controllers have to be those who actually control the firm according to the terms of their office: a system in which the ultimate controllers are different from those who are selected would completely

[63] *See infra* Chapter 2, Part IAii
[64] *See infra* Chapter 1, Part Axii

frustrate the mechanism of selection because it would make it ineffective. Thus, if directors are appointed as controllers of a corporation, the decisional powers granted to them have to be actually exercised by them and not by other players.

Third, as evident in Phaedrus' fable, effective organization of residual control requires that controllers exercise those rights only to the extent that the relinquishing parties authorize the controllers to do so (consider the example of the lion that in actuality takes over all the control power of his fellow-coventurers). Controllers that exercise residual control rights beyond their authority frustrate the selection mechanics (although to a smaller degree, since the overbearing controller, different from the shadow controller, has been selected and disclosed publically as controller).

xii. Intuitus Personae and Personal Qualities

The appointment of controllers, either on a horizontal basis (e.g. in the ancient Roman *societates consensus contractae*) or on a vertical basis (e.g. in a modern public corporation), given its confidentiality and fiduciary nature, is based on the personal qualities of the controllers. Their selection is based strictly on the assessment of their personal qualities. This created the *fraternitas* bond that characterized the relationship among the *socii* of the *societas consensu contracta*, and the fiduciary relationship between modern corporate entities and the members of the board of directors they entrust with the management of the firm on their behalf. This concept is described by the Latin phrase "*intuitus personae*," which means "in consideration of the person."[65]

In other words, "*intuitus personae*" is used to describe relationships where the personal qualities of the parties are essential.[66] The considered personal qualities characterize a person, and

[65] *See* generally GALASSO, *supra* note 3.
[66] *See* Gérard Cornu, Vocabulaire juridique, édition "Quadrige", 2007, at 523.

make them unique and distinguishable from others.[67] In the French doctrine, these personal qualities are referred to as 'moral identity'—that is, abilities, professionalism, *savoir-faire*, and morality.[68]

In Civil Law systems, a contract is described as agreed *intuitu personae* when one party enters into that contract in consideration of the personal qualities of the other party.

In fact, in the case of *intuitu personae* contracts, one party's trust in the other party's personal qualities is an essential element in the formation of the consent.

A typical consequence of a contract determined *intuitu personae* is that the contract is non-transferable.

For example, the choice of an employee generally depends on her personal qualities because the performance of the contract requires specific qualities and skills,[69] and the performance set forth in the employment contract cannot be fulfilled by any other person.

Another *intuitu personae* contract is the contract of mandate, by which the mandatary fiduciarily performs an act for the mandator.[70]

In short, the concept of *intuitus personae* plays a relevant role in relational contracts,[71] thus it extends to business organizations.

In Civil Law systems, *intuitus personae* is crucial in differentiating business organizations of persons from business organizations of properties.[72]

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[67] *See* Jean-François Renucci, L'identité du cocontractant, RTD COM. 1993, at 441.

[68] *See* Isabelle Pascual, *La prise en consideration de la personne physique dans le droit des sociétés*, RTD COM. 273 (1998).

[69] *See* G. Couturier, « Droit du travail », tome 1, PUF, 16 e éd., 1990, n° 166, at 150

[70] *See* GUSTAVO MINERVINI, IL MANDATO, LA COMMISSIONE, LA SPEDIZIONE (1954) and Angelo Luminoso, *Rappresentanza e Mandato a Confronto*, RIVISTA DI DIRITTO CIVILE 741 (2012). For an analysis of the substitutability of the mandatary, see CARLO SANTAGATA, DEL MANDATO, DELLE OBBLIGAZIONI DEL MANDATARIO, DELLE OBBLIGAZIONI DEL MANDANTE 279-379 (1998). See also Cass. Civ. Sez. V, 18 maggio 2012 n. 7876, in I CONTRATTI 349 (2013).

[71] *See* MACNEIL *supra* note 9 at 885. See also STOUT, *supra* note 32 at 181.

[72] *See* David Ciepley*, Is the U.S. Government a Corporation? The Corporate Roots of Modern Constitutionalism* (manuscript provided by the Author).

Business organizations of persons are governed by a strong *intuitu personae*. These business organizations are formed fundamentally in consideration of the personal qualities of the equity members. Some features of these business organizations attest to the importance of the personal qualities of the equity members. In particular, the restriction on the transferability of shares explains the persistence of the relevance of the qualities of the equity members beyond the stage of formation throughout the entire life of the business organization.[73]

The existence of a mandatory approval procedure for transfers of shares to third parties ensures a careful selection of new partners by the existing partners, thus perpetuating the climate of trust and knowledge of the parties that was originally indispensable to the contract.[74]

In contrast, in business organizations of property, *intuitu personae* among equity members does not have a pivotal relevance. They are primarily based on the contributed assets rather than on the personal qualities of equity members. The purest forms of business organizations of property, public corporations, are characterized by intrinsic free transferability of shares and delegated management. Given that the relevance of the personal qualities is primarily related to the exercise of control rights, in public corporations the assessment is carried out towards the members of the board of directors—the controllers of the firm. Nevertheless, in cases where other parties, e.g. shareholders, gain control, their personal qualities, other than the members of the board of directors, become relevant.

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[73] For an example of " intuitus personae" provisions in a Civil Law System jurisdiction, *see* French Commercial Code, articles L. 221-13 and L. 222-8. It should be noted here that article 221-13 recognizes the validity of clauses of transferability in general partnerships, within certain conditions. However, this does not bear on the general principle of non-transferability of shares. As for the limited liability company (SARL), a transfer of shares to a third party requires a majority vote, in accordance with article L. 223-14 of the Commercial Code.

[74] See Isabelle Pascual, *La prise en consideration de la personne physique dans le droit des sociétés*, RTD COM. 273 (1998).

B. Organization of Control Rights within Different Business Forms and Selection of Controllers: From *Societates Consensu Contractae* to Public Corporations

i. The Fraternitas *among* Socii *of* Societates Consensu Contractae

On a spectrum starting from a business association in which the relinquishment of control rights from equity holders is the strongest, to business associations in which such relinquishment is the weakest, the former is the American public corporation, and the latter is the Ancient Roman *societas consensu contracta*.

The *societas consensu contracta* was an archetype of current partnerships, though distinguished by an even smaller relinquishment of control rights by the founding members. This reason, together with the possibility of analyzing the evolution of partial legal solutions to overcome the intrinsic limits of the *societas consensu contracta*, motivates the choice to start this work with an overview of the *societas consensu contracta* and a summary of the strategies that cope with the lack of stability or efficient decision-making, which ultimately led to the creation of the *societas publicanorum* (the archetype of modern business legal entities).[75] The emphasis here is on the unsuitability of features that could possibly be granted to the *societas consensu contracta* via contracts or sets of contracts, and on the need to borrow the legal entity instrument from public law. In fact, the law already recognized typical features of legal persons in some government entities. As we later describe, such use of the legal personality was eventually granted for specific business activities that were considered in the public interest or for the public good (e.g., tax farming, mining, etc.).[76]

In *societates consensu contractae*, the geometry of the transfer of control rights is horizontal: the *socii* are appointed as controllers of the business association, retaining a larger part of control rights

[75] In addition, the choice to consider the *societas consensu contracta* as the end of the spectrum of minimum relinquishment of control rights and the public corporation as the maximum relinquishment is also a methodological choice to make the entire work more principle-based, rather than based on legal theories of a specific jurisdiction.

[76] See *infra* Chapter 3, Part IA.

and relinquishing a minor part.[77] The assets managed under the *societas* contracts were never transferred to the association, which was not a legal entity; *socii* could only form a pool of commonly owned assets intended for the scope of the *societas*.[78]

Socii could withdraw those assets practically at any time and their creditors could recover the assets of the *societas*. Consistent with strong equity ownership rights, decision-making mechanisms were individually based: decisions regarding the association were subject to the veto system. Moreover, each *socius* acted in his own name (not on behalf of his fellow-equity members or of a legal entity) vis-à-vis third parties and was liable for bringing the acquisitions and contracts concerning the *societas* within the agreed joint management. In return, the other equity members were obligated to reimburse him in proportion to their respective shares.[79]

From a different standpoint, and with some disregard for accuracy, the weak relinquishment of control rights and the horizontal allocation of residual control rights upon fellow-equity members accompanied the automatic termination of the association in the case of any change in their social status, or inclination to carry out the business in association with the fellow equity members (either expressly renounced or implied through a legal action on the association), or death of the *socii* themselves. In short, any fact or act that would have corrupted the security that the mutual selection of fellow-equity members created would terminate the *societas* contract.[80]

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[77] Margaret Blair provides an insightful analysis of the limits of horizontal transfer of control rights, pointing out that relative risks hold-up among partners of present-day partnerships. She also remarks that the practical solution is to limit the member-base to partners selected on the basis of their qualirties, in particular their trustworthyness: "[p]artnership thus grants considerable power and control rights to individual team members who are partners. In some ways, this protects each team member against unfair expropriation of the benefits of team production and provides positive incentives for all partners. But in other ways, partnership also allows individual team members to use their control rights to hold up the other team members, and it enhances their mutual ability to engage in wasteful 'rent-seeking' activities. With additional partners, this risk is increased relative to the incentive benefits that partnerships provide. Partnership is thus likely to provide a solution to the team production problem only in certain restricted situations: where the number of team members is small, and/or the personal, professional, family, or community ties are relatively strong". Blair, *supra* note 58, at 411–12.

[78] See *infra* Chapter 2, Part IA.

[79] See *infra* Chapter 2, Part IA.

[80] See *infra* Chapter 2, Part IA.

In other words, the security scheme to cope with vulnerability was based on the termination of the business organization due to the correspondence between equity ownership and control rights over the firm, and the interplay between the equity members' personal assets and those managed under the *societas*.[81]

Thus, this type of association was capable of pooling together inputs of multiple *socii*, but suffered significant instability (causing unreliability in bonding contracts on an associational basis) and burdensome decision-making.[82]

With that in mind, this work seeks to answer three questions. Why was it reasonable that the *societas* terminated when one of the *socii* dies?[83] Would protecting the business-going concerns, or ending the association because the agreement was made exclusively in consideration of each individual *socius*, thus preventing the business organization from surviving his death, be preferable? How might an association preserve the security created through the selection of controllers based on their qualities, and simultaneously grant the association continuity?

As pointed out by Margaret Blair with respect to the modern partnership, the most similar modern business organization to *societas* (as well as the one with the second weakest relinquishment of control rights and second largest equity ownership rights), the partnership, can "help to amass capital, but does not provide for centralized control, and cannot facilitate the commitment of capital for extended periods of time."[84]

When comparing the *societas consensu contracta* and sole proprietorships, the former stands to gain a larger amount of equity capital, but has disadvantages in decision-making and stability. In

[81] See *infra* Chapter 2, Part I.
[82] See *infra* Chapter 2, Part II.

[83] Borrowing the example from Robé: Bob is a controlling shareholder with the largest stake in a business organization. Bob is the victim of a car accident and dies. As a womanizer, he had a rich and fruitful life and many of his former female partners each claim that her child is his. What happens to his shares and to the business organization depends on the form of the business and the provisions in its charter. In any case, the impact of the death and of the potential inheritance of his stake in the business, assuming that the organization will survive, depends on the degree of equity ownership rights that the type of business the firm is organized as provides to an equity holder. Robé, *supra* note 31, at 54–55.
[84] Blair, *supra* note 58, at 413.

fact, entrepreneurs who organize their businesses in the form of *societas* saw the stability of their concerns depend on one another (by virtue of the security created via the selection of *socii*) and a much more onerous decision-making system. Not surprisingly, until the enterprise required larger financial investments (which could not be satisfied by the *societas* anyway), the sole proprietorship was by far the most common way of carrying out business in Ancient Rome.[85]

ii. An Imperfect Legal Solution to Delegate Management: the Prepositio Institoria *with* Peculium

Alternatively (aside from the family, around which Romans used to organize business), the *praepositio institoria* with or without *peculium* was a popular form of joint-enterprise. In such an organization, the owners appointed (co-owned) slaves that managed a firm, and sometimes provided the slaves with a pool of business assets: the *peculium*—or the family.[86]

In fact, the *praepositio institoria*, although weak in terms of continuity, provided a more efficient decision-making system, entrusting slaves with the management of the firm and, if combined with the *peculium*, a degree of limited liability (as long as the liability was not intentionally caused by the *exercitores*).[87] In substance, the *praepositio institoria cum peculium* was a form of non-associative joint-enterprise, in which the original owners of a pool of assets relinquished some control to let a *praepostus* manage them. As a practical matter, to some degree, the pattern was similar to current corporations, in which the "investor who uses her hard-earned money to buy shares from a public firm relinquishes her power to determine how those funds will be used in the future. Her personal assets become corporate assets subject to the directors' control. It is now the directors, and not the investor, who will decide how the firm shall be run, whom it shall hire, and in what it shall invest. It is also now the directors, and not the investor, who will decide whether

[85] See *infra* Chapter 2, Part II.
[86] See *infra* Chapter 2, Part II.
[87] See *infra* Chapter 2, Part II.

corporate earnings will be used to pay dividends—or used instead to build empires, raise salaries, and support charities."[88]

Functionally, but not legally, the *praepositio institoria cum peculium* was the archetype of organizing business by separating ownership over assets and control over the business by entrusting the management of the firm to a delegated controller.[89] This allowed the *exercitores* to separate the control over the firm from the ownership of the assets and to sell their "shares" without terminating the enterprise. Thus, the *de facto* separation between ownership and control in the *prepositio institioria cum peculium* gave rise to some of the organizational features of current corporations: separation of firms' assets from those of the equity holder (the *exercitores*), limited liability of the *exercitores*, transferable shares, and centralized control, as well as a degree of continuity (ultimately limited by the *exercitores*).[90]

As opposed to current corporations, however, the separation of a firms' assets from those of the equity holders was only functional, but not legal, because the association did not sever the link with the *exercitores'* ownership (slaves could not own property and the business form was not a legal entity). Furthermore, the *exercitores* could withdraw the contributed assets and terminate the enterprise allowing creditors to go after the assets contributed in the *peculium*.[91]

Therefore, this legal solution featured more efficient decision-making, though it was still imperfect for enterprises that required stability and continuity.

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[88] Lynn A. Stout, *Investors' Choices: The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 668 (2003).

[89] See *generally* Barbara Abatino, Giuseppe Dari-Mattiacci & Enrico C. Perotti, *Depersonalization of Business in Ancient Rome*, 31 OXFORD J. LEGAL STUD. 365 (2011).

[90] See *infra* Chapter 2, Part II.

[91] See *infra* Chapter 2, Part II.

iii. The Legal Entity Technology

A lack of asset lock-in and continuity in a venture characterized the defective apparatus of the structure of the *praepositio institoria cum peculium*. These defects affected credit, a firm's ability to grow, and the applicability of such a structure to certain types of businesses that required the stability of long-term investments. Thus, the assets remained in the realm of the *exercitores'* property with the aforementioned defects.[92]

In fact, the only effective legal instrument that provides firms with continuity (and ability to grow), and guarantees the selection of the controllers, is the legal separation of the firms' assets from their equity holders.[93] The organizational law technology making this feasible was the creation of legal entities within which ownership was independent of any physical person.[94]

This sparked the process that led to the *societas publicanorum*, the archetype of the modern public corporation, born out of a joinder between private business organizations and the concept of *corpus habere*, i.e., the fictional legal personality, a public law institution originally conceived within Rome's system of government.[95]

Roman legal experts developed the idea that an entity entirely apart from its individual member(s)[96] could bear legal rights and liabilities.[97]

Originally, governments created legal entities to provide states, municipalities, villages, and public officers with a capacity to hold property perpetually and in the public interest. Those public institutions were granted a legal personality, and thus had life and power independent of those who embodied and directed the institutions.[98]

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[92] See *infra* Chapter 2, Part II.
[93] *See* Hansmann & Kraakman, *supra* note 8, at 398; Blair, *supra* note 58, at 427.
[94] *See infra* Chapter 3, Part I.
[95] *See infra* Chapter 3, Part I.
[96] As in sole corporations, legal entities may have only one member.
[97] *See infra* Chapter 3, Part I.
[98] *See infra* Chapter 3, Part I. See also Ciepley *supra* note 72.

Such a concept is still valid today: the President of the United States of America, as a legal entity, owns different assets and exercises different powers than Mr. Barack Obama in his capacity as a private citizen. Those powers and assets are tied to the presidential legal entity. Therefore Air Force One and the power to issue executive directives do not belong to Barack Obama as a citizen, but to the U. S. President's legal entity (that Barack Obama now embodies) and will survive Barack Obama's term in office to potentially last perpetually.[99]

The "legal personality" instrument allows government and business organizations to overcome the limits related to the lack of continuity and credit via ownership, organization and governance of assets, the ability to enter into contracts, and the legal rights of entities to sue or be sued, which survive their constituencies' transiency.[100]

From a different perspective, the legal personality technology produced a new scheme for business organization, governance, and financing. In particular, as described above, the twofold separation of ownership and control[101] permitted contributing assets to a business legal entity (of which the firm is composed), locking those assets to the firm, and relinquishing control rights over the assets to selected controllers (that may or may not have been the equity holders).

iv. Basic Features of Business Corporate Entities

This work's implicit hypothesis is that the ultimate advantage of a legal entity owning a business' assets is the possibility of separating the control over the firm from the equity-holders[102].

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[99] *See* Ciepley *supra* note 72.

[100] *See infra* Chapter 3, Part IB.

[101] One of legal nature, which takes place at the moment of incorporation, which transfers the title to the contributed assets to the legal entity, and the second, which consists of the practical phenomenon that occurs in large public corporations with dispersed ownership if control over the firm's assets and outputs rests with the company's board of directors. See also *supra* Chapter 1, Part I.

[102] *See infra* Chapter 3, Part IB.

On one hand, this separation allows selecting the controllers and preserving the security achieved through such selection regardless of the fate and will of the equity holders and management-efficient decision-making.[103]

On the other hand, this scheme permits transferability of shares. Shareholders have a great deal of freedom in disposing of their shares, whether selling or gifting them. The same cannot be said of the shareholders' interactions with the firm's assets. Theoretically, with regards to the governance over the firm, the only thing shareholders may do is exercise the rights they have in connection with their ownership of shares (i.e., vote in general meetings, appoint directors, collect dividends, sue the board, and dispose of shares). While important, these rights never manifest in actual ownership of corporate assets.

In fact, as Robé points out, shares only exist as property rights—hence, one might find a complex contract called a "Share Sale and Purchase Agreement," but never a "Company Sale and Purchase Agreement." The *company* cannot be bought and sold in such a way because, strictly speaking no one "owns" the company.[104]

The strong relinquishment of control rights has groundbreaking effects on a joint enterprise's organization. As previously mentioned the relinquishment entails the transferring of rights on the contributed assets to the corporation and diverging from traditional rules of property. Shareholders own neither the contributed assets nor the assets the corporation acquires or produces in the course of business, which belong to the legal entity.[105]

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[103] Moreover, from a purely decisionmaking perspective, "it avoids having to agree in advance on detailed contracts among the shareholders to specify who will do what in what circumstances and get what in return. All the rights, including the residual control rights in connection with the various assets contributed to the business, are now owned by the "artificial" juridical person, not by any of the contracting parties. After contribution of the assets to the corporation, decisions about their use will not be made by contracting parties negotiating to revise their contract with some parties having residual control rights over the real assets while others have none. The decisions will be made by the officers or directors or shareholders, in accordance with the company's articles of incorporation and the applicable corporate law, which provide for procedural rules governing how decisions will be made through time in connection with the venture." Robé, *supra* note 31, at 17.

[104] *Id.* at 31.

[105] *See infra* Chapter 3, Part IB

With respect to the divergence from traditional rules of property, partitioning corporate assets from the shareholders' is a natural and necessary consequence that entails a chain of legal effects. First, shareholders cannot withdraw corporate assets. Second, shareholders' creditors cannot go after corporate assets. Third, the corporate entity delegates and entrusts control over the assets to the board of directors[106].

These three sides of the triangle that describe the effects of the break with the rules of property[107] in public corporations characterize the "asset lock-in" concept.[108] Given that assets belong to the legal entity and it delegates control over enterprise to the board, shareholders cannot sell the assets of the corporation, but rather, are able to trade their shares in the corporation. Moreover, consistent with the broad relinquishment of control rights and transferability of shares, shareholders are provided with limited liability.[109]

Lastly, with respect to the transfer of control rights, the selection of controllers, as anticipated, has a vertical geometry and takes place through systematic election of corporate directors and hierarchical delegation of power.[110]

Once selected, corporate directors manage the firm according to legal framework that grants them with limited liability and business discretion within the constraints of their fiduciary duties. Shareholders' trust in the board, which shareholders express by selecting board members,

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[106] *See infra* Chapter 3, Part IB

[107] See Ciepley, *supra* note 57, at 139.

[108] "Asset lock-in is not a binary characteristic. Corporate entities can be viewed as falling along a spectrum. At one end of the spectrum, nonprofit corporations with no shareholders have an extreme degree of asset lock-in. At the other end of the spectrum, a corporation with only one shareholder who can easily remove the board has very little lock in unless that sole shareholder is prevented from withdrawing corporate assets by other constraints, for example debt covenants that limit dividends and share repurchases. Most corporate entities fall somewhere between these two extremes on the lock-in spectrum. For example, a publicly traded firm with dispersed share ownership and strong antitakeover protections has a high degree of lock-in, as it is difficult or impossible for shareholders to demand cash from the corporation through dividends, share repurchases, or the sale of the firm". Stout, *supra* note 32, at 10.

[109] *See infra* Chapter 3, Part IB

[110] Blair & Stout have argued that the delegation of control rights to a board may help to solve the team production problem because it helps to convince all the parties that none of them can unilaterally make decisions that enrich themselves at the expense of others, and that decisionmaking is more likely to be 'fair." Blair & Stout, *supra* note 12, at 255.

validates this structure.[111] The directors do not have the full rights of owners (the articles of incorporation and bylaws, as well as all other applicable law, frame the directors' governance power), but are entrusted with the control of the enterprise.[112]

On this ground, given that shares are typically freely transferable, a potential policy that provides the equity holders with residual control rights would completely frustrate the principle that shareholders should select controllers on the basis of their personal qualities. Thus, providing residual control rights to shareholders would also frustrate the stability and soundness of governance achieved through the selection of the board of directors as well.[113]

Furthermore, if multiple constituencies make themselves vulnerable by investing in an enterprise, governance should be organized by "assigning control rights not to shareholders nor to any other stakeholder in the firm, but to a third party—the board of directors—which is largely insulated from the direct control of any of the various economic interests that constitute the corporation. Thus, we argue that an essential but generally overlooked 'contract' fundamental to the nature of public corporations is the '*pactum subjectionis*' under which shareholders, managers, employees, and other groups that make firm-specific investments yield control over both those investments and the resulting output to the corporation's internal governing hierarchy."[114]

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[111] See *infra* Chapter 3, Part IB and Chapter 4, Part I
[112] See *infra* Chapter 3, Part IB
[113] See *infra* Chapter 3, Part II and Part III
[114] Blair & Stout, *supra* note 12, at 320.

C. Anomalies in Organization of Residual Control Rights within Public Corporations and the Need for Assessing Shareholders' Personal Qualities

i. The Anomaly of Unselected Controllers in Corporations

Although shares of public corporations are typically freely transferable, and therefore a business cannot usually assess shareholders' qualities, equity holders retain a set of control rights and, above all, sometimes they can *de facto* exercise determinant governance influence.[115]

In fact, although primarily vertical, the transfer of residual control rights in public corporations has a minor horizontal tendency as well. Shareholders (to different degrees in different jurisdictions) have *de facto* influential power beyond their equity ownership rights.[116]

Typically, potential shareholders cannot lock-in current distinguished shareholders and current shareholders cannot exclude or expel potentially unwanted and predictably harmful shareholders. Moreover, public corporations' shareholders cannot normally avoid the acquisition of controlling (or relevant) interests by "fool" or "knave" investors, who buy stock on the market and exercise the governance power to which they are entitled (as well as the *de facto* influence that accompanies their purchase).[117]

As Rock reminded us, when the banks were sinking in 2008, they all wanted Warren Buffet to underwrite their shares.[118] The reasons for such a desire lie in the effect of his presence in the

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[115] See *infra* Chapter 3, Part II and Part III

[116] See *infra* Chapter 3, Part II and Part III

[117] See *infra* Chapter 3, Part III

[118] "Warren Buffett has acted as a relational investor for decades. He has a long track record of being supportive of management (which management views as a good characteristic) while also being a savvy judge of companies. He also acts quickly. His attributes made him the perfect (and maybe the only) relational investor for Goldman Sachs during the panic in the Fall of 2008. Goldman's challenge was to convince the markets that it had adequate funding sources even during the credit crunch and would thus not go broke. Buffett's investment provided credible reassurance: markets viewed him as a smart investor who would not invest without confidence that Goldman was sound; if he was wrong, he would lose his investment. Because Buffett's reputation is valuable to him both personally and in being offered opportunities to buy businesses for Berkshire Hathaway, Goldman could count on him to uphold his side of the bargain. In addition, he has a long track record of doing so." Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849, 864 (2012). See also *infra* Chapter 4, Part II.

firms' capital structures. His presence produces reputational effects in the market vis-à-vis the current shareholders (as a signal of confidence in their investment). Such reputational effects also influence potential investors (willing to emulate, or at least comforted in committing to the investments made by Warren Buffett), as well as current and potential lenders (similarly comforted by Warren Buffett's consolidated equity position). The governance benefits were a major advantage as well.[119]

Both the reputational and governance effects give rise to many considerations. With respect to the reputational effects, if metrics do not satisfy the need to deeply understand and assess the value of corporate long-term investments, reliance on the ability of skillful shareholders to read between the lines of balance sheets and investor relations could seem unsophisticated, but completely understandable investing behavior. Even more crucially, in periods of crisis and general disorientation, investment decisions of an eminent investor could appear as beacons and sources of judgment for other investors, and skeptical lenders. Indeed, an intellectually sophisticated investor's endorsement of a distressed company plays a strategic role in the financial markets. Nevertheless, the geometry and direction of the selection is different from business organizations in which equity members are self-selected and lock each other in (or at least limit the entrance of unwanted equity members). In the case of corporations in which shares are freely transferable, the organization itself plays the game of attraction through its board. Therefore, the corporation itself may warmly pursue a relationship with certain shareholders.[120]

With respect to governance, the shareholders' franchise has been at the center of academic debate for years.[121] Indeed, support for increasing shareholder power and rights has been strong

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[119] See *infra* Chapter 4, Part II

[120] See *infra* Chapter 4, Part II

[121] *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006); Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 711 (2007); Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); STOUT, *supra* note 29; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

recently. If we observe corporations' interest in engaging sophisticated and trustworthy shareholders, we can note that the shareholder franchise (together with their *de facto* power and influence on corporate governance) justifies the interest to attract shareholders on the basis of their qualities. This cannot be explained if shareholders' influence on governance were immaterial.[122]

The issue, therefore, appears not to be about the diversity of a shareholder base, but the lack of assessment of shareholders' qualities (given their exercise of residual control rights) and the anomalies this produces.[123]

Shareholders' power to affect the interests of other shareholders (and of the firm) lacks any quality-based selection system. If the cow, the goat, and the sheep should blame themselves for selecting an overbearing coventurer (the lion), how can corporate shareholders assess the personal qualities of their fellow shareholders?[124]

ii. Breaking down the Risks Related to Unselected Controllers

In a corporate context in which shareholders play a governing role, the lack of quality-based shareholder selection mechanisms allows untrustworthy and incompetent shareholders to harm other shareholders and the firm itself. Such power is consistently the object of investigation and debate in academia, courtrooms, and political institutions.[125] It presents at least three anomalies.

First, as previously stated,[126] it comes with a horizontal reorganization of residual control rights independent of the quality-based controller selection.

Second, the actual influence of shareholders is neither *pro-capite* nor proportional to the size of a shareholder's investment. If *pro-capite* voting is atypical of corporations (but is the default rule in horizontally structured partnerships), the one-share one-vote (default) principle does not

[122] See *infra* Chapter 3, Part III
[123] *See infra* Chapter 3, Part III.
[124] *See infra* Chapter 3, Part III.
[125] *See supra* note 121.
[126] See *supra* Chapter 1, Part I.

necessarily entail governance power strictly proportional to the number of shares (or votes) shareholders hold. In fact, shareholders' influence on governance can be witnessed in multiple ways—corporate voting is only one form.[127] If an influential shareholder sells his stock, the purchaser will value the shares significantly higher than the aggregate market price of the shares. The amount paid increases even more if the seller is a controlling shareholder. "Influence" and "control" are an asset-like *status*.[128] Thus, they go beyond the transfer of shares, which explains the asymmetry between perfectly proportional governance power, based on the one-share one-vote principle, and the actual allocation of control among shareholders.[129]

The fact that governance influence is not proportional with the amount of shares held is an additional anomaly: unselected shareholders can gain a governance influence that is inconsistent with both common sense and a controller's fiduciary relationship with other members of the firm, and is harmful to the other shareholders.[130]

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[127] For an overview of the form in which shareholders can exercise influence and control over a firm, see BERLE & MEANS, *supra* note 57, at 207–18. See *infra* Chapter 3, Part II.

[128] See *infra* Chapter 3, Part II.

[129] A series of corporate governance theories explain this phenomenon, such as dispersed shareholders' rational apathy, but the capability of influence that shareholders exercise over directors (potentially even removing directors if they do not comply with dominant shareholders' enterprenaurial – and financial! – requests) ultimately creates the phenomenon. As Lynn Stout remarks, extensive shareholder influence over the board ultimately frustrates the ground-breaking feature of corporations as legal entities: the asset lock-in or, put differently, the insulation of the firm's assets from its equity holders (and their assets). In fact, "[a] controlling shareholder enjoys indirect power to extract corporate assets because she can easily remove and replace the company's board of directors if they do not follow her instructions. Only as directors become independent of shareholders, does asset lock-in become possible." STOUT, *supra* note 32, at 4. Within this framework, shareholders' limited liability, which is the flip-side of the separation between a firm's assets and shareholders' assets, seems to be missing the logical basis upon which it is founded, because the equity holders implicitly control the firm's assets, violating the bilateral insulation of assets.

[130] This is particularly true in critical moments in a firms' life. For instance, with high descriptive power, modern sophisticated case-law recognizes severe risks related to high-handed, powerful shareholders and the inefficacy of current policies and provisions to address related matters. In 2002, Delaware Judge Leo Strine stated: "barriers . . . would be insufficient protection because of (what I will term) the 'inherent coercion' that exists when a controlling stockholder announces its desire to buy the minority's shares. In colloquial terms . . . the controlling stockholder as the 800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support)." In re Pure Resources, Inc. Shareholders Litig., 808 A.2d 421, 436 (Del. Ch. 2002).

Third, the legal framework provides shareholders and directors with limited liability. For shareholders, however, limited liability is not balanced with a well-structured pattern of duties that accompany residual control rights and *de facto* influence.[131]

iii. Incentives for Psychopathic Shareholding

In addition, the lack of power to select shareholders implies that, even within a repeated-games context,[132] "bad" shareholders do not suffer disadvantages due to their reputations. Shareholders do not suffer reputational damages by exploiting corporations because, in the selection process, such shareholders actively participate, making the investment decision unilateral, with the shareholders selecting and the corporations selected. Therefore, shareholders do not suffer a reputational disadvantage by extracting private benefits and thus harming the corporations in which they invest.[133]

Moreover, shareholders could even benefit from enacting exploitative policies.

First, if a shareholder is a fund or investing company, the selection scheme requires consideration of three players: (i) the corporation, (ii) the "professional shareholder" (a fund or investing company), and (iii) the current and potential investor of the professional shareholder. Selection also requires two selection processes: (i) the investor's selection of a given professional shareholder, and (ii) the professional shareholder's selection of a given corporation.

In this scheme, reputation plays a counterintuitive role. Given the two grades of separation between the final investor—who selects the professional shareholder (fund or investing company)—and the corporation, the first will usually[134] select the professional shareholder based on the

[131] See *infra* Chapter 3, Part III.

[132] *See generally* Jean-Francois Mertens, *Repeated Games*, *in* PROCEEDINGS OF THE INTERNATIONAL CONGRESS OF MATHEMATICIANS 1528–77 (1986); GEORGE J. MAILATH & LARRY SAMUELSON, REPEATED GAMES AND REPUTATIONS (2006).

[133] See *infra* Chapter 3, Part III.

[134] An investor may consider other interests, such as the social impact of the investment, the sustainability of the industry, and reputational or other idiosyncratic effects.

expected return on her investment. Therefore, the market in which the professional investor has an incentive to build a reputation is the capital market, which is subject to the selection of investors. As in a second-degree relationship, regardless of professional shareholders' methods seeking to extract the highest profit from the corporation, funds' and investing companies' reputations may have a strictly positive relationship with the profit stream they can provide to their investors within a suitable timeframe. Furthermore, such a system creates a screen between the final investor and the corporation.

As a result, even if the investor could potentially exercise a moral objection about a corporation's exploitative anti-socioeconomic policy, the investor would not be aware of such a behavior. Therefore, potential and current investors will only have delayed and incomplete information about the ethical reputation of the professional shareholders, and only if the behavior of the professional shareholders reaches a level of relevancy that makes it germane and knowable to rationally apathetic investors. On the other hand, the professional shareholder will document and accurately explain any return on its investment to potential investors, thus creating an information asymmetry between the means of creating profit and the profit itself.[135]

In such a scenario, the professional shareholder might experience a reputational advantage by exploiting a corporation for two reasons: first, an aggressive (and even unfair) approach vis-à-vis the corporation could lead to a positive reputation vis-à-vis its current and potential investors if the returns so achieved are larger and the means for reaching them are hidden. Some final investors could even appreciate the skill of being able to exploit the corporation to extract value that is redistributed to investors via the professional shareholders.[136]

In other words, exploiting corporations for the sake of increasing returns might help professional shareholders build a "good" reputation with current and potential investors. Repeated

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[135] See *infra* Chapter 3, Part III

[136] This would not be the case if financial markets developed and endorsed a strong ethical shareholding culture.

games[137] cannot disincentivize this effect. In such a case, the separation between the investor and the corporation creates a system in which the entity that operates the selection would favor an aggressive policy by the professional shareholder, as long as the policy is economically beneficial to the investors (who also benefit from unethical behaviors without the need to enact them nor be aware of them).

The second point is that, through repetition of these dynamics, the professional shareholder might reach the counterintuitive beneficial effect of being able to expand its shareholding at a discount. Assume that at least part of the reasons that cause the corporation to be interested in having Warren Buffet as a shareholder also defines the worry of having a bad shareholder. If a bad shareholder acquires shares in a corporation, it will decrease the corporation's value and cause other shareholders to sell their shares in an attempt to precede the market perception of the decrease of value of the firm. In turn, this provokes a significant drop in the price of shares, thus providing a "bad" professional shareholder with access to discounted shares.

At this point, we could imagine two scenarios: one is the case of a fool shareholder, the other of a knave shareholder. The fool (either careless or incompetent) professional shareholder will probably harm the firm without an intention to profit from such carelessness or incompetence.

In contrast, the knave professional shareholder intentionally takes advantage of such a scheme to strengthen its position in the corporation at a discount and leverages the effects of its increasingly important position in the financial markets. Thus, the fear of the knave's "bad" influence turns into financial advantage because of the economic effect of its exploitative actions over a firm, in the form of a discounted share price.

In this way, a financial advantage eventually becomes a governance advantage, because such a shareholder can strengthen her governance power by buying discounted shares and gaining a

[137] See *supra* note 132.

more harmful position towards the firm, as well as other shareholders. This would create a vicious cycle, potentially lethal for the corporation.

In short, the "bad reputation" of the professional shareholder always disadvantages the corporation and sometimes benefits the knave shareholder.

Nevertheless, the fact that a professional shareholder is a fool or a knave makes a relevant difference in the related risks. The fool might harm the corporation with its incompetency, but does not necessarily intend to do so and does not take advantage of it. In contrast, the knave professional shareholder harms the corporation by intentionally extracting private benefits: operating in a discounted market, threatening the operation of the firm, and eventually siphoning assets.[138]

iv. Scope of the Work

In light of the previous discussion, this work advocates that insulated board governance is the best option available for public corporations, or, in the words Lynn Stout borrows from Winston Churchill, "the worst possible form of public corporation governance—except for the alternatives,"[139] in the interests of the shareholders, in those of the other stakeholders of the firm, and in those of the corporation itself.[140]

Additionally, this dissertation advocates assessing the personal qualities of those entitled to residual control rights that equity holders and other stakeholders who contribute to the firm's production with specific investments relinquish.

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[138] See *infra* Chapter 3, Part III.

[139] Stout, *supra* note 88, at 689.

[140] In fact, "a greater degree of board control increases a corporate entity's ability to lock in its assets because the board is free to act as a 'mediating hierarch' precluded by law from taking the corporate entity's assets for its own benefit. Unlike shareholders, a board structured to act like a mediating hierarch does not benefit from unlocking corporate assets before achieving the corporation's long-term goals. Placing control of the firm in the board's hands can thus increase the odds of the corporation's long-term survival. Stout, *supra* note 88, at 4 note 10.

Notwithstanding management by a selected board, shareholders ultimately retain governance influence that frustrates controller selection mechanisms. Therefore, this work warns that business organizations must address the dearth of shareholders' personal quality assessment.

To this end, this investigation proposes policies to cope with such a defective selection mechanism, namely: (i) heightening shareholders' legal exposure, (ii) implementing corporate strategies to introduce a selection bias and develop shareholders' cultivation, and (iii) requiring independent authorization to exercise voting rights over given thresholds of ownership.

v. Main Caveats

In order to carry out this work's stated objectives, pointing out some preliminary caveats seems prudent. As previously indicated, the use of the *societas consensu contracta* and of the "American" public corporation as opposing ends of the control rights relinquishment spectrum provides analytical clarity for governance patterns and relationships with the nature and goals of different business organizations. This requires a general warning, however, with respect to the accuracy and comparability of business associations with different locations in time and space. A diachronic perspective[141] appears particularly appropriate to investigate the evolution of the controller selection patterns, from a perfect overlapping between equity holding and controlling positions to the relinquishment of control rights over the firm to meet the economic needs that have arisen throughout time, among which are continuity, contract credibility, and efficient decision-making.

This work is principle-based, but emphasizes Roman law in a portion regarding Ancient Roman business associations, and federal and state law of the United States when considering features and anomalies of public corporations, as well as when suggesting policies to address such

[141] About the diachronic perspective, see Pietro Cerami, *Impresa e* Societas *nei Primi Due Secoli dell'Impero*, *in* AFFARI, FINANZA E DIRITTI NEI PRIMI DUE SECOLI DELL'IMPERO 163, 172–73 (Francesco Milazzo ed., 2012).

anomalies. In addition, bearing in mind the Italian jurisprudence's roots in Civil Law, as well as the prevalence of dominant shareholder control over Italian corporations, this work considers Italian law as a comparative benchmark.

More generally, the theory outlined in this work is incomplete, but aims to be only the starting point for investigating the implications on corporate governance of assessing public shareholders' personal qualities, with the end being to contribute to a sound comprehension of corporate governance dynamics from a novel standpoint.

CHAPTER 2. THE *SOCIETAS CONSENSU CONTRACTA*: ANALYSIS OF FEATURES AND LIMITS OF A BUSINESS ORGANIZATION PURELY BASED ON THE QUALITIES OF ITS EQUITY MEMBERS

Introduction

This chapter sketches out the evolution of joint-enterprise organizations, starting from a model structured around a brotherhood bond between equity members, and moving to a more impersonal model designed to provide greater continuity, stability, and financial support at the expense of selecting specific coventurers for their personal qualities.

The first part of this chapter is an overview of Ancient Rome's *societas consensu contracta*, a business association similar to modern partnerships. The focus is on the quasi-consanguinity bond among its equity members: the *fraternitas* (brotherhood), which probably arose out of the family-based business form and was the original Ancient Roman proto-joint-enterprise association. Mere consent of its equity members, the *socii*, formed a *societas consensus contracta*, and the *socii*'s wish or any change in their individual or collective status (as such, changes would affect the benefits of mutual selection) dissolved the association just as easily. Thus, the association dissolved upon the *socii*'s renunciation, death, change of civil status, or poverty of any equity member, as well as through legal action or when *socii* begin to act separately, each in furtherance of his own business interests.

The second part explains the problematic elements of the *societates consensu contractae* and legal solutions sought to meet the needs of the Ancient Roman economy. Some firms, due to their size, temporal perspectives, investment returns, complexity, or business objectives, required a more efficient and stable organization. Roman lawyers therefore conceived partial legal solutions to address the limits of the *societates consensu contracta* (e.g., the *negotio per servos communes* provided with *peculium*).

Contractual solutions, however, were insufficient to develop truly stable, perpetual business organizations. As discussed in Chapter 3 of this work, this led to the creation of legal business entities. The *societas publicanorum*, the archetype of the modern public corporation, was born out of the joinder between private business organizations and the concept of "*corpus habere*," i.e., of the fictional legal personality, a public law institution originally conceived to develop Rome's system of government.

SECTION I. FEATURES OF A *FRATERNITAS*-BASED BUSINESS ORGANIZATION MODEL

This section provides an overview of Ancient Rome's *societas consensu contracta*, a business organization that, similar to partnership, was formed upon the mere consent of its equity members, the *socii*, and dissolved when they chose or upon any change in their individual or collective status. Thus, the association dissolved upon renunciation, death, change of civil status, poverty of any *socius* as well as through legal action or when a *socius* began to act separately to further personal business interests.

This section emphasizes the *societas consensus contracta*'s groundbreaking characteristic: a quasi-consanguinity bond among its *socii*, the so-called *fraternitas*, which probably arose out of the family-based business form and was the original Ancient Roman proto-joint-enterprise association.

Furthermore, this section describes how such a fiduciary-based organizational scheme provided the *socii* the power to select one another based on both intrinsic (e.g., inner qualities, such as trustworthiness, skills, etc.) and extrinsic (e.g., social status) qualities, but also produced fragility, instability, and uncertainty for the joint-enterprise. These negative effects arose because the business association could terminate upon events outside the control of the *socii* (*inter alia*, death or will of any co-venturer) and their heirs could not succeed them in the association, entailing harm to the *socii*'s investments and harm to the firm through higher transaction costs in negotiating with third parties as well as harm to the firm's ability to borrow. Therefore, such associations could not sustain larger businesses or medium to long-term investment strategies.

A. Formation of a *Societas Consensu Contracta*

i. Organization of Business in Ancient Rome

Although the ancient Roman economy was largely based on the *negotiatio unius* (i.e., the sole proprietor), both archeological, economic, and juridical investigations confirm the coexistence of sole proprietorships and *negotiationes plurium* (i.e., joint-enterprises).[142] Thus, the form of agreements and subsequent governance of the relationships was crucial in the development of business.[143] Joint-businesses took multiple forms, such as the family or *per servos communes*,[144] either appointing co-owned slaves as *praeposti*[145], managers, of a firm (*institores* or *magister navis* depending on the industry) or as independent managers of business asset pools, the *peculium*, belonging to two or more owners, the *exercitores*.[146] In short, the structural difference between the *praepositio institoria* (appointing the *praeposti*) and the *peculium* is the legal instrument

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[142] In his book, *Law and Life of Rome*, Crook recounts how the postsherds from Monte Testaccio evidence this sort of ancient Roman joint business. Potters' stamps and painted abbreviations of names on the remnants of a jar in which foodstuff were brought to Rome indicate the names of the joint-enterprise that produced the jar. Specifically, "the two Aurelii Heraclae, father and son," "the Fadii," "Cutius Celsianus and Fabius Galaticus," "the caecilii and freedmen," "the two Junii, Melissus and Melissa," "the partners Hyacinthus, Isidore and Pollio," and "L. Marius Phoebus and the Vibii, Viator and Restitutus." J.A. CROOK, LAW AND LIFE OF ROME 212, 229 (1967). On the employ of joint-enterprise in ancient Rome, see generally Hansmann & Kraakman, *supra* note 8.

[143] *See* Pietro Cerami, *supra* note 141, at 203.

> The *negotatio per servos communes* was characterized by two foundational elements: a slave and the *peculium* entrusted to him. Two or more partners were co-owners of a slave endowed with certain assets, the *peculium*, with which he ran a business but which formally remained property of his masters. The attribution of a *peculium* to a slave was not subject to specific formalities; rather, the owner's attribution of assets was to be inferred from the slave's actual management of such assets.
>
> The *peculium* realized a partitioning of the master's assets, defined as "separation" by the Roman jurists: the peculium is described as ". . . the property which the slave, with his master's permission, keeps in a separate account of his own, less anything owed to the master . . ." This partitioning was relevant for the determination of the master's liability and, possibly, entity shielding. There were also possible variations concerning the *peculium*, its internal compartmentalization, the hierarchical organization of the business, and the degree of owners' control, which allow for a host of different business structures serving heterogeneous commercial purposes. Although it is not clear how extensively this format was used in practice, legal and epigraphic sources demonstrate its actual use in some medium-scale businesses.

Barbara Abatino, Giuseppe Dari-Mattiacci & Enrico C. Perotti, *supra* note 89, at 372-73.

[145] According to Földi, besides slaves, sons and free persons outside a family also served as *magister navis* or *institor*: "sons and slaves . . . were of course no legal owners of their enterprise but they can be named enterpreneurs and *quasi owners*, and not simple managers as having considerable autonomy in their business activities." András Földi, *Remarks on the Legal Structure of Enterprises in Roman Law*, 43 RÉVUE INTERNATIONALE DES DROITS DE L'ANTIQUITÉ 179, 188 (1996).

[146] For a more detailed description of the features of the *peculium*, see *infra* Chapter 2, Part IIBiii.

that the *peculium* brought along: partitioning assets forming the *peculium* from the rest of the assets of the *exercitores*, i.e., the people who pooled together their assets and appointed the slave to manage them. Moreover, the Romans developed an arrangement to share a joint-enterprise's profits and losses in the form of a relational agreement perfected[147] by mere consent: the *societates consensu contracta*, often translated as "partnership"[148] or shortened to *societas*.

Thus, *societas* was the technical name[149] of a qualified association[150] between two or more people, called *socii* (or the singular *socius*), based on mutual consideration of each persons' qualities and an actual desire to be bound together to reach a common interest. Agreement without formalities "by act, by words, or through a messenger" formed this relationship and produced specific obligations among the *socii*.[151]

Despite some significant differences, such as a lack of mutual agency among equity members,[152] *societates* were largely similar to modern partnerships.[153] The regulation of these

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147 See *supra* Chapter 1, Part I.

148 See *supra* Chapter 1, Part I.

149 The term *societas* was used colloquially, both before and simultaneous to its technical use, to indicate the bond among parties sharing ownership or other interests, sharing and the same social or professional conditions, or being foreign allies. *See* ANTONIO GUARINO, STORIA DEL DIRITTO ROMANO 68 (4th ed. 1969). Similar to the modern use of the word "partner" outside the business organization context, these parties referred to each other as *socii.* These concurrent uses of the term *societas* find a point of contact in the consideration of each person's qualities and the selection of *socii* whom to associate with and be bound to—both essential to the functioning of *societas* as a legal institution entity.

150 The second part of the seventeenth book of *Domini Nostri Sacratissimi Principis Iustiniani Iutis Enucleati Ex Omini Vetere Iure Collecti DIGESTorum Seu Pandectarum*, more commonly known as the DIGEST of Justinian, is an invaluable source of information about Ancient Roman business associations and of insights on issues among their constituencies. It is entitled "Pro socio" and principally deals with the provisions regulating the *societas*. *See* DIGEST 17, *in* 2 THE DIGEST OF JUSTINIAN *supra* note 62, at 21, 54; *see also* THE INSTITUTES OF JUSTINIAN (J.B. Moyle trans., The Lawbook Exch. 5th ed. 2002) (1889); INSTITUTES OF ROMAN LAW BY GAIUS (Edward Poste trans., E.A. Whittuck ed., 1904).

151 "*Societatem coire et re et verbis et per nuntium posse nos dubium non est*." DIGEST 17.2.4 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 40.

152 Under current partnership regulation, "each partner is an agent of the partnership for the purpose of its business." Revised Uniform Partnership Act § 301(1) (1997).

153 Buckland and McNair observe that "*societas* corresponds roughly to our partnership but differs from it in many important ways." W.W. BUCKLAND & ARNOLD D. MCNAIR, ROMAN LAW AND COMMON LAW: A COMPARISON IN OUTLINE 300 (1952). With respect to the differences between current partnerships and *societates* Hansmann, Kraakman, & Squire emphasize that:

> Beyond joint enterprise, however, the *societas* had little in common with the modern partnership form. For one thing, the *societas* lacked mutual agency; each partner had to endorse a contract to be bound by it. Partners also did not stand behind one another's obligations: the default rule of liability when they cosigned a debt was pro rata rather than joint and several. More generally, Roman law made no distinction between the obligations and assets of the *societas* and those of its members, precluding the rules of weak asset partitioning that characterize the modern partnership. All the more did the *societas* lack strong entity

organizations revolved around the will of the equity members to bind to each other. The scope of the enterprise had to be mutually shared lawful ("one of a band of robbers could not bring proceedings for division of the spoil"[154]), and useful. Most of the time, the aim of *societates* was profit, but, in contrast to current partnerships,[155] a financial goal was not necessary.[156] For-profit *societates* were described as *propter quaestum* and entitled *societates quaestuariae* or *societas quaestus*, distinguishing them from non-profit *societates non quaestuariae*.

With regard to the formation of the confidential bond characterizing such business organizations, both then and now,

> [i]t is not enough that two parties have agreed together to act in concert to achieve some stated economic objective. Such agreement, by itself, creates no more than a contractual obligation; otherwise, every stockholder agreement would give rise to a joint venture. The fiduciary obligation arises upon the coagulation of property, profits, or other interests that the parties can then be said to hold jointly and which are made accessible to each other in terms of the confidential relationship which exists between joint associates.[157]

> shielding: although partners could agree not to withdraw firm assets before the expiration of a term, Roman law enforced such contracts through damages rather than specific performance, making a partner just one among many potential creditors grappling for his copartner's assets when that copartner fell insolvent.

Henry Hansmann, Reinier Kraakman, & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1356 (2006). Even if the lack of agency differentiates the two types of organizations, Blair points out that decisionmaking in modern partnerships is still strongly individualized because "partners have the legal authority to bind each other in contracts with outsiders, [and therefore] partnership law requires that all partners approve before new partners can be admitted, or major transactions or sales of property undertaken." Blair, *supra* note 58, at 411.

154 W.W. BUCKLAND, A TEXT-BOOK OF ROMAN LAW FROM AUGUSTUS TO JUSTINIAN 505 (1921).

155 *See* Revised Uniform Partnership Act § 101(6) (1997)

156 *See* BUCKLAND & MCNAIR, *supra* note 153, at 300.

157 Hasday v. Barocas, 10 Misc.2d 22, 26 (Sup. Ct. N.Y. County 1952) (internal citations omitted).

ii. The Societas Consensu Contracta *as* Modus Vivendi

The contract to form a *societas* was one of the four classes of *contracti* [158] that the *ius civile nuvum* permitted and regulated.[159] Mere *consensus in idem placitum* perfected these contracts,[160] which the *socii* could express in any form (including tacit)[161] and did not require any formalities. Thus, the resulting obligations were called *obligationes consensu contractae*,[162] meaning that they became effective on the mere consent of the parties, as distinguished from obligations that required specific procedures and forms to be executed and enforced, such as the *stipulatio*[163] (or the *stipulatio iuris gentium*[164]). Therefore, this "partnership-flavored" business organization was named *societas consensu contracta*.

In fact, characterizing the relation and agreement as a *societas* determined the rules applicable to the venture. Buckland and McNair explain that

> If you and I rent a field for our common use as a lawn-tennis court, we are *socii*, and our relation is *societas*, as much as if we had bought it to lay out in building sites, and we are thus subject to obligations which differ from those which result from mere common ownership. Indeed it may be that . . . any common ownership voluntarily created amounted to a *societas*.[165]

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158 The other contracts that the *ius civile novum* —or *ius gentium*—provided, and are formed by mere consent, are: *emptio-venditio*—a sale contract; *mandatum* —a mandate contract; and *locatio-conductio* —an employment contract. *See* WILLIAM L. BURDICK, THE PRINCIPLES OF ROMAN LAW AND THEIR RELATION TO MODERN LAW 442(1938); *see also* GUARINO, *supra* note 149, at 287–89.

159 *See* GUARINO, *supra* note 149, at 287.

160 About the moment of the perfection of the formation, Ulpian in "book 31 of the Edict" recounts that

> *Si id quod quis in societatem contulit exstinctum sit, videndum, an pro socio agere possit. Tractatum ita est apud Celsum libro septimo DIGESTorum ad epistulam Cornelii Felicis: cum tres equos haberes et ego unum, societatem coimus, ut accepto equo meo quadrigam venderes et ex pretio quartam mihi redderes. Si igitur ante venditionem equus meus mortuus sit, non putare se Celsus ait societatem manere nec ex pretio equorum tuorum partem deberi: non enim habendae quadrigae, sed vendendae coitam societatem. Ceterum si id actum dicatur, ut quadriga fieret eaque communicaretur tuque in ea tres partes haberes, ego quartam, non dubie adhuc socii sumus* [we should consider wheter an actio pro socio is available in the case where a person's contributron to a partnership is lost. Celsus, in the seventh book of his *DIGEST*, has this discussion in relation to a letter from Cornelius Felix: you had three horses and I one, and we formed a partnership on the terms that you would take my horse, sell the horses as a team of four, and give me a quarter of the proceeds. Then my horse dies before the sale. Celsus says that in his opinion the *societas* no longer exist, and I am owed no part of the price received from the sale of your horses; for the *societas* was made not to form but to sell a team of four. If, however, it was specified thata a team of four should be formed, that it should be owned in common, and that your share in it would be three quarters and mine one quarter, then we would certainly still be *socii* .]

DIGEST 17.2.58 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 47.

161 *See* BUCKLAND & MCNAIR, *supra* note 153, at 505.

162 For a deeper analysis of *obligations consensu contractae*, see GUARINO, *supra* note 149, at 287.

163 *See* BURDICK, *supra* note 158, at 433.

164 *See* GUARINO, *supra* note 149, at 287.

165 *See* BUCKLAND & MCNAIR, *supra* note 153, at 227.

They suggest that, regardless of the presence a financial goal, the relationship among two or more individuals could give rise to a *societas* as long as they share a common, useful purpose and they desire to bind each other under *societas* specific obligations.

In similar terms, in book 31 of the Edict, Ulpian narrates that

> Mela writes that if neighbors have made a space of half a foot for their joint use, with a view to putting up a wicker wall between their houses to carry the weights of both of them, and then, with the wall erected one of them will not allow anything to be built into it, an action on partnership is available. In the same way, again according to Mela, where they buy a piece of ground for their common use in preventing obstruction of their light and it is given over to one of them and he does not make available to the other, as was agreed upon, then there is an *actio pro socio* [the typical legal action on *societates*].[166]

Whereas Ulpian provides instances that potentially concern the establishment of a *societas consensu contracta*, to better understand their formation, one must focus on the intention to actually establish a *societas*.[167] To this end, Radin offers a useful key to understanding the boundaries between mere joint interests and *societates*, pointing out that

> *joint ownership could arise in many ways without anything that can be called a contract being involved. Two men, otherwise unconnected, might find themselves joint heirs of the same testator, joint donees of the same grantor. And this situation might continue an appreciable time by sheer acquiescence, without any wish to engage in mutual responsibilities toward each other. But at the same time, the two owners must decide upon a* modus vivendi, *if they had not done so at the beginning; and, when they do so, the relation between them would be called a partnership,* societas [*unius rei*—a partnership in respect to a single thing], *at Roman law.*[168]

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[166] DIGEST 17.2.52.13 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 46–47 (
Mela scribit, si vicini semipedes inter se contulerunt, ut ibi craticium parietem inter se aedificarent ad onera utriusque sustinenda, deinde aedificato pariete alter in eum immitti non patiatur, pro socio agendum. Idemque et si aream in commune emerint, ne luminibus suis officeretur, et alteri tradita sit nec praestet alteri quod convenit, pro socio actionem esse).

[167] On the cruciality of intention, Ulpian, in Edict, book 31, points out that
Cum duobus vicinis fundus coniunctus venalis esset, alter ex his petit ab altero, ut eum fundum emeret, ita ut ea pars, quae suo fundo iuncta esset, sibi cederetur: mox ipse eum fundum ignorante vicino emit: quaeritur, an aliquam actionem cum eo vicinus habeat. Iulianus scripsit implicitam esse facti quaestionem: nam si hoc solum actum est, ut fundum Lucii Titii vicinus emeret et mecum communicaret, adversus me qui emi nullam actionem vicino competere: si vero id actum est, ut quasi commune negotium gereretur. Societatis iudicio tenebor, ut tibi deducta parte quam mandaveram reliquas partes praestem. 1. Venit autem in hoc iudicium pro socio bona fides [a farm adjoining two others came uo for sale. The owner of one of the two adjoining properties asked the other to buy the farm, but to make over to him that part which was adjacent to his own farm. Soon afterward he bought the farm himself without informing his neighbor. Does the neighbor have an action against him? Julian says a question of fact is involved. For if the intention was merely that the neighbor buy the farm of Lucius Titius and shares it with me, he has no action against me if I buy the farm. If, on the other hand, the intention was to proceed as if we had a joint interest, then I will be liable, under the *actio pro socio*, to force me to hand over to you the shares remaining after that part which was the subject of my mandate has been deducted. Good faith comes into the reckoning in this *actio pro socio*.]
DIGEST 17.2.52 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 45–47.

[168] RADIN, *supra* note 62 at 259.

Thus, it was *societas*, and not mere common ownership, only if the parties embraced a given *modus vivendi*—the inclination to form a *societas*, also known as *affectio societatis*, and the confidential bond of brotherhood, "*since* societas *implies, in a sense, a law of* fraternitas."[169]

In short, *affectio societatis* is the actual intention to associate with someone as venturers.[170]

The *modus vivendi* that Radin refers to is the conceptual moment that represents the shift from mere common ownership to the application of the *societas* regulations. This *modus vivendi* consists of the will to form a relationship with one or more people who mutually recognize in their qualities the potential to be *socii*, thereby accepting a position of vulnerability and the duties it entails. [171]

In other words, as the court remarked with reference to present-day joint ventures in Hutchinson v. Birdsong: "to constitute a joint venture, it is not sufficient that the parties share in the profits and losses; but there must be, in addition, an intention of the parties to be associated together as partners, either as general partners, or for the more limited duration of a joint adventure."[172]

Conversely, as in the words of Ulpian,

> *Goods can be treated as held in common also outside a* societas*, as, for example, when we come to share ownership without having any* affectio societatis. *This occurs when goods are bequeathed as a legacy to two people or if goods are purchased by two people acting together or if an inheritance or gift comes to us jointly or if we independently purchase from two people their respective shares in a* societas *without ourselves having any intention to form a* societas."[173]

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[169] DIGEST 17.2.63 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 49–50 ("c*um societas ius quodammodo fraternitatis in se habeat*"); *see also* BUCKLAND, *supra* note 154, at 504 ("The relation involved '*affection societatis*,' and the existence of this set up specially confidential relations sometimes called '*fraternitas*.'").

[170] *See* Taubman, *supra* note 3, at 645.

[171] *See* Blair, *supra* note 58, at 411 n.77 (

> In a contemporary example of the importance of the hold-up problem to the organizational design of businesses, D. Gordon Smith describes the vulnerability of entrepreneurs to venture capitalists and vice versa over the question of when and on what terms the other party can exit. Smith notes that "neither an entrepreneur nor a venture capitalist would be willing to enter a relationship in which the other had unconstrained power over the exit decision." Holger Müller and Karl Wärneryd discuss these problems with partnerships, and suggest that the corporate form makes possible "outside ownership," which they argue can reduce the costs associated with these problems under some circumstances.

(internal citations omitted)).

[172] Hutchinson v. Birdsong, 211 A.D. 316, 319 (1st Dep't 1925).

[173] DIGEST 17.2.31 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 43 (

iii. The Bond of Fraternitas *among* Socii

Societates consensu contractae did not distinguish between the assets and liabilities of the organization and those of its equity members,[174] therefore risks deriving from *socii*'s defects or f generally exploitative attitude were potentially unlimited. Thus, unsurprisingly, although a *societas* does not require formalities, it was successfully formed only if the parties were conscientiously inclined to live according to the bond of *fraternitas*, which regulated the equity members' vulnerability and power, as well as the soundness of their relationship. For this reason, in forming *societates*, "people engaged themselves to each other as they were, with their imperfections on their heads."[175] Embarking on a partnership required an understanding of coventurers' personal characteristics and business preferences. The Romans used to say, "If a man chooses as his partner a careless person, he has no one to blame but himself."[176] The selection of fellow-equity members brought the corollary that *socii mei socius, socius meus non est*:[177] the external *socius* of an equity member

Communiter autem res agi potest etiam citra societatem, ut puta cum non affectione societatis incidimus in communionem, ut evenit in re duobus legata, item si a duobus simul empta res sit, aut si hereditas vel donatio communiter nobis obvenit, aut si a duobus separatim emimus partes eorum non socii futuri.)

In book 2 of the Edict, Ulpian states

Nam cum tractatu habito societas coita est, pro socio actio est, cum sine tractatu in re ipsa et negotio, communiter gestum videtur [Where a [societas] has been formed after deliberation, [the *pro socio*] is available; where, on the other hand, people have become associated without deliberation in the course of things and out of the business itself, then this is to be seen as a case of management in common.]

DIGEST 17.2.32 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 44. Such position needs to be contextualized and intrerpreted in accordance with the principle providing that "no form was necessary, and thus the consent might be tacit.

174 For a comparison with modern corporations, see *infra* Chapter 3, Part IB.

175 *See* RADIN *supra* note 1682, at 260; Justiniani Institutiones, 3.25.9 *in* THE INSTITUTES OF JUSTINIAN, *supra* note 150.

176 Justiniani Institutiones 3.25.7 *in* THE INSTITUTES OF JUSTINIAN, *supra* note 150. This section focuses on the standard of diligence that the *socii* required in managing a *societas*:

Socius socio utrum eo nomine tantum teneatur pro socio actione, si quid dolo commiserit, sicut is qui deponi apud se passus est, an etiam culpae, id est desidiae atque neglegentiae nomine, quaesitum est: praevaluit tamen, etiam culpae nomine teneri eum. Culpa autem non ad exactissimam diligentiam dirigenda est: sufficit enim talem diligentiam in communibus rebus adhibere socium, qualem suis rebus adhibere solet. nam qui parum diligentem socium sibi adsumit, de se queri, hoc est suae id imprudentiae imputare, debet. [It has been doubted whether one partner is answerable to another on the action of partnership for any wrong less than fraud, like the bailee in a deposit, or whether he is not suable also for carelessness, that is to say, for inattention and negligence; but the latter opinion has now prevailed, with this limitation, that a partner cannot be required to satisfy the highest standard of carefulness, provided that in partnership business he shows as much diligence as he does in his own private affairs: the reason for this being that if a man chooses as his partner a careless person, he has no one to blame but himself.]

177 DIGEST 17.2.20 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 42.

in a given *societas* do not become equity members of such *societas*. If the equity member allowed his external *socius* to commingle with firm business, the first equity member would be responsible for acts of the second, and could not avoid liability by ceding control to the second.[178] Furthermore, because the *societas* required active managerial participation by equity members, "there was no possibility of 'sleeping' partners,"[179] and thus of passive investment.[180] This is consistent with the importance of considering each person's character and with the *societas consensu contractae*'s governance framework.[181]

The *animus coeundae (contrahendae) societatis* or, more often, the *affectio societatis*, was the inclination of coventurers to bind one another in a *societas*. Therefore, the *affectio societatis*[182]

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[178] *See* BUCKLAND, *supra* note 154, at 507, 510 (pointing out that in case the sub-societas "was formed merely in respect of the concerns of the principal firm, it necessarily ended if that ceased to exist").

[179] *See* CROOK, *supra* note 142, at 230.

[180] See *infra* Chapter 3 Section 1-B.

[181] In general the *socii* were, as against third persons, so many individual men: one who had contracted with one [*socius*] had no right or liability as against the others. If all took part in the contract all were liable or entitled *pro rata*, or, if they were *correi*, in *solidum*. And there were exceptional extensions. The *actiones institoria* and *exercitoria* lay *in solidum* against any of them. If a *socius* was acting under a mandate of another or others, the *actiones utiles* which arose out of mandate would apply. Some special types of *societas* created solidary liability. And under Justinian, but probably not before, a creditor of one could sue the others by an extended *actio de in rem verso*, [so far as he had profited].

BUCKLAND, *supra* note 154, at 507.

[182] In addition to distinguishing *societates* from communities of interest, *affectio societatis* appears to be the determinant element distinguishing *societas* contracts from lending contracts. For instance, Uplian provides the following example of a *societas mixta*, which is formed with different kinds of contributions:

> *Flavius Victor and Bellicus Asianus had agreed that monuments should be erected with the exertions and skill of Asianus on land purchased with Victor's money. They would then be sold. Victor would recover his money with the addition of an agreed sum, and Asianus would get the rest in recognition of the hard work he had put into the* societas. *Papinian's ruling was that there is a right of* actio pro socio *here.* [I*nter Flavium Victorem et Bellicum Asianum placuerat, ut locis emptis pecunia victoris monumenta fierent opera et peritia Asiani, quibus distractis pecuniam Victor cum certa quantitate reciperet, superfluum Asianus acciperet, qui operam in societatem contulit: erit pro socio action*].

DIGEST 17.2.52.7 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 46. Under a modern perspective, the relationship between Flavius Victor and Bellicus Asianus might seem to be a loan because "Victor would recover his money with the addition of an agreed sum." Papinian's interpretation qualifying the relationship as a *societas*, however, appears consistent with contemporary business law principles and ancient Roman law for two categorical reasons. The first category involves risk bearing: Victor only had a fixed claim and did not benefit from profit above that fixed amount, but, without the right to enforce such claim at will, Victor was only able to enforce his claim after Asanius sold the monuments, thus bearing the enterprise risk together with Asianus. The second categorical reason regards the parties' intention to commit themselves to *societas* dynamics: in particular, the *affectio societatis* based on the mutual *intuitus personae*. Although the first categorical reason provides a compelling argument to characterize the relationship as a *societas*, the psychology of the partiesmust originate a *societas* to form it. Furthermore, the agreement in question seems to respect the *societas leonina* prohibition. Under a different point of view, to regulate the *socii's* loans to the *societas* (as opposed to a loan to a partner,), Ulpian recounts that a *socius*:

> [R]estores parts of one or more apartment-blocks that need repair. He can either recover his principal with interest [at an agreed rate] in four months, after the work is completed, and make use of his preferential right to exact it, or he can take the property over forthwith as his own. Nevertheless, it is also open to him to proceed

distinguished the *societas* from communal property (*communio*) and from the slave-managed business (*negotiatio per servos communes*). The *affection societatis* also entailed specific regulations, for example, governing lawsuits,[183] causes of termination, and transferability of the participation[184].

A *societas*' objective, could be (i) all present and future assets of the *socii*—*societates omnium (totorum, universorum) bonorum*, also called *societates universarum fortunarum*; (ii) all of the *societas*' future profits (i.e., not assets from other activities such as inheritance or donation)—*societates universorum (omnium) quae ex quaestu veniunt*, also called *societates questus, lucri, compendii*; or (iii) one or more specific assets—*societates alicuius (unius) rei*.[185]

In the absence of an express provision, a *societas*' objective was any future profit derived from the *socii*'s under the *societas* agreement*,* the *societates universorum (omnium) quae ex quaestu veniunt*. Thus, as mentioned above, assets received via donations or inheritance were not generally a *societas*' objective.[186]

iv. Contributions and Shares

In addition, because a *societas* was plainly a contract with consideration, each *socius* was expected to contribute something (*quid pro quo*).[187] Accordingly, each *socius* was contractually required to provide agreed upon capital in different forms and amounts. With respect to such forms, the *societas* was referred to as *rerum* if the contribution consisted only of funds and goods (including money, wares, real estate, and credits). Conversely, the *societas* was referred to as *operarum*

> by an actio pro socio to this end, to obtain what was due to him. He may, of course, choose to secure what is due to him rather than acquire ownership of an apartment-block. An oration of the deified Marcus sets four months as the limit for the agreed interest, precisely because ownership is given after four months.

DIGEST 17.2.52.10 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 46.

183 The *societas* contract's enforcement mechanism was different from that of passing out of the community, respectively: the *actio pro socio* and the *actio communi dividundo*. *See* CESARE BERTOLINI, APPUNTI DIDATTICI DI DIRITTO ROMANO 760 (1907).

184 *See infra* Chapter 2, Part IBii.

185 *See* BERTOLINI, *supra* note 183, at 741–42.

186 *See* Cerami, *supra* note 1431, at 192.

187 *See* BUCKLAND & MCNAIR, *supra* note 153, at 301.

if the contribution consisted of only skills, labor, knowledge, experience, or reputation (homogeneity among the activities was not required—some *socii* could provide intellectual work and others manual work). If the contribution consisted of both of these categories of assets, the *societas* was called *mixta*.

If the *societas* owned the contribution in common, the *societas* was called *quoad sortem*; if the *societas* was only allowed use of the contribution, it was called *quoad usum*.[188] Furthermore, contributions could differ in terms of quality, quantity, and value. If a person contributed to the *societas* but did not participate in its profits and losses,[189] that contribution was only a gift and the person was not an equity member of the *societas*. Conversely, according to Radin, if the *socius* made no contribution yet still shared the profits, the agreement could have been void under the *societas leonina* prohibition.[190]

A *societas* that provides for a *socius* with all the profit and for others to bear all the loss would be void under the *societas leonina* prohibition. [191]

In light of the risks of exploitation intrinsic to the relationship between coventurers, as seen in Phaedrus' fable "The Cow, the Goat, the Sheep, and the Lion," the *societas leonina* limitation—that derives its name from that fable—was a mandatory rule. Although consistent with the *ratio* of the prohibition, the limits of the *societas leonina* probably did not apply to the initial contribution, but rather to ongoing profits and losses—which, especially in the absence of limited liability, were a very different thing from the initial contribution (as mentioned above, these could consist of intangible assets).[192]

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[188] *See* BUCKLAND, *supra* note 154, at 505.

[189] If he only participates in losses and not profits, it seems proper to consider the agreement void under the *societas leonina*.

[190] *See* RADIN, *supra* note 168, at 259.

[191] "*Societatem talem coiri non posse, ut alter lucrum tantum, alter damnum sentiret, et hanc societatem Leoninam solitum appellare: et nos consentimus talem societatem nullam esse, ut alter lucrum sentiret, alter vero nullum lucrum, sed damnum sentiret*." DIGEST 17.2.29.2 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 43.

[192] In fact, a *socius* admitted to participate in the *societas* without a formal initial contribution (but maybe in consideration of his standing or experience) would have participated in the losses (unless the *societas* contract provided otherwise). This did not violate the *societas leonina* prohibition.

Furthermore, because all equity members of *societates* were active participants in the governance of the association—serving as both contributors and managers—the choice to include a specific individual could lie exclusively in his decision-making qualities: "Who is to say which team member's contribution was more valuable, when all were essential to the venture?"[193] To put it another way, "the managers have to make an investment that is specific to the asset. This may consist of their specializing their human capital" and because in *societates*, all equity members are (although without direct agency) managers, their time and skills could legitimately be their "firm-specific" contribution.[194]

The default rule was that profits and losses were divided among the *socii* equally, but *societas* contracts generally overrode this default rule.[195] Within the *societas leonina* limitation, *societas* agreements could provide unequal shares to each *socius*, so that the share of profits for a *socius* might differ from his share in the losses.[196]

The rationale of such restriction lies in the fact that, within business organizations, the relationship between risk and governance power is a warranty of correct and diligent operation.[197] Such relationships play a pivotal role in all types of business organizations, thus being articulated in different geometries and applying to different constituencies.[198] Also with respect to profits and loss sharing in twentieth-century American joint ventures, Taubman remarks, "There must be the sharing of adventure by the associates, *i.e.,* the seeking of profits together with its correlative obligation of sharing of losses. . . . Adventure denotes two things: (a) *affectio societatis-the* intention

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[193] Blair & Stout, *supra* note 12 at 266.

[194] Blair & Stout, *supra* note 12, at 272 n.51 (quoting Raghuram G. Rajan & Luigi Zingales, see *supra* note 37, at 392).

[195] LORD MACKENZIE, STUDIES IN ROMAN LAW WITH COMPARATIVE VIEWS OF THE LAWS OF FRANCE, ENGLAND, AND SCOTLAND 228 (William Blackwood & Sons 1865).

[196] *See* BUCKLAND & MCNAIR, *supra* note 153, at 303.

[197] *See* A. GRAZIANI ET AL., MANUALE DI DIRITTO COMMERCIALE 199 (2013).

[198] Article 2265 of the Italian Civil Code still provides that any agreement by which one or more members do not share profits or losses is void.

to associate as venturers; and (b) the purpose of sharing in the results, good or bad, of the venture."[199]

v. The Consideration of the Personal Qualities of the Socius

There is some disagreement as to what degree a *societas* was able to exclude some *socii* c from profits or losses. In the words of Cassius, reported by Ulpianus, if one of the *socii* takes the profit and the other receives no gain, but sustains losses, such *societas* was void. In fact, a *societas* in which one *socius* suffered a loss and received no benefit was extremely unjust.[200] For Curzon,[201] Mackenzie,[202] and Buckland,[203] only an agreement that excludes a *socius* from profits (and not one which excludes a *socius* from losses) was void.[204] An agreement that excludes a *socius* from losses was valid based on the consideration of his essential qualities. Buckland, both alone and in his work with McNair, agrees on the possibility of wholly excluding a *socius* from loss,[205] suggesting that a "partner's qualities might be so valuable as to be worth having, even on these terms."[206] Buckland and McNair support their interpretation with the Digest of Justinian:

> Cassius holds that a *societas* can be formed in such a way that, while one of the *socii* will not be liable for any loss, the profit will be common to all. This, however, will only be valid (as Sabinus says) where the value of the services of the partner will be equal to the loss; for it frequently happens that the industry of one *socius* is of greater advantage to the *societas* than

199 *See* Taubman, *supra* note 3, at 644-45. In *Marston* v. *Gould* the court states that: "[a] share in the net profits is an interest in the profits and implies a participation in the profits and losses." Marston v. Gould, 69 N.Y. 220, 223 (1877). Taubman clarifies that "even though there is no express provision for sharing losses, one may be implied." Taubman, *supra* note 3, at 645. *See also* Haxton & Sons v. Rich, 267 A.D. 492, 495, (3d Dep't 1944); *and* Pierce v. McDonald, 168 A.D. 47, 55 (1st Dep't 1915).

200 "[*I*]*niquissimum enim genus societatis est, ex qua quis damnum, non etiam lucrum spectet*." DIGEST 17.2.29.2 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 43.

201 *See* LESLIE B. CURZON, ROMAN LAW 155 (1966).

202 A socius "may stipulate for two-thirds of the profit and to bear only one-third of the loss, or even to participate and to be entirely free from loss; and this will hold good as between himself and the other partners, whatever liability he may incur to strangers." MACKENZIE, *supra* note 195, at 228.

203 *See* BUCKLAND, *supra* note 154, at 505.

204 Under Italian law of business organizations any agreement that excludes a *socius* from participating in loss or profit is void and any structure (e.g., a shareholder agreement) that leads to the same effect is void as well (art. 2265 c.c.). *See* 2 Campobasso, DIRITTO COMMERCIALE (2012) at 80.

205 *See* BUCKLAND, *supra* note 154, at 505; BUCKLAND & MCNAIR, *supra* note 153, at 303.

206 BUCKLAND & MCNAIR, *supra* note 153, at 303.

the capital invested. The same rule applies if one partner alone makes a voyage by sea or land, as only he is exposed to danger.[207]

An interpretation that allows the *societas* to exclude a *socius* from loss in consideration for the particular benefits his equity membership brings is consistent with the consideration of each equity members' qualities. Nevertheless, the *logos* of this interpretation is questionable if we consider that the validity of these arrangements was essentially conditioned on a balance between the value *socius*' equity membership and the total potential losses of the organization. In fact, an upfront evaluation of the advantages and risks of a given *socius*' equity membership would require that the amount of possible loss is known, or at least knowable, at the moment of formation. Otherwise, such equity member's participation would have operated as a wager due to the unknown risks and the potential significant imbalance in value. Buckland and McNair explain that an imbalance between the value of intangible assets that an equity member contributed and his share in the profits was acceptable, "but the unfair advantage would be a [donation] and subject to restrictions on gifts."[208] Therefore, the exclusion of a *socius* from loss because of the advantage of his equity membership does not account for the unknown factors and was effectively a generic waiver of an equity member's liabilities, in conflict with the nature of the *societas*.[209] Notwithstanding such aporia, according to Buckland and McNair, such a provision would have been valid, but limited by the regulation of donation.

Furthermore, by virtue of the mutual consideration of each *socius*, it was possible to agree that one of the equity members would arrange share distribution and eventually correct the distribution if it was unfair. As pointed out by Buckland and McNair, such a provision is "as if one of the parties to a sale were to have the right to fix the price, a thing which was inadmissible."[210]

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[207] *See Id.* (citing DIGEST 17.2.29.1 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 43 ("*Ita coiri societatem posse, ut nullam partem damni alter sentiat, lucrum vero commune sit, Cassius putat: quod ita demum valebit, ut et Sabinus scribit, si tanti sit opera, quanti damnum est: plerumque enim tanta est industria socii, ut plus societati conferat quam pecunia, item si solus naviget, si solus peregrinetur, pericula subeat solus*.")).

[208] BUCKLAND & MCNAIR, *supra* note 153, at 303.

[209] Such a provision is void under Article 2265 of the Italian Civil Code.

[210] BUCKLAND & MCNAIR, *supra* note 153, at 304.

Ultimately, the presumption of loyalty among the equity members was so absolute that entrusting a theoretically fully conflicted fellow *socius* to arbitrate the assignment of shares was common. Once again, the initial selection of fellow equity members addressed any potential vulnerability, whose roles spanned from an equity holder to a manager, and even to a third-party arbitrator throughout the life of the *societas*.

B. Life of the ***Societas Consensu Contracta***

i. Governance of the Societas Consensu Contracta

With respect to governance, *socii* were not agents for each other nor agents of the *societas* itself (which was not an independent entity[211] from the *socii*, but rather a mere agreement to regulate the obligations among the equity members).[212] In addition, governance was individual: any equity member's act or contract *prima facie* bound only that *socius*.[213] A *socius* initiating an agreement with third parties, however, was liable to bring such acquisitions and contracts within the joint management of the *societas* and the other equity members were obligated to reimburse him in proportion to their respective shares.[214] Therefore, equity members did not bind the *societas*, nor other *socii* vis-à-vis third parties. The other *socii*, however, were liable if they had expressly or impliedly authorized, acquiesced in, ratified, or (to the extent of their enrichment) profited by, the acts.[215]

In such a scenario, active participation in management by all the equity members was not only appropriate, but also mandatory, serving both the interest of the *societas* and their own.

In the interest of the *societas*, some contracts, due to their subject or size, required the unanimous consent and action of all of the equity members. Therefore, passivity or apathy amongst the equity members would have harmed the functioning of the entire *societas*, potentially causing the failure of the business[216] and damaging the equity members collectively and as individuals.

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211 Today, however, partnerships are entities distinct from their partners. *See* Revised Uniform Partnership Act § 201(a) (1997).

212 *See* BUCKLAND, *supra* note 154, at 507.

213 Burdick explains that "[t]here were some exceptions to this rule, especially in the case of bank partners (argentarii) and partners engaged in slave trade, and shipmasters. Partners who transacted business through the captain of a ship or the manager of a shop were individually liable for contracts made by such representative." BURDICK, *supra* note 158, at 455.

214 The *actio pro socio* was the legal action that provided contribution against fellow partners if a *socius* was liable for a debt that a fellow *socius* contracted for the benefit of the *societas*. *Id.* at 455.

215 *See* RADIN, *supra* note 62, at 264.

216 *See* Hansmann, Kraakman & Squire, *supra* note 153, at 359; *see also* Buckland, *supra* note 154, at 507.

In their individual interests, each equity member who entered into a contract was required to bring the contract within the joint-management of the *societas*, while his coventurers were obligated to reimburse and support him in observance of the *fraternitas* bond. Furthermore, even in the absence of mutual agency within the *societas*, in some cases the *socii* were liable for acts of their fellow equity members.[217] Therefore, all the coventurers had claims against each other, notwithstanding the lack of agency vis-à-vis third parties. In fact, every time one or more equity members authorized a co-venturer to contract, they were liable for his agreements by the *actio institoria* or *quasi institoria*, but not entitled to act under the agreements.[218] In addition, as anticipated, the *bona fide* contract of a *societas* did not distinguish between the obligations and assets of the business organization and those of the *socii*, "precluding the rules of weak asset partitioning that characterize the modern partnership."[219] In other words, there was no limited liability of *socii*. Therefore, the financial condition of an equity member directly affected the assets and the operation of the *societas* and the personal interests of each equity member.

ii. Dependency on the Will and Fate of Socii

Fraternitas, in its manifestation as consistent *intuitus personae* and *affectio societatis* throughout the life of the firm, played a crucial role in shaping regulation of the duration and lifespan of the *societas*. Equity members favored the security that mutual selection of fellow equity members afforded over the continuity of the enterprise.

In fact, the *societas*' existence necessitated protecting the quality-based selection of each equity member and the equity members' persistent inclination to bind each other in a fiduciary-based joint-enterprise. This depended on conserving the qualities of the *socii*, both as individuals and collectively, and on their attitudes, to carry out the business together.

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[217] *See* RADIN, *supra* note 62, at 264.
[218] *See* BUCKLAND & MCNAIR, *supra* note 153, at 301.
[219] Hansmann, Kraakman, & Squire, *supra* note 153, at 1356.

Although the *socii* could agree *ab initio* that the organization would last through a certain term, from a particular moment, under certain conditions,[220] for a transaction (or for specific transactions), or *in perpetuum*,[221] the existence of the *societas* ultimately depended only on the *socii*.[222] Pragmatically, "no association of *societas* is formed for all time."[223]

Societates were dissolved *ope legis,* upon death,[224] or *latu sensu*, upon changes in the civil status of any *socius*.[225]

The absence of any separation between ownership and control together with the lack of asset partitioning in *societates* explains these strict dissolution rules. The governance role, the relevance of personal *status* and the mutual vulnerability of the equity members was so high that any disturbance of the *socii*'s personal qualities terminated the agreement between the coventurers. The perpetuity we are familiar with in corporate contexts, which allows the firm to survive a transfer of shares *inter vivos* or *causa mortis* and shields the existence of the enterprise beyond that of its transient equity members, is a very distant concept from *societates*' *in perpetuum, id est dum vivunt,* i.e. perpetuity subject to end when any of the partners dies (or otherwise causes the end of the enterprise).

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220 Buckland points out that notwithstanding the cited provision, the possibility of conditions has been in doubt. *See* BUCKLAND, *supra* note 154, at 505.

221 *Societas coiri potest vel in perpetuum, id est dum vivunt, vel ad tempus vel ex tempore vel sub condicione* [a societas could be formed either for all time, that is as long as the contracting *socii* live, or for a limited period of time or from a particular moment or under a condition.]

DIGEST 17.2.1 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 40; *see also* BUCKLAND, *supra* note 154, at 505.

222 "*Societas coiri potest vel in perpetuum, id est dum vivunt, vel ad tempus vel ex tempore vel sub condicione*." DIGEST 17.2.1 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 40.

223 "*Nulla societatis in aeternum coitio est*." DIGEST 17.2.70 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 52.

224 "*Adeo morte socii solvitur societas, ut nec ab initio pacisci possimus, ut heres etiam succedat societati. Haec ita in privatis societatibus*." DIGEST 17.2.59 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 48.

225 *Societas solvitur ex personis, ex rebus, ex voluntate, ex actione. Ideoque sive homines sive res sive voluntas sive actio interierit, distrahi videtur societas. Intereunt autem homines quidem maxima aut media capitis deminutione aut morte: res vero, cum aut nullae relinquantur aut condicionem mutaverint, neque enim eius rei quae iam nulla sit quisquam socius est neque eius quae consecrata publicatave sit. Voluntate distrahitur societas renuntiatione* [a [*societas*] was dissolved by changes in persons or things, by free choice, or through a legal action. So if either persons or things or the will or an action perish, then the societas is considered dissolved. People perish through a change in civil status, maximum or medium, or by death. Thing perish when nothing is left of them or they change their nature; you cannot be a partner in respect of something which no longer exists or which has been consecrated or confiscated. A [*societas*] is dissolved by a free decision when it is renounced].

DIGEST 17.2.64 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50.

For the same reasons, unlike in common ownership and slave-run business (wherein shares were transferable), *socii* could not transfer their shares in the *societas* to third parties by contract or inheritance.[226]

In contrast to current partnerships,[227] when forming a *societas*, *socii* could not agree that, at death, the business organization continued among the remaining equity members or with the heirs.[228] The specific personal qualities of each equity member were so important that the death of a *socius* necessarily ended the association for all; otherwise, someone might be made a *socius* against his will by someone with whom he did not wish to be associated.[229]

For the same reason, any changes in the civil status of fellow equity members had similar effects. Loss of liberty;[230] loss of *civitas* without loss of liberty;[231] change of family position;[232]

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[226] [A]lienation of the whole business (the slave with the peculium) . . . follows the same rules laid down for the general case of co-owned assets (communio). Absent an agreement to the contrary, each of the co-owners could convey his share of property to a third party, if this did not bring prejudice to the other co-owners. The third party who acquired the share would become a partner in the business.

Abatino, Dari-Mattiacci & Perotti, *supra* note 89, at 378.

[227] For a comparison with current regulation framework, see Revised Uniform Partneship Act §§ 601, 701, 801 (1997), as well as the regulation of Italian *societa' in nome collettivo*, see Italian Civil Code art. 2284, 2289. *See also* GRAZIANI ET AL., *supra* note 197, at 201; CAMPOBASSO, *supra* note 204, at 110.

[228] It is said in Inst. 3.25.5 that the death of a *socius* need not end the *societas* if a contrary agreement had been made *in coeunda societate*. This provision is probably due to Justinian, but in fact it means less than it appears. It means only that though the original *societas* is ended by death, the business does not necessarily stop: it may well go on, and usually will, but it will be a new *societas*.

BUCKLAND & MCNAIR, *supra* note 153, at 305. In simple words: the business survived but the organization ended.

[229] "*Societas quemadmodum ad heredes socii non transit, ita nec ad adrogatorem, ne alioquin invitus quis socius efficiatur cui non vult. Ipse autem adrogatus socius permanet: nam et si filius familias emancipatus fuerit, permanebit socius.*" DIGEST 17.2.65.11 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 51.

[230] In ancient Rome: *capitis deminutio maxima* (i.e. enslavement, involving loss of *civitas* and family rights). *See* BUCKLAND, *supra* note 154, at 134–41.On *capitis deminutio* generally, *see* BERNARDO ALBANESE, LE PERSONE NEL DIRITTO PRIVATO ROMANO 330 n.41, 335 n.55, 338 n.69 (1979).

[231] In ancient Rome: *capitis deminutio media* or *minor* (i.e. loss of *civitas* by perpetual banishment of a person condemned for a crime, the *deportatio*). *See* BUCKLAND, *supra* note 154, at 134–41.

[232] In ancient Rome: *capitis deminutio minima*. It involved rupture of agnatic ties, leaving liberty and *civitas* unaffected. Probably *capitis deminutio minima* caused termination of the societs only in classical law (i.e. in the period of the Universal Roman *Respubblica*, from the first century B.C. to the end of the Third Century A.D., or more precisely, from the bestowal of the *princeps* powers to *Augustus* in 27 B.C. to the end of the third military anarchy and the connected Diocletianus (284 A.D)., while in later law only *capitis deminutio maxima* and *capitis deminutio media* produced such effect. "For Gaius, [*capitis deminutio*] *minima* sufficied, though the parties could agree to renew. Where there had been a *capitis deminutio minima* and the *societas* continued, there were complex questions as to the rights of action on events before and after the change." BUCKLAND, *supra* note 154, at 509.

confiscation of one's property for conviction of a crime against the State;[233] compulsory sale;[234] or voluntary surrender of one's whole property in insolvency;[235]indigence[236] of any *socius*,[237] were all cause for termination of the entire business organization. These causes for termination include events that occur accidentally or that are outside the control of the *socii*.

In fact, *societates* terminated if the relationship among the equity members was corrupted or if the equity members sought to carry out joint-business. Early termination could be the effect of a voluntary act of any *socius* or the mere disinclination to bind each other: "the duration of a partnership depended upon the continuance of mutual consent."[238] Of course, if all *socii* agreed to discontinue the *societas*, the association was dissolved.[239] In addition, renunciation terminated

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[233] In ancient Rome: *publicatio bonorum*. *See* ADOLF BERGER, ENCYCLOPEDIC DICTIONARY OF ROMAN LAW 661 (1953). With respect to the *publicatio,* Paul points out that

> Publicatione quoque distrahi societatem diximus. Quod videtur spectare ad universorum bonorum publicationem, si socii bona publicentur: nam cum in eius locum alius succedat, pro mortuo habetur. [We have already said that partnership is dissolved also by confiscation. This is held to apply to the confiscation of a man's entire property, if man whose property was confiscated is a member of a partnership; if someone else succeds to his position, he is treated as dead.]

DIGEST 17.2.65.12 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 51.

[234] In ancient Rome: *bonorum venditio*. *See* BERGER, *supra* note 233, at 377. With respect to *bonorum venditio*, Paul points out that "bonis a creditoribus venditis unius socii distrahi societatem Labeo ait. [Labeo says that a partnership is dissolved when a partner's good has been sold by his creditors]." DIGEST 17.2.65.1 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50.

[235] In ancient Rome: *cessio bonorum*. *See* BERGER, *supra* note 233, at 387.

[236] In ancient Rome: *egestas*. *See id.* at 451. With reference to current partnerships, Blair explains that "[o]ne reason why the personal bankruptcy of one of the partners would compel dissolution of the partnership is that the creditors of the bankrupt partner would have a claim against partnership assets to pay the debts owed by the bankrupt partner." Blair, *supra* note 58, at 410 n.70.

[237] *See* BERTOLINI, *supra* note 183, at 798.

[238] BURDICK, *supra* note 158, at 456.

[239] "*Diximus dissensu solvi societatem: hoc ita est, si omnes dissentiunt* [We said above that the *societas* is dissolved when it is agreed that it be discontinued, that is, when all parnters are of this mind.]" DIGEST 17.2.65.3 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50.

societates,[240] "through legal action,"[241] or if "*socii* began to act separately and each to further his own business interests."[242]

<u>*iii. Renunciation and Termination of the* Societas Consensu Contracta</u>

In fact, the equity members of a *societas* could, despite an agreement to the contrary,[243] withdraw at any time, even though they had fixed a definite period of equity membership.[244] The *fraternitas* bond could not last beyond the wishes of the *socii*.[245] Therefore, equity members of *societates* could not be required to remain in a partnership against their will,[246] and renunciation by any *socius* ended the *societas*.

Nonetheless, if a *socius* fraudulently renounced, renounced in breach of an agreement not to do so, or if renouncing entailed the loss of his services or capital, he could be held liable for damages.[247] It was said that the renouncing *socius* freed his fellow equity members from their bonds

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240 "*Voluntate distrahitur societas renuntiatione* [A *societas* is dissolved by a free decision when it is renounced.]" DIGEST 17.2.64 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50.

241 Proculus enim ait hoc ipso quod iudicium ideo dictatum est, ut societas distrahatur, renuntiatam societatem, sive totorum bonorum sive unius rei societas coita sit. [Proculs says that a societas is ipso facto renounced when legal proceedings have been launched with a view to dissolving the societas and this is so wheter the partnership was in all goods or in one thing.]

DIGEST 17.2.65 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50.

242 "C*um separatim socii agere coeperint et unusquisque eorum sibi negotietur, sine dubio ius societatis dissolvitur* [when partners begin to act separately and each other to further his own business interests, there is no doubt that the legal relationship of partnership is dissolved.]" DIGEST 17.2.64 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50.

243 *Quid tamen si hoc convenit, ne abeatur, an valeat? Eleganter Pomponius scripsit frustra hoc convenire: nam et si non convenit, si tamen intempestive renuntietur societati, esse pro socio actionem.* [But if an agreement against dissolution is made, does it have validity? Pomponius, in a neat answer, says that such an agreement is null and void, adding that even in the absence of such a clause, if the partnership is renounced at an inopportune moment, an action on partnership is available.]

DIGEST 17.2.14 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 41; *see also* BUCKLAND, *supra* note 154, at 508.

244 *See* BUCKLAND & MCNAIR, *supra* note 153, at 305.

245 For a broader discussion on the limits to renunciation, see *infra* Chapter 2, Part IIAiv.

246 *See* BURDICK, *supra* note 158, at 456.

247 *Cassius scripsit eum qui renuntiaverit societati a se quidem liberare socios suos, se autem ab illis non liberare. Quod utique observandum est, si dolo malo renuntiatio facta sit, veluti si, cum omnium bonorum societatem inissemus, deinde cum obvenisset uni hereditas, propter hoc renuntiavit: ideoque si quidem damnum attulerit hereditas, hoc ad eum qui renuntiavit pertinebit, commodum autem communicare cogetur actione pro socio. Quod si quid post renuntiationem adquisierit, non erit communicandum, quia nec dolus admissus est in eo. Item si societatem ineamus ad aliquam rem emendam, deinde solus volueris eam emere ideoque renuntiaveris societati, ut solus emeres, teneberis quanti interest mea: sed si ideo renuntiaveris, quia emptio tibi displicebat, non teneberis, quamvis ego emero, quia hic nulla fraus est: eaque et Iuliano placent. Labeo autem posteriorum libris scripsit, si renuntiaverit societati unus ex sociis eo tempore, quo interfuit socii non dirimi societatem, committere eum in pro socio actione: nam si emimus mancipia inita societate, deinde renunties mihi eo tempore, quo vendere mancipia non expedit, hoc casu, quia deteriorem causam meam facis, teneri te pro socio iudicio. Proculus hoc ita verum esse*

to him, but did not free himself from his bonds to them.[248] Such provisions applied regardless of any specific warning in the contract concerning renunciation because of the *fraternitas* bond[249] that formed the enterprise.[250]

Similarly, *socii* might be held liable if the *societas* was for a fixed term.[251] Although, there were circumstances that justified early renunciation and protected a renunciating *socius* from liability, such

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ait, si societatis non intersit dirimi societatem: semper enim non id, quod privatim interest unius ex sociis, servari solet, sed quod societati expedit. Haec ita accipienda sunt, si nihil de hoc in coeunda societate convenit. Item qui societatem in tempus coit, eam ante tempus renuntiando socium a se, non se a socio liberat: itaque si quid compendii postea factum erit, eius partem non fert, at si dispendium, aeque praestabit portionem: nisi renuntiatio ex necessitate quadam facta sit. Quod si tempus finitum est, liberum est recedere, quia sine dolo malo id fiat. [Cassius writes that someone who renounces a partnership free his co-partners in respect to his own actions, but does not free himself in respect of theirs. This is certainly the rule to comply with when the renountiationwas made with fraudolent intent. An example would be if, after the formation of a partnership in all goods, one partner saw he was coming into an inheritance, and renounced for that reason. In such a case, if the inheritance brings him loss, this will be borne by the man who renounced, whereas he may be compelled by an action on partnership to share any profit. But anything acquired after renountiation of partnership will not have to be shared, because he did nothing fraudolent in respect of it. Similarly, if we form a partnership to purchase something and you wish to make the purchase on your own account and renounce the partnership for the purpose of making the purchase yourself, you will be liable to the extent of my interest in the matter. If, on the other hand, you renounce because you do not approve of the purchase, you will not be liable, even if I made the purchase, because there was no fraud involved; this is Julian's view]. However, in Labeo's Posthumous Works we read that if one partner renounces the partnership at a time when it was important to his co-partner that the partnership be not dissolved, than he makes himself liable to an action on partnership. Suppose, for example, we form a partnership and buy slaves, and then you renounce at a time which is disadvantageous for selling slaves, you are liable to an action on partnership, because in this case you are altering my prospects for the worse. Proculus says that this is only true if it not to the advantage of a partnership that it be broken up; for invariably it is the interest of the partnership, not the private advantage of one of the partners, which is safeguarded. The rule is as outlined, always provided that nothing was agreed upon with respect to the matter in question when the partnership was formed. Similarly, someone who forms a partnership for a specified period of time and renounces it before it has run its course, free his co-partner. Thus, if any profit is made after the renuntiation, he gets no share of it, whereas, if a loss is incurred, he will be liable for part of it, as before, unless the renunciation was the product of some necessity. But if the time is up, he is free to withdraw, because this can be done without malicius intent.]

DIGEST 17.2.65.3–6 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50–51; *see also* BUCKLAND, *supra* note 154, at 508.

[248] *See* BUCKLAND, *supra* note 154, at 508.

[249] By virtue of the relevance of *fraternitas*,

Si absenti renuntiata societas sit, quoad is scierit, quod is adquisivit qui renuntiavit in commune redigi, detrimentum autem solius eius esse qui renuntiaverit: sed quod absens adquisiit, ad solum eum pertinere, detrimentum ab eo factum commune esse [if one partner renounces the partnership while the other is absent, until such time as the absent partner is apprised of the fact, any gains by the renouncing partner are shared, but any losses are for the latter one to bear. On the other hand, whatever the absent partner has gained goes to him alone, whereas any loss incurred by him is shared.]

DIGEST 17.2.17.1 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 41–42.

[250] *In societate autem coeunda nihil attinet de renuntiatione cavere, quia ipso iure societatis intempestiva renuntiatio in aestimationem venit.* [There is no need when a partnership is being formed to include a warning concerning renunciation, since, by the rules governing partnership themselves, a renunciation which is inopportune comes into the final assessment.]

DIGEST 17.2.17.2 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 42.

[251] *See* BUCKLAND, *supra* note 154, at 508.

as "necessary absence on public affairs,"[252] misconduct of another equity member, or unfulfillment of a specific term on the basis of which the *societas* was formed.[253]

Renunciation could be express, when a *socius* articulated his will to withdraw, or tacit, when a *socius* sold his shares. An alienation of the shares was a "breach of an agreement not to divide and the rules of renunciation applied."[254] Moreover, such a sale would inevitably corrupt the bond of *fraternitas*. Like the concerns about potential transfers of shares *causa mortis*, it was not permissible for a *socius* to dispose of his shares *inter vivos* because doing so would force upon remaining s*ocii* an unselected and potentially unwanted person.

The *societas* also ceased to exist if clear facts demonstrated that the inclination to carry out the joint business had ended, typically because a *socius* started to do business separately. This practice was another form of tacit—or *de facto*—renunciation. The risk of corruption of the fiduciary bond among the *socii* and of their inclination to carry out joint business justified this type of renunciation. Without renunciation, the business organization would have likely been exposed to a "sleeping" equity member not fully engaged in the *societas*, with diminished fiduciary duties of loyalty and care.

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[252] *Idemque erit dicendum, si socius renuntiaverit societati, qui rei publicae causa diu et invitus sit afuturus: quamvis nonnumquam ei obici possit, quia potuit et per alium societatem administrare vel socio committere: sed hoc non alias, nisi valde sit idoneus socius aut facilis afuturo etiam per alium societatis administratio* [It is the same when a partner renounces a partnership to go away on state business for a considerable period of time against his will. Certainly, it may sometimes be objected that he could manage the partnership through another man or entrust it to a co-partner. But this would not be appropriate unless the partner concerned is particularly reliable or unless the management of the partnership in the absence of on of the partners should prove straightforwad even if put in another's hands.]
DIGEST 17.2.16 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 41.

[253] *Nec tenebitur pro socio qui ideo renuntiavit, quia condicio quaedam, qua societas erat coita, ei non praestatur: aut quid si ita iniuriosus et damnosus socius sit, ut non expediat eum pati? Sed et si convenit, ne intra certum tempus societate abeatur, et ante tempus renuntietur, potest rationem habere renuntiatio* [If, however, there is a clause against the withdrawal within an agreed period of time and the partnership is renounced before the expiration of that period, the renountiation may have reasonable cause. A partner will not be subjectto an action on partnership if he renounced the partnership specifically because a particulr term on the basis of which the partnership was formed was not fullfilled. Again, what a case where a partner's behaviour is so damaging and harmsul that is not worth putting up with him?]
DIGEST 17.2.14 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 41.

[254] BUCKLAND, *supra* note 154, at 508; *see also* DIGEST 17.2.16.1 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 41.

iv. Actio Pro Socio *and Termination of the* Societas Consensu Contracta

Furthermore, because brotherhood and legal actions do not mix well, legal action on the agreement[255] terminated the *societas*.[256] In fact, any *socius* could bring an action for breach of their express agreements (normally for contribution) or breach of the obligation to act in good faith, which was called *actio pro socio*.[257] The rationale behind the extinctive effect of the *actio pro socio* lies in the fact that the functional aim of such action was predominantly the final distribution of assets and liabilities and for liquidation, rather than specific obtainment of contributions.[258] An *actio pro socio* "signif[ied] a lack of unanimous consent and hence implied the automatic dissolution of the partnership."[259]

In addition, the *fraternitas* bond among the *socii* is the basis for two relevant features of the *actio pro socio*. First, condemnation[260] in an *actio pro socio* involved infamy[261] (unlike common

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[255] "It must be remembered that *socii* were commonly also joint owners, and thus the *actio communi dividundo* also was available between them for adjustment of liabilities in respect of the property. As it affected only property questions and adjustment, i.e. not debts and credits, it was narrower but it contained *adiudicatio*, which *pro socio* did not. It did not necessarily end the *societas* under Justinian: wheter it did so in classical law is uncertain." BUCKLAND, *supra* note 154, at 509–10.

[256] *Actione distrahitur, cum aut stipulatione aut iudicio mutata sit causa societatis. Proculus enim ait hoc ipso quod iudicium ideo dictatum est, ut societas distrahatur, renuntiatam societatem, sive totorum bonorum sive unius rei societas coita sit. Item bonis a creditoribus venditis unius socii distrahi societatem Labeo ait. Si in rem certam emendam conducendamve coita sit societas, tunc etiam post alicuius mortem quidquid lucri detrimentive factum sit, commune esse Labeo ait. Diximus dissensu solvi societatem: hoc ita est, si omnes dissentiunt.* [A societas is dissolved by an action when the position of a societas is altered by a stipulation or a judicial judgment. Proculus says that a partnership is ipso facto renounced when legal proceeedings have be launched with view to dissolving the societas, and this is so wheter the partnership was in all goods or in one thing. Similarly, Labeo says that if a societas is formed with a view to buying or hiring a particular thing, then any profit or loss incurring after the death of one of the partners is shared. We said above that partnership is dissolved when it is agreed that it will be discontinued, that is, when all socii are of this mind.]

DIGEST 17.2.65 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62, at 50–51.

[257] For a broader dissertation on the *actio pro socio*, see BUCKLAND, *supra* note 100, at 507; see also RADIN, *supra* note 62, at 261–62. Cerami points out that, according to a famous thesis of Guarino, the *actio pro socio* ended only a *societas* between two *socii*, but not a societas among multiple *socii*. *See* Cerami, *supra* note 141, at 203 n.104 (citing ANTONIO GUARINO, LA SOCIETÀ IN DIRITTO ROMANO 42, 81, 123 (1988)). This thesis, however, remains an outlier. *See* MARIO TALAMANCA, SOCIETÀ IN GENERALE 840 (1990). Cerami advances a different argument; specifically, that *action pro socio* ended ordinary *societates*, but not *societates* of public interest.

[258] *See* Cerami, *supra* note 141, at 204.

[259] Abatino, Dari-Mattiacci, & Perotti, *supra* note 89, at 368 n.18.

[260] *Condemnatio* in the *actio pro socio* probably involved infamy only in case of an intentional act, and not negligence. *See* BUCKLAND, *supra* note 154, at 509.

[261] In the words of Radin:

[Infamy, or *infamia*] in Rome, was not a mere moral reprobation, but carried with it certain well-defined disabilities. These were, first of all, disqualification for public office and incapacity either to be represented by counsel or to represent any one as counsel in a lawsuit. Apparently there were other disqualifications. *Infamia*, however, was also a consequence of condemnation in some contractual actions of fiduciary ownership, because the *actio communi dividundo* did not involve *infamia*[262]).[263] Second, *socii* were allowed the *beneficium competentie*, which protected enough of the liable *socius*' property from an *action pro socio* to provide for his and his family's maintenance.[264] Although this should not be considered a limitation of liability, it nevertheless probably fostered the use of *societates* and certainly foreshadowed some features of modern insolvency law.

v. Final Remarks

In short, *societates consensus contractae* regulation was entirely structured around the confidential bond among its equity members. The *societas* originated from the actual will of the *socii* to bind each other under fiduciary obligations by virtue of considering the qualities each equity member. Therefore, the *societas* would terminate upon any modification of the equity members' qualities or if the equity members corrupted the inclination to carry out a joint business. Similarly, features exhibited during the lifespan of the *societates*, such as the assignment of profits and losses or aspects of litigation, like the *beneficium competentie*, found their *ratios* in the *fraternitas*. The development of the *societas-negotiatio plurium*, from the third century B.C. to the third century A.D., required regulation to respond to the evolving socioeconomic environment and foster the risk-taking that such relational contracting entailed. Nonetheless, the security that *socii* gained from the selection and protection of the intrinsic (e.g., inner qualities, such as trustworthiness, skills, etc.) and extrinsic (e.g., social status) qualities of the *socii* was limited. These static protection mechanisms

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> character, and was further inflicted by the magistrate for certain reprehensible kinds of conduct; e.g., clandestine marriages, hasty espousals of widows, the assumption of one of several degrading tasks, particularly public stage performances.

RADIN, *supra* note 62, at 137.

262 *See* BUCKLAND, *supra* note 154, at 540.

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> [T]he notion of *fraternitas* and the fact that condemnation of any *socius* in the *actio pro socio* involved *infamia*, with serious resulting civil disabilities, indicate that, if there had been a scheme of contracts in order of their confidential character, *societas* would have been near the top of the list.

BUCKLAND & MCNAIR, *supra* note 153, at 304.

264 *See* RADIN, *supra* note 62 at 261. Such exemption did not apply if a *socius* fraudulently made himself unable to pay. *See* BUCKLAND, *supra* note 154, at 509.

came at the expenses of the going-concern of the enterprise. Ultimately, there was no provision for flexibility or change in the equity member base or in the governance of *societates*.

This model entailed fragility, instability, and uncertainty for the joint-enterprise, with negative effects on the firm (e.g., higher transaction costs in negotiating with third parties and less reliability when asking for credit[265] or entering into long-term contracts) and on *socii's* investments. This was because the association could terminate upon uncontrollable events (e.g., the death or the will of any co-venturer) and because the *socii*'s heirs could not succeed in the association (and the liquidation of their quotas did not allow them to take part in the future revenues that eventually arose from longer term investments).

Therefore, *societates* reached their limit as an effective form of organization if a business required stability, continuity, and efficient management. Longer-term investments, as well as contracts to build massive facilities, could not succeed under the *fraternitas*-based *societas*. This drove Roman lawyers and policy-makers to develop strategies to cope with the faults of the *societas consensus contracta* in order to suit certain types of enterprises. Such partial legal solutions are the object of the following section of this chapter.

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[265] The risk of a firm's dissolution and the lack of asset partitioning meant that the firm's creditworthiness was hardly estimable and completely based on the equity members' solvency instead of on the organization's credit alone. This implied much higher monitoring costs, and, therefore, potential creditors would likely increase the cost of credit or would not lend entirely.

> This becomes all the more obvious when one considers that it is not just the personal financial affairs of the individual [members] that would be relevant to a potential firm creditor, but also the affairs of any other businesses in which the owners had an equity investment. Thus, suppose that [a *societas*] A were to have among its [members] individual X, who also [is member] in [*societates*] B, C, and D. Someone considering doing business with firm A would need to consider not only the probability that A would mismanage his personal finances in a fashion that would render him insolvent, but also that any of firms B, C, or D might for any reason fail, with the result that the creditors of the failed firm would seek to foreclose, via their claims against X, on X's share in A. Nor is it just potential creditors of the firm that would have an interest in the status of each [member]'s personal and other business affairs. All [members] of the firm would have a similar interest, since they would bear the consequences in terms of the firm's cost of credit.

Hansmann & Kraakman, *supra* note 8, at 402–03.

SECTION II. LIMITS OF THE *SOCIETAS CONSENSU CONTRACTA* AND PARTIAL LEGAL SOLUTIONS

The development of the Roman economy increased joint-enterprises' organizational needs in order to carry out business on a larger scale.

Larger investments, specialization of the employees, stability of the enterprise, efficient decision making and protection of the assets designated to carry out the business became primary necessities for the evolution of productive activities and thus for the provision of goods and services to the population.

This section seeks to investigate the limits of the *societas consensu contracta* within a modern perspective of business organization, and to analyze the faults of the partial legal solutions that Roman lawyers and business players developed to fix the defects that such an organizational model revealed when applied to larger enterprises.

A. Challenging the *Societas Consensu Contracta Fraternitas*-Based Model

i. Socio-Economic Context

After an age of socially based restrictions, the enterprise (*exercitio negotiatiorum*) started to become the underpinning of the entire political-economic system, thus making business the goal of various social classes. Those elements gave rise to a quasi-global economic system based on an interest in profit and wealth accumulation.[266]

The significant growth of Roman territorial holdings made possible the development of a manufacturing-based economy and the associated financial and commercial industries. Over roughly a two hundred year period (spanning from the third to first century B.C.), the rural community of Rome expanded from its modern-day location to include the entire Italian peninsula and the Mediterranean region: Asia Minor, North Africa (including Egypt), the Near East, and Europe (both West and South).[267]

The advancement of technology further enhanced development of the Roman economy. For example, the volume of metal extraction facilitated the development of water-powered hydraulic mining tools and techniques.[268] Additional illustrations of technological advancement include the implementation of artificial selection of cattle for advantageous skeletal structure and density, hydraulic grain mills, equipment used in the pressing of eudicot fruits (i.e., olives and grapes), and proto-sump pumps used in sub-water table mining.[269]

Moreover, in the first two centuries of the Roman Empire, the trade of goods both within and beyond the imperial boarders established an economy that spread beyond the city of Rome. The imperial economy was unique in its evolution from static to dynamic interclass wealth and for

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[266] *See* Cerami, *supra* note 141, at 177–78.
[267] *See* Ulrike Malmendier, *Law and Finance "at the Origin"*, 47 J. ECON. LITERATURE 1076, 1079–82 (2009).
[268] *See* Andrew Wilson, *Machines, Power and the Ancient Economy*, 92 J. ROMAN STUD. 1 (2002).
[269] *See* Malmendier, *supra* note 267, at 1082.

the establishment of a capitalist system featuring an entrepreneurial attitude aiming to craft and trade goods on worldwide scale, and provide credit, financial services, transportation and other services, as well as real estate investment. Those elements gave rise to a global economic system based on a universal interest in profit and wealth accumulation.

The regimentation of the Roman financial system allowed for its sound development. A certain degree of development of financial intermediation supported the growth of enterprise: both bankers (*argentarii*) and brokers (*proxenetae*) pooled and distributed funds effectively.[270]

In such a political and economic context, Ancient Roman joint-enterprises developed organizational needs to carry out business on a larger scale in far-flung geographic regions. This necessitated specialized employees and wider investments, sometimes with longer terms for returns. Thus, some organizational features characteristic of large, present-day firms began to arise.[271]

The features for an effective organization of collective enterprise started to be perceived as necessary by business people.

Hansmann and Kraakman outline these features, remarking that:

> [A] firm must generally have two attributes. The first is well-defined decisionmaking authority. More particularly, there must be one or more persons who have ultimate

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[270] *Id.*; *see generally* Peter Temin, *Financial Intermediation in the Early Roman Empire*, 64 J. ECON. HIST. 705 (2004).

[271] With respect to the ability of Roman law to support fast-paced economic development and designing a parallelism with common law systems, Malmendier points out that:

> Roman private law did not undergo systematic codification until the beginning of the sixth century AD. During the pre-classical and classical periods, legislated statutes (acts [leges], plebeian resolutions [plebiscite], or senate resolutions [senatus consulta]) played a fairly small role. Rather, the law emanated from the advice of legal experts, the responsa prudentium, to the judicature, i.e., to the praetor (judge), to the aediles curules (senatorial superintendents), and to the governors in the provinces. These magistrates and their jurors, called tribunales, usually had no legal training, but appointed jurists into a committee of legal experts, the consilium. The appointment as an expert was honorable and and desired among lawyers, who usually belonged to the aristocratic class (patricians) and also advised plaintiffs and defendants. Based on the experts' opinion, the magistrates would grant actions (actiones), defenses (exceptiones) and other legal remedies. Those expert opinions shaped the legal system, even if they had no formal legal power. Hence, Roman law textbooks often characterize Roman law as 'juristic law' (e.g. Fritz Schulz 1951: W. W. Buckland and Peter Stein 1963). Since legal experts did not discuss abstract concepts but concrete cases of current interest, Roman law developed in step with the legal issues of the day. In fact, Roman-law scholars like P. W. Duff (1938) and Kaser (1980) liken Roman law to English law today: largely free of abstract concepts and essentially 'case law.' This gave the Roman law an enormous degree of flexibility, providing the ability to cope with the transformation of Rome from a rural community to a large empire.

Malmendier, *supra* note 267, at 1083.

> authority to commit the firm to contracts. We term those persons the 'managers' of the firm. In a corporation, the managers (as we use the term here) are the members of the firm's board of directors; in a partnership, they are the firm's general partners. . . . The second attribute a firm must have, if it is to serve effectively as a locus of contracts, is the ability to bond its contracts credibly - that is, to provide assurance that the firm will perform its contractual obligations. Bonding generally requires that there exist a pool of assets that the firm's managers can offer as satisfaction for the firm's obligations. We term this pool of assets the firm's "bonding assets."[272]

Could the *societas consensu contracta* model suit those organizational requirements?

ii. Features Characterizing the Limits of the Societas Consensu Contracta

As described in the previous section of this chapter, the common sense rule, formulated in Phaedrus' *Fabula* I.5. "The Cow, the Goat, the Sheep, and the Lion", that an engagement with a fool or knave co-venturer is never fruitful, frames the outline of the most relevant provision regulating the life of an association.

The *societas* was a contract, which regulated only the relationship among its members—it did not imply any form of agency.[273]

By forming a *societas*, the members, on one hand, bonded each other to make specific contributions to the association with the agreement of sharing in the advantages and costs arising from the pursuit of a common goal.[274]

On the other hand, the members committed to actively participate in management of the assets organized under the *societas* agreement (although acting as individuals vis-a-vis third parties). The regime of intangible contributions presents an intrinsic relationship with the mutual selection based on personal qualities and skills.

All members were both controllers of the firm and equity holders of the business organization.

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[272] Henry Hansmann & Reinier Kraakman, *supra* note 8, at 392.
[273] See *supra* Chapter 2, Part IBi.
[274] See *supra* Chapter 2, Part IAii.

Decision-making was inefficient both in the mechanics of forming the decision and in executing agreements with third parties.

From a different standpoint, given the overlap between equity holding and control over the firm, entering into a *societas* contract meant committing contributions *uti socio* (i.e., as equity holder) and participating in the management of the joint-enterprise.

This explains how, as described in the former section, the contribution of intangible assets (e.g., standing, managerial ability, germane knowledge, etc.) from members was at least as crucial as the contribution of tangible assets.[275] In fact, the *socii*'s position was twofold.[276]

Furthermore, a lack of asset partitioning, the impossibility of predicating the *societas*' ownership on the assets composing the firm, the easy renunciation, as well as the vast causes for breaking up the *societas* (*in primis*, those related to the will of, or the fate of, any *socius*) caused the instability of the association and an inability to contractually bind the business as a legal entity.

Because the *socii* were not only equity holders, but also controllers of the firm, their personal qualities and skills played a significant role in their selection, just as the particular attributes of executives and directors of modern corporations are important.[277]

The members who entered into a *societas* agreement did not give up their control rights over the assets they dedicated to the firm. Indeed, such agreement did not sever their property rights over the assets: the contract was ultimately an obligation to merely designate the assets to a specific, common goal throughout the life of the association.[278] The veto system, under which decisions concerning the *societas* operated, reflected the maximum possible retention of control rights over the assets. Additionally, the open renunciation of membership, an option through which members

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[275] "Every member must contribute something, but it need not to be money or goods, but could perfectly well be skill, knowledge or standing." CROOK, *supra* note 142, at 230.

[276] See *supra* Chapter 2, Part IAiv.

[277] See *infra* Chapter 3, Part IIAiii.

[278] For a comparison to modern corporations, see *supra* Chapter 3, Part IBiii.

could at any time recall their investments and dispose of them, reflected such robust control right retention.

Moreover, in a large number of cases, the contributed assets were not detachable from the individuals themselves. For example, *in primis* intangible assets, such as expertise, were physically inseparable from members that contributed them.[279] This is similar to present-day partnerships, in which the knowledge and reputation of distinguished figures are inseparable from the professional herself, representing an asset of the organization only so long as the person is a member and applies his talents under an agreement.

In his article "Beyond Public and Private: Toward a Political Theory of the Corporation," David Ciepley provides a clear explanation of the mechanisms of property in current partnerships and corporations, and his remarks on partnerships' legal property framework directly apply to the *societates consensu contractae*. In particular, Ciepley indirectly comments on the limitations of firms organized in such a way through his commentary on partnerships:

> Partnerships pool assets in a simple and straightforward fashion. Partners put in money, which is used to purchase assets for carrying on the business of the partnership. These assets remain bound to the partners who collectively own them. For this very reason, the partnership falls short of being a separate contracting individual. The partnership does not own its own property; the partners own it. […] In a corporation, in contrast, the normal rules of property are broken. Investments are permanent; the investor cannot directly pull out his contribution. An investor may recoup the monetary value of his investment if he can find another investor to take his place—that is, to buy his 'share.' However, the assets that the corporation purchases with his initial investment are locked in, becoming corporate property. They form a separate fund.[280]

In fact, different from *societates consensus contractae* and partnerships, in corporations, "the rules of property are broken"—shareholders do not own the assets of corporations in which they

[279] *See* BUCKLAND & MCNAIR, *supra* note 153 at 302.

[280] Ciepley, *supra* note 57, at 143. In reference to the effects of corporate asset lock–in, the Author remarks:

> The business benefits of this feature are considerable. First, it lowers the corporation's capital costs, because lenders need not fear expropriation by withdrawing investors. Second, it increases firm productivity. It allows the corporation to specialize its assets to the production process, rather than keep them in more liquid form out of fear that investor withdrawal will force a sell-off. This in turn allows the corporation to specialize its workers to its specialized assets.

Id; *see also* Blair, *supra* note 58 at 247; Blair & Stout, *supra* note 12, at 266.

hold shares. Rather, shareholders are entitled to the specific rights provided by the securities they hold, such as the right to transfer (trade or inherit) their shares.[281]

As discussed in the next chapter, the forfeiture of property rights over the contributed assets is a pivotal organizational instrument to organize larger enterprises that the individual-based *societates consensu contractae* lacked.[282]

Furthermore, because *fraternitas* and a lack of any (even weak) asset partitioning[283] did not allow restrictions on governance power, the individual-based decision-making pattern[284] was mandatory. Thus, the association could not exclude any member from managerial power, nor from active participation in the association's management.[285] All *socii* were entrusted with the power to affect each other's wealth (and social position).

On this foundation, the mechanics of the *societas consensu contracta* (similar to modern partnerships[286]) were designed to regulate a simplistic legal association.

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281 *See generally* Lynn Stout, THE SHAREHOLDER VALUE MYTH 39–40 (2012).

282 See *infra* Chapter 3, Part IBi.

283 For a description of levels of asset partitioning, see generally Hansmann & Kraakman, *supra* note 8.

284 "Apparently any *socius* might veto an administrative proposal of any or all the others, so as to make persistence in it a wrong, but if the prohibition was unreasonable or dolose, he would be liable for any resulting loss." BUCKLAND, *supra* note 154, at 506.

285 This framework operated within the limits of the governance pointed out above. *See* Hansmann, Kraakman, & Squire, *supra* note 153 at 1356.

286 Blair illustrates the limits that current partnerships and *societates consensu contractae* share as such:

> Unless the partners specified otherwise in a formal partnership agreement, the agreement would be assumed to be at will. This meant that any partner could terminate the relationship, and thereby force dissolution of the assets of the business, at any time and for any reason. The exception was if they had explicitly agreed to continue in the relationship until a specific time, or until specified conditions were met (such as the completion of a particular project or venture). A partnership would also be automatically dissolved if a partner died, became insane, or went bankrupt. Although there were no legal limits on the number of individuals that could become partners, under a classic general partnership arrangement of the time, each individual partner had full authority to bind the other partners contractually, and all were, individually and collectively, responsible for the obligations of the business. So business people had to be quite selective in choosing partners. A third party who sued a partnership was required to name all of the partners individually in the complaint. Partners, meanwhile, could not sue the partnership (to do so would be to sue themselves), and the partnership could not sue an individual partner (for the same reason).

Blair, *supra* note 58, at 409-410.

As owners of the assets composing the firm, *socii* could directly (or indirectly, *via* renunciation or *actio pro socio*) divide the association's assets (and their creditors could seize the assets managed under the *societas*).[287]

As controllers of the enterprise, according to the *societas* contract, if, on the one hand, *socii* were not agents for each other, each individual could rely on reimbursement of business-related transactions from the other members (who were liable vis-à-vis third parties, if they had authorized the acts of the *socius* and in any event if those transactions enriched them).

Two considerations arise from this scenario. First, because the risks related to poor selection of fellow-members could harm the firm and the other *socii*, it was expected that due care was paid to identify individuals whose personal qualities could provide a secure performance of the whole *societas* agreement. Second, the loss of any of those *socii*'s personal qualities (as well as the lack of consistent inclination to be bound under the *societas* agreement) would lead to the end of the business association. In other words, given the governance power and proprietary legal framework that the *status* of a *socius* entailed, when selecting fellow partners, the members of the association were also appointing co-managers (or fellow controllers) of the same and potentially selecting co-owners of the pool of assets.[288]

A perfect horizontal relationship between owners and controllers characterized the *societas consensu contracta*. The members co-owned the property and ran the association on an individual basis. This feature went hand-in-hand with the absence of any partitioning of the firm's property from that of its members and of delegated management. The fact that this type of joint-association was a derivative of the concept of common ownership of family property by undivided heirs explains this characteristic.[289]

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[287] For a comparison to modern corporations, see *infra* Chapter 3, Part IBiii.
[288] *See generally* Cerami, *supra* note 141.
[289] CROOK, *supra* note 142, at 229.

The *societas consensu contracta* (with its regulation shaped around the protection of security created via the mutual selection of the members and their management of the firm on an individual basis) lacked efficient decision-making capabilities, formal hierarchy, and an effective system to reliably bind assets of the firm. Thus, geographic expansions, technological evolutions, and socio-economic changes in the society made the emersion of the intrinsic limitations of the *societas*' organizational structure more apparent.[290]

The defining characteristics of the *societas consensu contracta* ultimately shaped its organizational limitations. The consolidated position of *socii* as owners and controllers made the enterprise depend on the fate of the *socii*.[291]

In a well-known article, Edward Rock states that the central mystery of corporate law revolves around two questions: "how is it that millions of people entrust trillions of dollars to corporate managers over whom they have little control and on whose discretion their profits depend?"[292] and "how is it that most managers most of the time seem to do a pretty good job looking out for shareholders' interests?"[293]

The next chapters of this work, focused on present-day corporations, are meant to provide a humble contribution towards answering those questions. Yet some explanation might actually be found in the limitations of the *societas consensu contracta* in which those phenomena described by Rock do *not* take place. In short, the following considers the limits of alternative associative structures in order to understand the beneficial effects of the organizational features of corporations. Thus, an observation of the organizational problems of the control-retained and individually governed *societas consensu contracta* is a useful tool for a critical analysis of the modern corporate structure.

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[290] For a comparison to modern corporations, see *infra* Chapter 3 IBi.
[291] For a comparison to modern corporations, see *infra* Chapter 3 IBii.
[292] Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1010 (1997).
[293] *Id.*

iii. Organizational Limits of the Societas Consensu Contracta

Geographic expansion, technological evolutions, and socio-economic changes in society exposed the intrinsic limitations of the *societas* as an organizational structure.

As infrastructure contracts became more complex and financially demanding, it became necessary for individuals to form associations in order to bid on such contracts. By the time the contracts became exorbitantly expensive, this practice of collective bargaining was common. For example, a contract to build the Marcian aqueduct in the mid-second century A.D. was roughly 45 million *denarii*. To put this in context, M. Crassus, supposedly the wealthiest Roman in the age of Caesar and Cicero, had a net worth of 8,000 *talents*, or 48 million *denarii.* The contract price for the construction of this aqueduct was therefore roughly 450 times the minimum financial holdings of the amount required to be a member of the equestrian class,[294] and equivalent to the total wealth of Rome's richest man.[295]

The development and continual operation of large-scale industry requires large-scale investments. The means of developing such an industry vary, but may include buying land rights, finding and purchasing raw resources, staffing the project's construction and operation, and developing the requisite technologies to make the blueprint a reality.

The fact that physical and financial capital is essential for the growth of industrial economies is common knowledge among legislators, businesspersons, economists, and historians. Yet basic practice for businesspersons is that these industries not only require physical and financial capital, but also non-material resources, such as technological and managerial skills for specific productive activity. As Margaret Blair points out:

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[294] The equites were originally cavalrymen, or knights. Over time, they developed special privileges, and their initial establishment as cavalrymen became largely immaterial. In 67 B.C., the *lex Roscia theatralis* set the minimum wealth qualification for membership in the equestrian rank at 400,000 sesterces (one sesterce was the equivalent of four denari). See BERGER, *supra* note 233, at 455.

[295] ERNST BADIAN, PUBLICANS AND SINNERS: PRIVATE ENTERPRISE IN THE SERVICE OF THE ROMAN EMPIRE 67–68 (1972).

> Finance capital and physical capital do not operate themselves. They must be coordinated, managed, maintained, and operated daily by people, who must then develop systems, routines, and reputational and information networks to carry out their tasks. Production and distribution on a large scale, then, requires a wide variety of inputs from many different individuals. Often, the needed inputs are highly specialized to particular tasks, and difficult to specify in advance, but must be worked out over a long period of time.[296]

In other words, effective productive activity takes time, commitment, and specialization.

Entrepreneurial tasks required organization of productive factors: long-term investment in specialized labor, and larger investments in enterprise-related assets. Those required effective organization of the productive activity. In Ancient Rome, for example, the development of aqueducts required significant financial resources. First, a developer must acquire the land on which the aqueducts would be built as well as raw resources for the aqueducts' construction and operation. The developer would also require quarries to produce large quantities of stone, and the developer would have to expend resources to transport the stone to the construction site. The developer would also have to acquire and transport water for the aqueducts. Furthermore, the design and construction of an engineering feat such as the aqueducts required considerable brainpower, manpower, and dedication. Additionally, none of these investments would easily be resalable outside the firm. In fact, the requisite, and highly specialized, managerial and professional skills of *socii* or employees required a long time commitment, thus making them actual investments in the firm (rather than in the individual). Therefore, the enterprise required a vast amount of specific investment.[297]

Could *societas consensu contracta* meet such productive requirements?

Consistent with their *fraternitas*-based organizational features, most commercial *societates* had no more than a few members[298] and they easily met their critical size.

Two dimensions shaped the limitations of the *societas consensu contracta*: time and space.

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[296] Blair, *supra* note 58, at 397–98.
[297] See Chapter 3, Part IB
[298] *See* Hansmann, Kraakman, & Squire, *supra* note 153, at 1356.

Time limited the *societas consensu contracta* because the association was completely dependent on the fate and will of the *socii*.[299]

Space limited the *societas consensu contracta* for multiple reasons: logistical limits in geographical expansion (the individual-based decision-making system plus the lack of delegated management[300]), limits on asset growth (a rich, but potentially careless or incompetent individual was not eligible to be a *socius* due to the potential liabilities such membership would impose on all the other *socii*).

As Margaret Blair points out in reference to partnerships[301]

> Thus, while a few individuals known to each other and their communities might be able to sustain a modest-sized manufacturing, trading, or other business for a while as a partnership, the implicit veto power that partnership rules give to each partner, and the vulnerability of the pool of bonding assets to the fortunes, talents, and good behavior of every partner would likely become problematic as the business grew. Participants in a large network of business relationships—in which mutual success depends on numerous individuals making team-specific investments over a sustained period of time—require some assurance of continuity and financial stability. Partnership [and *societates consensu contractae*] appears to be a poor vehicle for providing such continuity and stability. Partnership can thus help to amass capital, but this organizational form does not provide for centralized control, and cannot facilitate the commitment of capital for extended periods of time. [302]

In fact, when it comes to *societates*, problems with critical size were even more pronounced.

First, because individual-based decisionmaking was mandatory, raising capital required finding "all-around good" people willing to contribute their assets, actively participate in management, and tie themselves to other members' fates and wills with respect to the termination of the enterprise.

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[299] See Chapter 3, Part IB

[300] Members of the *societas* could appoint directors to run the association, however, this would be inconsistent with the lack of agency in such organizations that required active participation of each member in the firm's governance. *See* BUCKLAND, *supra* note 154, at 506. For the absence of agency and the mandatory active participation of all the members, see BUCKLAND, *supra* note 154, at 505; Hansmann, Kraakman, & Squire, *supra* note 153, at 1356.

[301] A specific exception to the regulation of classic partnerships provides that

> In the joint venture, laissez choisir is subject to the limitation that where the success of the venture will be jeopardized by the withdrawal, the court will permit the venture to continue to completion. This modification is also true of the special partnership of England where there is no separate classification of joint adventure.

Taubman, *supra* note 3 , at 646

[302] See Blair, *supra* note 58, at 412–13.

Second, lack of effective decisionmaking was manifest not only in the lack of centralized control, but also in the lack of agency.

In sum, the *societas consensu contracta* lacked features fundamental to successful organization of complex firms and long-term investments: (i) continuity, (ii) asset partitioning, (iii) delegated management, and (iv) free transferability of participation in the business.[303]

These features reveal a level of taxonomy. The most relevant limitations of *societates* were discontinuity and instability, and the second most relevant was inefficient decisionmaking.[304] Moreover, intrinsic relationships tie free transferability of participation in the business to asset partitioning and centralized management.

iv. Continuity and Related Features: Asset Lock-In and Transferability of Shares

The instability and discontinuity was the effect of the early termination of the firm from the fate or will of the *socii*, or dilution of the firm's assets.

Put differently, continuity required two intrinsically related features of the organization: asset lock-in and transferability of shares.[305]

Asset lock-in is the legal instrument that separates assets contributed to the organization from those of equity holders. As a result, equity members of business organizations do not have a claim to the organization's assets during the ordinary course of business ("*strictu sensu* asset lock-in"). Likewise, equity members' creditors may not seize the assets of the business organization ("*latu sensu* asset lock-in" or "entity shielding").

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[303] See Hansmann & Kraakman, *supra* note 8, at 392. For a comparison with modern corporations, see *infra* Chapter 3, Part IB

[304] Discontinuity and instability meant an inability to bind its contracts credibly, while individual-based decisionmaking (with no form of agency) meant an absence of well-defined decisionmaking authority.

[305] For a comparison with modern corporations, see *infra* Chapter 3, Part IB

Socii's direct ownership and management of a *societas*' assets the absence of asset lock-in with two effects on groundbreaking property rules. First, free withdrawal of assets (causing the association's termination) and second, lack of protection from *socii*'s creditors.[306]

The law held void agreements not to dissolve the *societas*, except in specific instances. Locking-in *socii* against their will was inconceivable, especially without limited liability and with the requisite active participation in management.

In general, the effect of the lack of asset lock-in is resource dilution. Both the *socii*'s creditors and the *socii* themselves (consistent with the lack of separation between the owners' property and assets managed under the *societas*)[307] represented a threat for the firm.

With regard to the *societas consensus contracta*, by virtue of the *fraternitas* bond among the *socii*, renunciation did not only subtract resources from the enterprise, but entirely ended the association.

Although dilution of firms' assets seems secondary, concerns regarding dilution are still valid because remaining *socii* could continue the enterprise without the renouncing *socius*, merely by establishing a new *societas*.[308]

With respect protecting the enterprise's assets, Blair remarks: "perhaps as important as protecting the assets of the enterprise from participants' creditors, however, was the role that

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306 Hansmann & Kraakman, *supra* note 8, at 435 ("Strong-form legal entities, which are characterized by liquidation protection from the owners' personal creditors, also typically provide for substantial liquidation protection from the owners themselves.").

307 [T]he separation between the firm's bonding assets and the personal assets of the firm's owners and managers is the core defining characteristic of a legal entity, and establishing this separation is the principal role that organizational law plays in the organization of enterprise. More particularly, our argument has four elements: (1) that a characteristic of all legal entities, and hence of organizational law in general, is the partitioning off of a separate set of assets in which creditors of the firm itself have a prior security interest; (2) that this partitioning offers important efficiency advantages in the creation of large firms; (3) that it would generally be infeasible to establish this form of asset partitioning without organizational law; and (4) that this attribute - essentially a property attribute - is the only essential contribution that organizational law makes to commercial activity, in the sense that it is the only basic attribute of a firm that could not feasibly be established by contractual means alone.

Id. at 393.

308 In this case, however, the continuing *socii* would have to face all of the contractual inconveniences related to the new *societas*.

incorporation played in establishing a pool of assets that was not subject to being liquidated or dissolved by any of the individual participants who might want to recover their investment."[309]

In general, asset partitioning is the severance of ownership over contributed assets. From the business organization's point of view, asset partitioning's effect is asset lock-in (or entity shielding), while from the equity holders' perspective, the effect is limited liability of equity holders (or owner's shielding) and accompanies transfer of control over the assets to controllers entrusted with power over the assets within their fiduciary duties.

In fact, "Roman law made no distinction between the obligations and assets of the societas and those of its members, precluding the rules of weak asset partitioning that characterize the modern partnership."[310]

When it comes to corporate legal entities, perfect asset partitioning takes place through the transfer of property titles to the organization, whereas *societates* lacked both entity shielding and limited liability for equity holders.

Theoretically, asset partitioning is the outcome of special legal rules

> [R]equired to determine which [physical or legal] entities bond which contracts, and which assets belong to which entities. Often, the asset partitioning between entities is complete: the creditors of one entity may not levy on assets held by another. But asset partitioning can also be partial, as in the modern general partnership: personal creditors of partners may levy on firm assets, but only if the partnership creditors have first been paid in full. As this example suggests, the separation between the assets of a commercial firm and those of its owners comes in two forms, depending on which set

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309 Blair, *supra* note 58, at 392–93 ("This role extends also to the heirs of these participants, who might prefer to see the assets of the business liquidated rather than accept a pro rata claim on potential distributions from the business in the settlement of the estate of the deceased corporate participant. Such a protected pool of assets could therefore be committed more credibly to the enterprise for a substantial amount of time. Investors in corporate shares could subscribe in small units, but once the funds paid to purchase those shares had been committed, limits were imposed—sometimes severe ones—on the ability of investors to withdraw funds from the business. The commitment of capital by shareholders, I argue, helped protect the at-risk investments made by other corporate participants. To again use a phrase from Hansmann and Kraakman, the capital contributed or pledged in the form of equity shares helped secure a pool of 'bonding assets,' which made it easier to draw in other risky contributions to the enterprise. The most important other investors in the first half of the nineteenth century probably included banks and trade creditors (as well as the other shareholders), but the mechanism of separate entity status, and the resulting ability to lock in the assets, protected the interests of nonfinancial contributors assets as well as the interests of financial investors.").

310 Hansmann, Kraakman & Squire, *supra* note 153, at 1356.

> of assets is being shielded from which group of creditors. We label the two forms entity-shielding and owner-shielding.[311]

From a different standpoint, given a lack of asset partitioning, and separation of ownership and control,[312] protecting the security that copartner selection created required terminating an enterprise upon any event that would have potentially corrupted the *socii*'s qualities (i.e., equity holders/controllers), both as individuals and collectively.

Thus, in the absence of limited liability and entity shielding, a *societas* protected the association by termination. The mechanics of such a policy were in line with the confidential character of the *societas* contract[313] and clearly protected *socii* as individuals, but also entailed a

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[311] *Id.* at 1337.

[312] The insights that Blair points out regarding modern business organizations are a terrific tool to better understand the relevance of the separation between ownership and control in ancient business organizations and to pick out the limits of the *societas consensu contracta*.

> [T]he 'separation of ownership from control,' far from being an infirmity of the corporate form, was actually one of the most important benefits of the corporate form. Early articles of association of joint stock companies, as well as most corporate charters, provided that decisionmaking authority for the company would be delegated to a group that was legally distinct from the contributors of financial capital (though this group often included major investors). In unincorporated joint stock companies, this delegation of decisionmaking authority was necessary to get around the default rule of partnerships that major decisions must be made by unanimous decision of the partners. A requirement of unanimous decisionmaking, we have seen, gives every partner the power to compel dissolution, or hold up the other partners in an effort to extract more of the wealth being created by the joint enterprise. Delegation of authority to a small decisionmaking body streamlines decisionmaking in large organizations with many investors and participants, and numerous other scholars have noted that the resulting "centralization" of control is one of the benefits of incorporation.
>
> In corporations, because the law recognizes the corporation as a separate legal entity, the law also insists that some designated group of human persons be made responsible and accountable for the activities of the participants in the business, at least insofar as those activities relate to the carrying out of the business for which the firm was incorporated.
>
> But in addition, I would suggest that the benefits of assigning decisionmaking authority to a board of managers, or board of directors, are not just that it streamlines decisionmaking (relative to unanimous approval by numerous partners), and identifies accountable human persons to act for the entity. Instead, the benefit is that assigning decisionmaking to a board restricts the control that various individual participants, such as the president, or a major financial investor, might otherwise have. Decisionmaking by a designated small group thereby helps assure all participants that financial investors will not be able to easily pull assets out of the firm once other participants have made investments that are committed to the enterprise, and that active managers will not be allowed to use the assets of the firm for their own personal benefit. Thus, when decisionmaking authority is allocated to a board of directors, individual team members relinquish some of the ability they might otherwise have had to hold up other members. This makes their commitments to engage with the others in a cooperative way more credible.

Blair, *supra* note 58, at 433–34.

[313] In the words of Buckland and McNair: "the notion of fraternitas and the fact that the condemnation of any socius in action pro socio involved infamia, with serious resulting civil disbilities, indicate that, if there had been a scheme of contracts in order of their confidential character, societas would have been near to the top of the list." BUCKLAND & MCNAIR, *supra* note 153, at 306.

complete lack of stability for an enterprise, which ended up having no temporal limitation because *socii*s would not agree on such a duration.

The relevance of the bond based on the *socii*s' qualities lies primarily in protecting the *socii*, but also in predictable uniformity in business preferences. Given the lack of limited liability, equity members must select fellow equity holders "with similar assets and risk preferences, or else face significant negotiating costs."[314] This is particularly consistent with the role of *intuitu personae* in the *societates consensu contractae*, though such a presumption seems too weak to solve burdensome decisionmaking mechanics.

Furthermore, limited liability significantly effects governance costs. First, by lowering decisionmaking costs and homogenizing economic interests of the members, "limited liability ensures that all owners in such a firm experience the same proportional gains and losses from the firm's policies, regardless of their identities or assets. Consequently, limited liability gives these owners a homogeneous economic interest in the firm's decisions, which greatly facilitates collective decisionmaking."[315] Therefore, once again, a firm's efficiency required—and still requires—the intervention of organizational law.[316] Another flipside of the lack of separating control and ownership rights is the dependence of disinvestment on the requisite withdrawal of contributed assets. This causes instability in the firm, and harmfully effects productivity (primarily due to the lack of protection of firm-specific investments), especially when in a highly complex enterprise.

In particular, if a firm's organization requires specialization, production structure, long-term commitment of different stakeholders, and dedicated and specialized employees, investments in the firm go far beyond those labeled as *socii's* contributions. Indeed, each member of the production team makes a partially irrevocable commitment of resources to the *negotiatio plurium*.[317] In the

[314] See Hansmann & Kraakman, *supra* note 8, at 424.
[315] *Id.*
[316] In particular, see Hansmann and Kraakman conclude that limited liability achieves such efficiency. *Id.*
[317] Rajan & Zingales, *supra* note 37, at 392.

modern context, Blair and Stout offer the example of A and B, researchers trying to develop a new pharmaceutical: "each may have to invest time and skill that will be wasted if the venture fails."[318] The massive infrastructure that arose around the rise of the Roman Empire required comparable work commitments, including intellectual work, which could not be resold for other activities. The more complex and structured a business venture was, the more specialization it required, and the deeper the bond between the investments of each team member to the specific project became. Sophisticated projects and infrastructures require effective specialization and commitment from team members. The interaction between specialized members produces more than the sum of their individual inputs,[319] but requires the team's specialized human capital, thus their investments were specific to the assets.[320]

Investments in those ventures became "firm specific," which entails two effects. First, the team members who contribute the most "firm specific" investments become the most vulnerable[321] because of their contributions' intrinsic irrevocability. Second, to attract necessary firm specific investments, the enterprise must be organized and operated in a fashion that protects the firm-specific investments from the actions of the other members.

The necessity of firm-specific investments was directly proportional to an enterprise's complexity. The evolving socio-economic scenario began to require a decisionmaking mechanism that did not depend on individual *socii* and asset protection against events occurring to *socii* and from the *socii* themselves.

It is reasonable to see the resistance of the members to firm specific investments when we consider the regulatory context. Any event affecting the *socii* potentially terminated the association; therefore, a firm's instability threatened their finances and firm specific investments.

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318 Blair & Stout, *supra* note 12, at 272.
319 *Id.* at 271.
320 Rajan & Zingales, *supra* note 37, at 392.
321 *Id.*

Together with asset partitioning, the legal technology permitted severing assets contributed to the firm from equity owners and made the shares in the business organization transferable as long as the control over the firm is delegated and does not attach to the shares.

An association that would terminate upon any *socius*' exit (or even disagreement) could hardly handle the *socii*'s necessities and those of the enterprise.

Free transferability *inter vivos* and *causa mortis*, and thus tradability and inheritability, of the shares is necessary to support continuity in two ways. First, it entails the possibility of changing an association's members without terminating the enterprise. Second, it allows the association to carry out longer-term investments without a threat of early termination, affecting not only the value of the firm, but also the economy in general.[322]

Moreover, the great benefit of transferability is that it unlocks the enterprise-investment perspective from the *socii*-investment perspective. Thus, the investment of the *socii* is liquefiable without subtracting assets from the firm. The intrinsic bond between capital lock-in and transferability of shares provides continuity and separation between the investment strategies of the members and those of the corporation.

On this ground, the delegation of control rights from owners to controllers (i.e., third party managers or directors) addresses the free-riding problem among *socii* (who were otherwise required to run the firm, but might shirk) and prevents members of the firm from making decisions that enrich themselves at the expense of others.[323]

According to the scheme provided above, delegated management is (together with entity shielding) one of the necessary pillars that supports an association's continuity.

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[322] For a comparison with modern corporations, see *infra* Chapter 3, Part IB

[323] *See generally* Blair & Stout, *supra* note 12, at 271.

v. Decisionmaking in Societates Consensu Contractae

In the *societates consensu contractae*, decisionmaking mechanics and management were archaic: *socii* could not delegate management (all *socii* were supposed to actively participate) could not act on one another's behalf while managing the *societas*. To provide sound management, however, a practice of "hiring" *socii* with managerial talent and experience developed. In fact, some *socii* were possessed particular managerial expertise that was sufficient contribution to bestow membership and such *socii* were excluded from losses (but were still subject to fiduciary duties).

Why were those *socii* admitted to share in the profits but excluded from bearing the losses if not for their skills in the management of the *societas*? Their business administration qualities were likely infungible. They were *de jure socii*, but also *de facto* managers.

The reason behind such practice lies, once again, in the overlap between the *socii*'s positions as equity holders and controllers. To attract skillful managers, *socii* treated managerial and professional qualities of a potential member as contributions to bestow membership in the association as a *socius* with an emphasized role as a controller.

The interests of fellow-*socii* to "hire" the talented *socius*, justified membership without any tangible contribution, and justified excluding the talented *socius* from sharing in losses.

Although *socii* could not entirely delegate control over the firm, the *societas vectigalis* regulated hiring *de facto* managers and their heirs. Indeed, one of the conditions for admitting the heir was that the deceased *socius* was not brought on in specific consideration for managerial talent. Thus making the *socius*-managers' shares non-inheritable under any type of specific *societas* regulation.[324]

Like present-day directors, limited liability protected such "quasi-hired" managers, as long as they did not breach the fiduciary duties owed to the *societas*.[325]

[324] See Cerami, *supra* note 141, at 211.
[325] For a comparison with modern corporations, see *infra* Chapter 3, Part IB

The *fraternitas* bond granted discretion in business decisions and the selection of fellow *socii*, on one hand, and the tolerance and forgiveness accompanying the *fraternitas* bond on the other, justified low standards of care.

As Radin remarks,

> [*Socii*] owed each other only a reasonable care in the conduct of their affairs—not the abstract standard of a thoroughly competent business man. People engaged themselves to each other as they were, with their imperfections on their heads. But the care he must use, while measured by a less severe standard, could not be disregarded. If loss had been sustained by the culpable negligence of a partner, he must make it good, and he could not counterclaim any profit that exceptional industry and zeal had added to the partnership.[326]

From a different standpoint, the lack of agency delayed governance mechanisms, which, on the one hand, affected a firm's spatial expansion, and on the other, restricted the firm's temporal expansion.

In fact, as pointed out above, the *societas* lacked any agency power pattern (distinguishing the *societas* from modern-day partnerships).

The lack of agency made decisionmaking burdensome and required constant participation of a firm's members. Such participation was often impossible, because of either a shirking attitude or objective difficulties with some members. In fact, only members who were actually so participating entered into contracts concerning the *societates consensus contractae;* thus, such contracts were not on behalf of fellow-members. Accordingly, assets managed under the association could not be bound unless all the *socii* took part in the transaction.

Thus, the lack of external effects (vis-à-vis third parties) of the *societas* ultimately entailed the inability of such organizations to lower transaction costs in contracting with third parties because there was no system for bonding pooled assets. Vis-à-vis third parties, the *socii* were individuals; each of them had to amass enough assets to create contracts. In short, *societates* were organizations without any external relevance nor transactional cost benefits.

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[326] MAX RADIN, *supra* note 62 at 261–62; *see also* WILLIAM L. BURDICK, *supra* note 158, at 454–55 ("It was the legal duty of partners to care for the common property with the same diligence as he cared for his own personal affairs, and the mutual duties and responsibilities of partners could be enforced by the action pro socio.").

The complete lack of centralized governance mandated active participation in the administration of the association. [327]This was a proper rule because human capital and inclinations of the *socii* to carry out business together were crucial. In addition, it was a safe provision to protect members from vulnerability, considering the lack of limited liability. Not surprisingly, in an organization in which the assets of the *socii* and those of the organization are not partitioned from one another, decisionmaking mechanisms suffered many disadvantages in terms of efficiency.

[327] For a comparison with modern corporations, see *infra* Chapter 3, Part IB

B. Imperfect Legal Solutions

i. Solutions for Continuity

Roman lawyers and experts were well aware of the two main limits of the *societates consensu contractae*: on the one hand, stability and continuity of the enterprise, and on the other, the burdensome operation of the *societates* due to cumbersome decisionmaking processes and a lack of power for a *socius* to act as agent for the others vis-à-vis third parties.

These experts therefore studied and developed various legal solutions to overcome such limitations, realizing that contractual provisions could not meet some requirements of a larger enterprise. The experts thus borrowed the legal technology of *corpus habere*, i.e., the fictional legal personality, from Rome's system of government.

As illustrated, the lack of stability and continuity in the *societates* could be due to either intentional acts, such as renunciation, or unintentional events, including a *socius*' death or *capitis deminutio*. In addition, an *actio pro socio* action terminated the *societates*.

Termination resulting from death and *capitis deminutio*, strongly related to the principle of *qui societatem contrahit certam personam eligit*, which means that he who enters into an associative business organization wants to be part of that association with a specific person due to the fellow socii's personal qualities. Thus, the loss of a single equity member or of their specific qualities causes the termination of the organization. The general principle was that the business organization could not carry on with the surviving *socii*, nor *a fortiori* with the heirs of the *de cuius*.

A specific exception to this principle of termination upon death was provided for the *societas vectigalis*, an organization formed for tax farming, but only if two conditions were met: first, that the inheritance of a *de cuius*' shares was designated to an heir in the *societas*' articles of organization; and second, that the *socii* did not select the deceased *socius* to be a member because of his specific managerial skills, upon which the remaining *socii* would make a collegial decision.[328] Regardless of such decision, the *societas vectigalis* would survive, with or without a new member.[329] The reason behind such an exception lies in the strong public interest in the continuation of the *societas vectigalis*. Further, this exception eventually became a general principle to put in comparison the interests of the *socii* in protecting the security created through selection and the interest of the enterprise, together with the economic benefits to society.[330]

Similar to the effect of a *socius'* death, *capitis deminutio* terminated a *societates*, according to the principle that the *capitis deminutio* was equivalent to death. Whether such principle of termination was avoidable by agreement of the *socii* is unclear.[331]

Furthermore, as mentioned, the renunciation by any *socius* was a lethal threat to the continuity of the *societas*. Labeone, Cassio, Proculo, and Guiliano elaborated on hermeneutic criteria to regulate free renunciation of *socii*, taking into consideration *bona fide* principles to disadvantage disloyal behaviors of *socii*.

Cassio specifically directed criterion to sanction the *socius* who, by withdrawal from the *societas*, intended to gain a larger personal benefit to the detriment of the *societas*.[332] For example, the *socius* who renounced his membership in the *societas omnium bonorum* (whose object was to amass all the *socii*'s assets) directly before coming into a large inheritance, in order to avoid sharing the incoming wealth with the other *socii*, was liable for damages.

On the other hand, Labeone developed criterion for the larger joint-enterprises based on harm of a socius' withdrawal in light of its timing in the life of the enterprise. Thus, a departing *socius* was only liable for damages if the withdrawal of capital caused economic damage to the other *socii* by affecting the business strategy of the joint-enterprise. The typical case was a renunciation

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[328] See DIGEST 17.2.59, *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62.
[329] See generally MARIA ROSA CIMMA, RICERCHE SULLE SOCIETÀ DI PUBLICANI 238 (1981).
[330] See Cerami, *supra* note 141, at 211.
[331] See INSTITUTES OF ROMAN LAW BY GAIUS 3.153 (Edward Poste trans., E.A. Whittuck ed., 1904).
[332] See Cerami, *supra* note 141, at 207.

that terminated a *societas* formed to deal in slaves when liquidating its slave holdings was inopportune, thus forcing the sale and causing significant economic damage to the firm.[333] Proculo perfected this criterion, who pointed out the importance of balance between the poor timing of the *facultas renuntiandi* (*quod privatum* interest) and the collective interest of the *socii* in pursuing the scope of the enterprise (*quod societati expedit*).

Aside from these hermeneutic criteria, the *socii* could contractually restrict the *facultas renuntiandi*, by a *societas* that was *in tempus coita*, meaning that the *socii* formed the *societas* for a specific period of time. In this case, the anticipated renunciation would have freed the other *socii* from the renouncing *socius*, but would not have freed the renouncing *socius* from the remaining *socii*.[334]

Lastly, in order to neutralize the terminating effect of the *actio pro socio* (generally for the purpose of liquidating the *societas*), jurisprudence developed the possibility of bringing such an action within the continuity of the *societas* when the enterprise had a specific public-interest related function: the *actio pro socio manente societate*.[335]

ii. Construction of Quasi-Agency through Mandates

At the same time, Roman lawyers understood the need for a more efficient decision making system within the association, and thus developed two types of solutions. The first was a contractual solution consisting of a network of mandates with which *socii* allowed each other to act on one another's behalf.[336] This network of mandates, however, exposed *socii* to a higher level of vulnerability. On one hand, the mandates heightened the potential for the association to affect socii's private assets. On the other, the mandates disincentivized monitoring because the members

[333] *Id.*
[334] *See* DIGEST 17.2.65.6 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62.
[335] *See* Cerami, *supra* note 141, at 218–21.
[336] The contract of mandatum was an indirect agency contract: the mandator (principal) was required to bear the costs made by the mandatarius (agent); in turn, the mandatarius was required to transfer to the mandator the rights acquired within the scope of the contract. In contrast, direct agency contracts are common in modern legal systems, so that the agent can act in name of the principal. Abatino, Dari-Mattiacci & Perotti, *supra* note 89, 377 n.64.

agreed upfront on sharing profits and losses, thereby exacerbating the free-rider problem: each *socius* would be inclined to shirk, since he would still receive the agreed-upon share of the final gain, whether or not he had worked hard.[337]

Contractual legal solutions did not permit the organization to feature continuity by layering provisions, therefore necessitating reform in organization law.[338]

iii. Peculium *and Delegated Management*

The second type of solution to overcome the lack of agency was to layer the institution of the *peculium* over the *societas*.

The *peculium* permitted *de facto* agency if members of a *societas* agreed to overlap such an institution and their association. *Peculium* presented rough similarities with current legal capital, and more generally, the *negotiatio per servos communes* presented many commonalities with legal entity-based business organizations.

In particular, some features were partly covered: separation between ownership and control, delegated management based on the selection of an entrusted manager, transferability of participation, a degree of limited liability (that was a function of share transferability and that relinquishment of control over contributed assets, together with delegated management, justified), and a general propensity to continuity. The weakness of this organization (or the main difference from current capital-based business organizations), however, was the lack of asset lock-in—or, in other words, the severance of ultimate control over contributed assets from the *institores* or *exercitores*.

337 *See* Blair & Stout, *supra* note 12, at 266.
338 *See* Hansmann & Kraakman, *supra* note 8, at 428-38.

The *peculium* was a set of assets that one or more freemen (masters) provided to a selected slave[339] for use in a business venture. The *peculium* had a single-owner nature,[340] although if its master co-owned slaves (*servos communes*), and endowed one of them with the *peculium*,[341] this created a *de facto* joint enterprise (*exercere negotiationes per servos communes*[342]) not based on an associative pattern.[343] Alberto Burdese specifies two types of *plurium exercitio negotiationum*. The first was based on the preposition *institoria* or *exercitoria* of one or more slaves (or sons) and featured unlimited liability for the masters. The second was based on slaves or sons entrusted with the *peculium* and provided masters with limited liability.

In either case, the enterprise could be a sole proprietorship that operated through the *servus*, or a joint venture, that operated through a *servus communis* (co-owned slave). Legally, slaves were objects ("*res*") that one or more masters (*servus communis exercitor, servus communis negotiator*) could own.[344] The fact that slaves did not have legal personalities, but the capacity to act, allowed the formation of a *de facto* agency relationship:

> [T]he delegation of authority by the master to the slave was rooted in the *dominica potestas*, the property right that the owner enjoyed both over the slave and over the peculium entrusted to the slave. . . . The praetorian remedies examined earlier allowed transactions by slaves to produce some effects for their masters by recognizing some creditors' claims against slave masters. . . . Transactions by the slave produced effects in the portion of the owners' assets identified as the peculium, which, in turn, *de facto* served as the business patrimony.[345]

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339 A master could also entrust the peculium to his sons (in addition to the slaves). *See* AARON KIRSCHENBAUM, SONS, SLAVES AND FREEDMEN IN ROMAN COMMERCE 37 (1987).

340 *See* Hansmann & Kraakman, *supra* note 8, at 424.

341 *See* Abatino, Dari-Mattiacci & Perotti, *supra* note 89, at 371.

342 *See* DIGEST 14.3.13.2 *in* 2 THE DIGEST OF JUSTINIAN, *supra* note 62; DIGEST 14.3.14, *in* 2 THE DIGEST OF JUSTINIAN *supra* note 62; *and* DIGEST 14.4.3, *in* 2 THE DIGEST OF JUSTINIAN *supra* note 61.

343 *See* Alberto Burdese, *Impresa Collettiva E Schiavo 'Manager'*, 32 LABEO 204, 206 (1986).

344 In his article "Remarks on the legal structure of enterprise in Roman Law", Földi describes such organization of business as "collective two level enterprise" and points out that "[t]his type is characterized by a slave entrepreneur being under the power of more than one master". The Author also quotes pieces of the DIGEST regulating both maritime and overland enterprise:

> The co-owners having *voluntas* concerning the maritime enterprise activity of their common slave are liable in *solidum*, that means they are liable for the total debt and at the same time in form of solidarity . . . Ulpian speaks about a common slave having an overland enterprise. His co-owners may be sued either with the *action tributoria* (in the case of *scientia*) or the *actio tributoria* (in the case of *scientia*) or the *actio de peculio* (also in the case of *ignorantia*). It is a striking phenomenon that neither the unlimited liability nor the *voluntas* appear in these texts.

András Földi, *supra* note 145 at 203.

345 Abatino, Dari-Mattiacci & Perotti, *supra* note 8144, at 378. The Authors also point out:

iv. Peculium *and Transferability of Shares*

Besides *de facto* agency, combining the *negotiatio per servos communes* with the *peculium* made available other legal technologies with respect to continuity, because the *negotiatio per servos communes* survived changes in the identity, or fate, of the owners. In fact, the *negotiatio per servos communes* provided the enterprise with a certain degree of continuity—in particular, as opposed to the *societas consensu contracta*, owners of a *negotiatio per servos communes* could transfer the business (i.e., the slave with the *peculium*) without terminating the enterprise.[346]

Furthermore, "absent an agreement to the contrary, each of the co-owners could convey his share of property to a third party, if this did not bring prejudice to the other co-owners. The third party who acquired the share would become a partner in the business."[347] Partners did not have direct governance control. In fact, the strong relinquishment of direct control over the assets justified the masters' "weak" limited liability. This type of organization did provide the masters with a degree of liability shielding, however: "the slaves' creditors could only seize the *peculium* assets, while generally being barred from reaching out to the personal assets of the owner, provided that the master's posture towards the slave-run business be described as *ignorantia* or *scientia* (but not *voluntas*)."[348] This means that identifying the *peculium* was crucial to determining the solvency of the

The separation between the effects on the substantive rights of the parties and possible judicial proceedings also illustrates that the slave-run business was a de facto alternative to direct agency contracts with effects for third parties. While the parties to a contract were the slave and the creditors, the parties to a possible related trial were the owners (at least one of them) and the creditors. Judicial decisions concerning debts contracted by the slave were taken directly against or in favour of his masters.

[346] Obviously, the whole business could be conveyed only with the agreement of all the owners. *See id.*, at 377.
[347] *Id.*
[348]

If the master had appointed a slave (praepositus) to the management of a specific terrestrial or maritime business, these edicta gave creditors a remedy—the actio institoria or the actio exercitoria, respectively—which allowed them to recover against the master. The master's liability was unlimited in amount but limited in scope, and covered only the debts incurred by slaves within the scope of the appointment.

In contrast, the edictum de peculio and the edictum de tributoria actione defined the conditions under which the master's liability was limited in amount but unlimited in scope. Although the peculium remained property of the master, the actio de peculio generated a partitioning of the master's assets, distinguishing his personal assets (the ratio dominica), shielded from business creditors, and the assets pertaining to the slave-run firm. On one hand, because slaves were prohibited from property ownership, the mere fact that they were managing assets was presumptively assigned those assets to the *peculium*. On the other hand, masters provided some goods to slaves as compensation and therefore were not part of the *peculium* (having an economic—but not legal—function of a masters' debt master vis-à-vis the slave).

v. Imperfections in the Peculium*-Based Legal Solution*

The weakness of this organization (or the main difference with current capital-based business organizations) was the lack of entity shielding and asset lock-in, which ultimately affected the stability and the continuity of an enterprise. In fact, although entity-shielding evolved over time, "the typical peculium business (like the societas) appears not to have provided entity shielding.

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business (the peculium), which the creditors could seize in order to satisfy debt. Moreover, if the master had credits toward the peculium, he had priority over other creditors. The actio de peculio was available if the master did not define the scope of the business, but simply assigned certain assets to the slave: The master completely distanced himself from management and lacked knowledge (scientia) of the transactions by his slave. In contrast, the actio tributoria differed from the actio de peculio because it presupposed the master's knowledge of the trading by his slave. As a consequence, the master lost priority for his credits, while still enjoying limited liability. If the peculium was insufficient to satisfy business creditors and the master had materially benefited from a transaction by his slave, the actio de in rem verso made the master personally liable to the extent that he had been enriched by the transaction. In this case, business creditors could seize the master's personal assets to the extent of his enrichment. From an economic perspective, by means of the actio de in rem verso, funds that had been placed into the master's personal assets, thus out of reach of business creditors, were considered as if they were still in the peculium. In fact, the jurist Ulpian observes "the benefit conferred on the master forms part of the peculium; and payment by him on behalf of the slave is tantamount to payment back to the slave." The combination of these praetorian remedies made the liability of the master increase with his involvement in the business activity. Summing up: - Ignorantia: the master was unaware of the slaves' transactions. Creditors could use the actio de peculio, the master's liability was limited to the peculium, net of any credit the master had with the slave; that is, the master had priority over other creditors. Scientia: the master had knowledge of the slaves' transactions. Creditors could use the actio tributoria; the master's liability was still limited to the merx peculiaris but the master did not have priority over other creditors. - Voluntas: the master consented to the slaves' transactions. Creditors were allowed the actio institoria or exercitoria, which gave them the possibility to seize personal assets of the master, even if the slave had been assigned a peculium. Therefore, the master's liability is unlimited within the scope of the activities entrusted to the slave. In addition, the actio de in rem verso had the effect of making it more difficult for the master to place the profits of the slave's activity out of reach of creditors and, to some extent, guaranteed the solvency of the slave-run business.

Id.

That is, the personal creditors of a slaveholder may have enjoyed a claim to his assets, including those committed to peculium, equal in priority to the claims of the peculium creditors."[349]

Modern corporate organization provides a firm with the aforementioned continuity, stability, large financial ability, and efficient decisionmaking through its groundbreaking legal technology: the legal entity,[350] which makes possible asset lock-in and separation of ownership and control.

As opposed to modern corporations, because organizing a business as a *negotiatio per servos communes* did not sever *exercitores'* ownership over the business' assets, (because slaves could not own property and the business form was not a legal entity) the separation of firms' assets from those of the equity holders was only functional, but not legal. Thus, the assets remained in the

[349] Hansmann, Kraakman & Squire, *supra* note 153, at 1358–59; *but see* Abatino, Dari-Mattiacci & Perotti, *supra* note 89, at 379 ("The negotiatio per servos communes provided for a form of entity shielding, protecting the company assets from personal creditors of the owners and from business creditors of other businesses with the same owners. The protection afforded by entity shielding was embedded in two sets of rules: one protecting the peculium from creditors and even the owners themselves, the other regulating priority in case of insolvency. As a result, there appears to have been a form of weak entity shielding: company assets were weakly protected against personal creditors of the owners. Yet there was no liquidation protection, hence no strong entity shielding.");. Hansmann, Kraakman & Squire, *supra* note 153, at 1359 (" We only know for sure that in the peculium castrense - a special type of peculium consisting of sums earned or otherwise acquired by a son from military service - creditors of the peculium evidently did enjoy a prior claim on peculium assets, and thus the peculium castrense provided weak entity shielding. But this explicit recognition of priority in the peculium castrense suggests that the background rule for peculium creditors in general was the contrary. If that inference is correct, slave-managed peculium businesses, which were a mainstay of Roman commerce, used a highly anomalous form of asset partitioning: complete owner shielding (limited liability) but no entity shielding at all. This is a pattern we will not see again in our historical survey, and one that has not to our knowledge appeared in any other significant class of commercial organizations in the past or present. The pattern is unusual because, in general, entity shielding lays a necessary foundation for owner shielding by providing firm creditors with an affirmative claim on firm assets to offset the impairment of their claim to the firm owners' personal assets."). .

[350] Entity status for incorporated businesses meant that a chartered corporation was recognized as a distinct legal entity, separate from any of its investors or managers, for purposes of buying, selling, or holding property; of making contracts; and of suing and being sued. Creating a separate legal entity allows business organizers to partition business assets in two regards: individual participants in the business are not held personally responsible for a business' debts or liabilities ("limited liability"), and the pool of assets used in the business are available to meet the needs of the business (such as, to pay the claims of the business's creditors) before being distributed to shareholders. *See* Hansmann & Kraakman, *supra* note 8, at 393-95.

Limited liability also allows corporations to attract modest investments by many small investors. Without minimizing this important role of limited liability, this Article places stress on other side of asset partitioning's role, which I call "resource commitment." Hansmann and Kraakman have recently argued, similarly, that "the truly essential aspect of asset partitioning is . . . the reverse of limited liability - namely, the shielding of the assets of the entity from claims of the creditors of the entity's owners or managers." Hansmann & Kraakman, *supra* note 8, at 391–92.

realm of the *exercitores*' property, and therefore, *exercitores* could withdraw contributed assets and terminate the enterprise, and *exercitores*' creditors could go after the assets contributed in the *peculium*.

Thus, a *negotiatio per servos communes* did not provide continuity vis-à-vis the will of the masters from withdrawing pooled assets or terminating the enterprise. Moreover, the regulation only protected creditors from fraud and distribution of all the assets among the owners. Therefore, the focus was on satisfying creditors' claims, not asset lock-in.

The firm itself was not shielded from a masters' abuses Masters could distribute all of the earnings, and there is no evidence of an accounting system that provided that the value contributed in the *peculium* had to remain stable to ensure that earnings were covered losses, as in current statutory capital systems. Furthermore, masters' creditors[351] could go after slaves' *peculium* business assets. From a modern approach, the *peculium* lacked asset lock-in, because owners could distribute all of the earnings and withdraw their assets at any time, and the co-owners could only recover losses through damages. Property law did not protect a firm from a withdrawal of (potentially essential) assets. Once again, firm-specific investments were not protected, to the detriment of stability, contractual reliability, and productivity of the firm.[352]

In summary, the lack of asset lock-in and continuity of the venture represented the defects of the *praepositio institoria cum peculium*. It affected bonding firm's credit, capacity for growth, and the applicability of such a structure to certain types of businesses that required the stability of long-term investments.

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[351] Even advocates of a form of entity shielding for slave-run businesses (pointing out *de facto* entity shielding in cases of multiple peculia, which shield one another by limiting the liability of each slave's peculium) admit:

> [T]here could potentially be an attempt by personal creditors of the masters to seize the peculium assets. However, the owner's ability to withdraw company assets—including for the purpose of paying other debts—was limited. As shown earlier in Section 2.A, under certain conditions, peculium creditors had the right to seize assets that had been subtracted from the peculium as if those assets were still in the peculium or to sue the owners for restitution.

Abatino, Dari-Mattiacci & Perotti, *supra* note 89, at 379. In short, no entity shielding or asset lock-in was provided to the enterprise. Complementarily, on the systems of creditors priorities provided by Ancient Rome's legal framework, see *id.* at 379–81.

[352] *See* Abatino, Dari-Mattiacci & Perotti, *supra* note 89, at 375–77.

Nowadays, organizational law remedies these problems with legal technology.

In corporations, asset lock-in protects firm assets and specific investments from the corporation's shareholders and their creditors, while imposing duties on fiduciaries entrusted with management. In addition, separation between ownership and control entails delegated management (i.e., entrusting corporate directors with assets to manage on behalf of the legal entity) and permits the transferability of the shares.

As a corollary of asset lock-in and separation of ownership and control, corporate shareholders enjoy limited liability. Limited liability boosts financial investors' attraction to invest, but requires that these investors relinquish control over the firm. In the same way, directors enjoy limited liability as long as they comply with their fiduciary duties, in order to maximize corporate productivity.

In this scenario, groundbreaking and innovative organizational law solved contract law's inability to meet the needs of complex and large firms. This solution was manifest in the idea that legal rights and liabilities could attach to a body or group as an entity entirely apart from its individual member(s), i.e., the "*corpus habere*" or, the creation of the legal entity permitted to make business organizations independent from the will and fate of its transient equity members. Such technology, originally conceived to develop Rome's system of government, applied to the *societas publicanorum* for the public interest. The following chapter investigates this application as a necessary tool, which permits the organization of bigger firms and, at the same time, frames both the vertical dynamics of the transfer of control rights to a body specifically appointed to govern the corporation, and the free transferability of shares.

CHAPTER 3. ASSESSING SHAREHOLDERS' PERSONAL QUALITIES: FROM *SOCIETATES PUBLICANORUM* TO PUBLIC CORPORATIONS

Introduction

In order to overcome the limits of *societates consensu contractae*, ancient firms needed to structurally modify their legal framework. As analyzed in the previous chapter, contractual solutions were only partial and imperfect. In particular, contractual solutions were unable to provide an essential feature for sizable business organizations: continuity. This is because of the lack of at least two additional organizational characteristics. First, a stable commitment to the enterprise of the organized assets needed to carry out the productive activities and, second, independence and insulation of the enterprises from its equity members' fates and wills.

Ultimately, both of these characteristics are intrinsic effects of the provision of legal personality, which permits to sever equity-members' property rights from assets designated to an enterprise. When incorporation takes place, investors obtain shares vis-à-vis "property received" by the business entity.[353]

The legal personality is both a legal and a logical requirement: relinquished control rights must be transferable to an entity able to receive them. Such an operation was impossible in the case of *societates consensu contractae* even with *praepositio institoria*, because slaves could not own property. This fact made these forms of business associations inadequate to organize large and long-term enterprise, as they were mere contracts to regulate duties and rights among *socii*, but did not give origin to a legal entity.

On this ground, only a revolutionary organizational innovation could satisfy the needs of Ancient Roman firms. Roman jurists found the solution in a legal instrument that governmental law had already applied: "the conception of a legal entity, a sort of legal personality, apart from and independent of the individual members that composed the associated group."[354]

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[353] *See* Ciepley, supra note 57, at 139; BERLE & MEANS, *supra* note 57, at 222.
[354] BURDICK, *supra* note 158, at 277.

Since then, organizing enterprises as legal entities has provided continuity to firms mostly by insulating the business association's organized assets from the fate and will of the equity members, supported by the transferability of shares and centralized management.

When relinquishing their property rights over the assets, equity members simultaneously relinquish control rights over the firm, which are thereby reorganized and entrusted to delegated controllers appointed with the specific power to run a business. As result of the separation between equity ownership and control over the firm, the selection of controllers is completely detached from the selection of equity coventurers. In other words, the model based on the fraternity among the *socii* was replaced by systems of selection and appointment of professional controllers.

Nowadays, a corporation appoints a board of directors to manage a firm. The legal framework in which such management operates grants directors limited liability in their business decisions, as long as directors comply with their fiduciary duties vis-à-vis the corporate entity that appoints them.

Nevertheless, shareholders still enjoy a set of control rights that they receive as equity members of the corporation. Beyond these control rights *qua* shareholders, in some circumstances, they can exercise a determinant *de facto* governance influence—an asset-like power, which is not proportionally distributed among shareholders and might be originated from the holding of a majority of shares, control or influence enhancing tools as well as investors' attitudes.

Any investor, even a fool or felon, can buy shares of a public corporation and influence corporate activities and actions. The inability to control the personal qualities of investors can cause problems when a shareholder or a group of shareholders gain the power to participate in, or actively influence, corporate affairs.

Unselected controlling or influential shareholders, by practically regaining the control rights of the firm, corrupt the security created through the upfront assessment of controllers' qualities and the delegation of the management to a corporate body, the board of directors, which has neither an "equity" nor a "non-equity" coventurer position.

This chapter describes the origin of the archetype of business legal entities, sketches their main organizational traits, and discusses the corporate governance defects that the lack of shareholders' personal qualities' assessment causes.

SECTION I. RISE OF BUSINESS LEGAL ENTITIES

A. Development of the Legal Personality in Ancient Roman Government Law and Application to Business Purposes

i. Organizational Legal Solutions to Firms' Necessities: Help from Governmental Law

The Roman state was unable to perform two necessary services: providing supplies for religious and secular civic purposes, and collecting money for essential state services (with some disregard for accuracy: *taxes*).[355]

Therefore, the Romans used to outsource such economic activities. Such contracts were practically the only way of getting supplies, so much so that contractors had systematized such process into set forms. The *praetor* held an auction when circumstances required those supplies and services.[356]

One of the first contracts for the provision of supplies was that for feeding the sacred geese at the Capital.[357] Other early contracts were for summoning the *centuriate* assembly, the supply of horses and chariots for the games in the Circus, constructing early temples, and other secular infrastructure projects, as well as contracts for army supplies.[358]

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355 BADIAN, *supra* note 295, at 16.

356 *Id.*, at 16.

357 *Id.* ("The geese had distinguished themselves by raising the alarm when the Gauls took Rome around 390 B.C. The contract must go back as far as that, and quite probably further: the geese had been there, sacred to Juno, when they saved the city-and hardly without official rations.")

358 For the war against Hannibal, "the contracts included food, clothing, and 'whatever was needed in addition, for the navy.' Payment was to be made as soon as the Treasury had some money. Three companies – nineteen men altogether – were prepared to bid. But they insisted on exceptional conditions in return: freedom from military service for the time of the contracts; and public insurance for all supplies once they were put on board ship. The preator had to accept the terms, We do not hear whether he also undertook to pay interest until payment of the sum due was made: this is very probable, especially since there was no security whatsoever, and with the high interest rates normal in antiquity (especially in times of crisis), businessmen probably could not afford to wait for years without getting any money at all. *Id.,* at 17.

Those who supplied these economic services were the *publicani*[359]: groups of investors "who bid on state contracts for projects such as the construction of public works, provision of armaments, and collection of taxes."[360]Indeed, their name is due to their dealings in public property (*publica*) of the *Romanae gentes*; and the *publicani* were "an integral part of the *res publica* as far back as we can observe it or trace it back."[361]

The role for which the *publicani* are best known, however, relates to collecting money for essential state services, i.e., tax farming.[362]

Not surprisingly, the *publicani*'s activity required collective business organization. Thus, bidders for those contracts initially associated in *societates consensu contractae*.

Societates consensu contractae, however, did not meet the requirements (stability, contract credibility, capacity for growth, and efficient decisionmaking) that such business activities required because of their instability, burdensome decisionmaking, lack of representation vis-à-vis third parties and asset partitioning, as well as the impossibility of owning property as an entity.

Furthermore, contractual solutions were only partial and imperfect.[363]

Therefore, these collective firms needed an organizational structure that did not depend on *socii*.

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359 The standard exposure most educated people have to the Roman *publicani* is limited to the New Testament of the Bible, which describes *publicani* as sinful tax-collectorsthat served as an example in Jesus's lesson about loving sinners. The *publicani* of the Bible, however, were not truly *publicani*, but were locals that the actual *publicani* in Rome hired to collect taxes in Roman territories. Nonetheless, localsdetested such agents of the *publicani* of the Roman conquerors. In fact, these agents may have been the ultimate source of general disdain for the Roman name throughout the Roman Empire during the era of Cicero. The historian Livy, for example, says that the *publicani* were inconsistent with effective public law and the freedom of the state's. Likewise, in the mid third-century B.C., Cicero frames the *publicani* as callous exploiters who society must placate due to the *publicani*'s political and economic status, a situation that does not seem anachronistic. Badian summarizes the circumstances well:"the problem as such falls into a class that is perhaps one of the most urgent in advanced modern societies: that of relations between government and private enterprise in the service of the community." BADIAN, *supra* note 295, at 11 and 12.

360 Hansmann, Kraakman & Squire, *supra* note 153, at 1360.

361 BADIAN, *supra* note 295, at 16.

362 The *publicani*'s largest profit stream came from the *ultro tribute*, i.e., activities other than tax farming, including contracts for goods and service, especially army supplies. For a discussion of the advantages and disadvantages of appointingprivate businessmen as tax-farmers, *see* BADIAN, *supra* note 295, at 12–13.

363 See *supra* Chapter 2, Section II.

The solution was the legal separation of the firms' assets from those of their equity holders and delegated management.[364]

The legal technology to make this feasible was the creation of legal entities in which ownership was independent of any physical person.[365]

Indeed, a modern corporate lawyer would likely conclude that the business activities of the *publicani* required organization in the corporate form.

Such a straightforward solution, however, did not exist within the set of business forms at that time. Nevertheless, Roman lawyers and policymakers observed a legal instrument applied in governmental law, which overcame the limits of human lifespan and transient constituencies.

In fact, the growth and structure of the Roman state, which consisted of villages, colonies, and municipalities, required an organization of just this sort. [366]

Roman experts and policymakers developed the idea that legal rights and liabilities could be predicated upon a body or group—a *universitas*—that was an entity entirely separate from its individual members.

Assets and liabilities could be bestowed upon a *universitas*, which was considered "*corpus habere*" (to have a body, a distinct entity) completely isolated from the individual rights and responsibilities of the members composing it.[367] Thus the term *universitas*, which we translate as "corporation," came into use in order to allow a fictitious, collective body to own property, a feature that Roman law initially applied to municipalities.[368] In a legal sense, on the other hand, "*universitas*" entailed an abstract entity that could own property and have rights and responsibilities independent of its members; however, this did not entail ownership by members over corporate property.[369]

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364 *See generally* Hansmann & Kraakman, *supra* note 8; Blair, *supra* note 58.
365 *See infra* Chapter 3, Part IB.
366 *See* BURDICK, *supra* note 158, at 280.
367 *Id.*, at 282.
368 *Id.*, at 282.
369 *See id.*, at 282–283; *see* Robé, *The Legal Structure of the Firm*, *supra* note 31, at 28–29.

The original intent of this legal technology was to grant various types of municipalities (states, villages, districts, etc.) the ability to hold property intended for the good of the public indefinitely. Those public institutions were granted a "legal personality"—a conceptual body—that provided government entities a life independent of their transient constituencies, the ability to sue and be sued, as well as to enter into agreements and have rights, privileges, and obligations in their own name.

Moreover, such legal entities provided states, municipalities, villages, and public officers the capacity to hold property perpetually and in the public interest.

The legal entity technology was the crowning achievement of the Ancient Roman system of government in organizational law.[370]

Indeed, even today, governmental institutions[371] are organized as legal-entities.[372] As remarked in the first chapter of this work, Air Force One belongs to the President of the United States, not Barack Obama.[373]

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[370] *See* BURDICK, *supra* note 158, at 275-276.

[371] For a broader and insightful survey of governmental institutions as juridical persons, see David Ciepley, *The Corporate Roots of the Liberal Democratic State* (manuscript provided by the Author).

[372] See Ciepley, *supra* note 72.

[373] As in sole proprietorships, legal entities may have one member. *See* MACKENZIE, *supra* note 195, at 157 (clarifying that "the Romans recognised another class of artificial persons as capable of rights and obligations, bearing some resemblance to the corporation sole of the English law. Of this description were the state itself, the prince, in so far as he was regarded as the depository of sovereign power; every public office, considered with reference to the rights and duties attached to it; the public treasury or fisc; and, finally, the inheritance of a deceased person (haereditas jacens), so long as it was not taken up by any one as heir."). Corporations sole assist in understanding corporation's societal role because of the "corpus habere" that such organization pursued. To a broader extent, corporations sole sought to provide certain offices with the legal technologies of corporation, such as, *in primis*, the ability to survive the transient person in charge of it and, probably, capital lock-in and limited liability. Under a different point of view, corporations sole formally differ from true corporations, because the former lacked the internal social structure of the latter. *See* JOHN P. DAVIS, CORPORATIONS: A STUDY OF THE ORIGIN AND DEVELOPMENT OF GREAT BUSINESS COMBINATIONS AND OF THEIR RELATION TO THE AUTHORITY OF THE STATE, 15 (1961) ("[W]hile the functions of corporations aggregate and corporation sole may be the same, the latter lack the continuity of existance that is so prominent a characteristic of the former. When it is said that the king never dies and that he thus resembles a corporation, the actual continuous group life of the latter is confused with the continuity of existence of the public office not possessed by its successive incumbents. Groups may, but individuals may not, have continuous existence; social functions of both groups and individuals may endure continuously.").

ii. Origin of the Corporate Form

Roman legal experts were well aware that because all personal rights die with the person,[374] and *societates* depended on the fate and will of their members, organizing large enterprise and amassing necessary assets was very inconvenient unless a business sufficiently stable and continuous.[375]

This sparked the process that led to the *societas publicanorum*, the archetype of the modern public corporation, born from a joinder between private business organizations and a legal personality—originally conceived to develop Rome's system of government.[376]

The activities carried out by the *publicani* ultimately served the community; thus, Roman policymakers extended the legal entity form to such business organizations that served the public interest.[377] The rationale behind this development was that "it has been found necessary, when it is for the advantage of the public, to have particular rights continued, to constitute artificial persons, who may maintain perpetual succession and enjoy a kind of legal immortality. These artificial persons are called bodies politic, bodies corporate (*corpora corporata*), or corporations."[378]

Just as municipal property had been reclassified within the law of private ownership, various groups such as *collegia* and *societates* were granted the right to own property; subsequently, the Roman government designated its treasury (*fiscus*) as a corporation.[379] Indeed, Gaius remarked that "those who are permitted to form a corporation (*corpus* habere) for the purpose of a *collegium* or a *societas*

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[374] *See* MACKENZIE, *supra* note 195, at 76 (noting that the Romans established corporations "for the advancement of religion, learning and commerce, and even for social and convivial purposes," because corporations preserve "particular rights . . . for an indefinite period, in place of allowing them to fall with the lieves of the members of which the body corporate might at any time be composed").

[375] *See* WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 455 (1979).

[376] For an insightful discussion of legal personality in governmental and business entities, see Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1057, 1099 (1980).

[377] *See* BURDICK, *supra* note 158, at 283–284 ("In all the incorporations, however, the public welfare was supposed to be served. Corporations were not originally created, theoretically at least, for the sake of the private gain of any group, but only that the welfare of the state might be promoted.").

[378] BLACKSTONE, *supra* note 375, at 455.

[379] *See* BURDICK, *supra* note 158, at 283–284.

or any other similar body, have the right, after the manner of a municipality (*ad exemplum rei publicae*), to have common property, a common chest, and an actor or *syndicus* by whom, just as in a municipal body (*tamquam in re publica*), anything that has to be transacted or done for the common welfare may be so transacted and done."[380]

Although Roman lawmakers did not specify corporations as public or private legal entities, such entities reflected the models of government bodies that had independent legal personalities.[381] Thus, for a limited number of purposes, all having the public good in mind,[382] entrepreneurs could form business organizations under the corporate form.

Chartering a corporation required the explicit approval of the Roman state, and could not be enacted only by the members-to-be.[383]

As Burdick translates:

> [T]he Digest, quoting from Gaius, says: "A societas or a collegium or a similar corporation (corpus) is not a common right. This is a matter that is controlled by statutes (*leges*), decrees of the senate, and imperial constitutions. It is only in a few cases that such corporations have been allowed, such as to partners in the collection of the public revenues, and in the operation of gold and silver and salt mines. There are also at Rome certain *collegia* whose corporate existence has been created by decrees of the senate and imperial constitutions, such as *collegia* of bakers and certain others, also of shipowners, colleges of whom are also found in the provinces."[384]

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[380] *Id.* at 284.

[381] *Id.* at 283–284. For insightful considerations about the nature of corporations as a *tertium genus*, a third form, separate from public and private entities, *see generally* Ciepley, *supra* note 57. For a further discussion on corporate personality, see generally Ron Harris, *The Transplantation of a Legal Discourse: Corporate Personality Theories from German Codification to British Political Pluralism and American Big Business*, 63 WASH. & LEE L. REV. 1421 (2006).

[382] In the time of the Empire, mining corporations, tax collecting corporations, and corporations of shipwrights seem to have been the most common, because Roman writers of the period specifically used such businesses as case examples. *See* BURDICK, *supra* note 158, at 285

[383] *See id.* at 286.

[384] *Id.* at 286 Neque societas neque collegium neque huiusmodi corpus passim omnibus habere conceditur: nam et legibus et senatus consultis et principalibus constitutionibus ea res coercetur. Paucis admodum in causis concessa sunt huiusmodi corpopra: ut ecce vectigalium publicorum sociis permissum est corpus habere vel aurifodinarum vel argentinfondinarum et salinarum. Item collegia Romae certa sunt, quorum corpus senatus consultis atque constitutionibus principalibus confirmatum est, veluti pistorum quorundam aliorum, et navicolariorum, qui et in provinciis sunt. Quibus autem permissum est corpus habere collegi societatis sive syndicum, per quem tamquam in re pubblica, quod communiter agi fierique oporteat, agatur fiat (D.3.4.1 pr. – 1; Gai 3 ad ed. Prov.)

Thus, as Blackstone remarked, Roman lawyers may validly claim that they originated the corporation as a legal entity and its application to business firms.[385] The phrase "*corpus habere ad exemplum rei publicae*" indicates the conceptual unity of a "*corpus*" beyond those of single members of the "*societas*" or of the "*collegium*." Thus, such a unified body is qualified as corporate entities, which maintains its legal identity in spite of changes in its members and is a center of imputation for legal relations. In other words, such a unified body is a legal person.

Such business corporations could hold property, sue and be sued, as well as enter into agreements in their own name. Then, as now, all corporate property and affects belonged to the corporate body as a separate person in law, and not to the particular members that composed the corporate body.[386] The same principle applies to debts due the corporation[387]. In fact, individual members of a corporation could neither claim property rights to corporate assets –here, the difference with the *societas consensu contracta* and its *actio pro socius* or *renuntiatio* is glaring – nor were they liable for corporate debts.[388] In other words, with the provision *si quid universitas debetur, singulis non debetur; nec quod debetur singuli debent*, the Romans granted corporations, including businesses, a groundbreaking organizational technology: perfect asset partitioning.[389] This entails two pivotal legal effects, namely asset lock-in[390] and limited liability,[391] and a crucial practical result: continuity of the business organization (in other words, insulation of the business organization from the fate and will of its equity members)[392].

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[385] BLACKSTONE, *supra* note 375, at 455.
[386] *See* BURDICK, *supra* note 158, at 283–284
[387] *See id.*
[388] *See* Hansmann & Kraakman, *supra* note 8 at 387–440; Blair, *supra* note 58, at 427-28.
[389] *See* Hansmann, Kraakman & Squire, *supra* note 153, at 1358.
[390]*See* Hansmann & Kraakman, *supra* note 8, at 440.
[391] See Blair, *supra* note 58, at 436.
[392] *See* BURDICK, *supra* note 158, at 287.

iii. The Main Features of the Societas Publicanorum

In summary, the Roman government had a quandary on its hands: the activities carried out by the *publicani* were necessary for the public good, but the available business forms at that time could not suit their needs. Thus, as explained above, the solution was applying the legal entity technology to these entrepreneurs' productive activities. This originated the *societas publicanorum*, which differs from the *societas consensu contractae* by a set of exceptions only possible by virtue of its legal personality.

Ultimately, this set of exceptions provided the *publicani* with stability and continuity, thus enhancing the public good.[393]

First, because of perfect asset partitioning and asset lock-in, the "departure" of individual equity members did not affect the existence of the *societas publicanorum*. This provided business continuity and stability in economic transactions.

This exception to the *societas consensu contracta* concerns the termination of the *societas publicanorum* in the case of a *socius*'s death.[394] As opposed to *societates consensu contractae*, the death of a *socius* of a *societates publicanorum* did not terminate the business organization.[395]

The general rule was that a *societas publicanorum* remained in existence after the death of a *socius*.[396] An exception to this rule, however, was upon the death of a *manceps*, i.e. a *socius* who managed the business organization, bid for and signed contracts with the government.[397] The *socii* typically selected the most upstanding and admirable individual among them as *manceps*, making

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393 With regard to the need for a public purpose, Lord Mackenzie states that *cities, colleges, hospitals, scientific and trading associations and societas for other public purposes may be so incorporated*. *See* MACKENZIE, *supra* note 195, at 155.

394 For a comparison to the *societas consensu contracta*, see Chapter 2, Part I.

395 "*[I]n societate vectigalium nihilo minus manet societas et post mortem alicuius, sed ita demum, si pars defuncti ad personam herediseius adscripta sit, ut heredi quoque conferri oporteat; quod ipsum ex causa aestimandum est. quid enim, si is mortuus sit, propter cuius operam maxime societas coita sit aut sine quo societas administrari non possit?*" ("in the case of the society of tax collectors, the partnership remains in existence even after the death of one of the partners, as long as the deceased partner's share was bequeathed to his heir, so that it must be conferred upon him"). DIG.17, 2, 59 PR.

396 Ulrike Malmendier, *Roman Shares, in* THE ORIGINS OF VALUE, THE FINANCIAL INNOVATIONS THAT CREATED MODERN CAPITAL MARKETS 31, 37 (W. Goetzmann & G. Rouwenhorst eds., 2005).

397 *See* BADIAN, *supra* note 295, at 136.

him *princeps inter suos*, or "the first among equals."[398] In other words, *socii* selected the controllers of a firm, and entrusted them with the power to manage the enterprise. Such controllers were called *manceps* because they bid on contracts by raising their hand (*manus*) that were willing to bid on a contract at an increased price.[399]

Socii appointed *manceps* with decision-making power and representation of the organization.[400] *Manceps* managed the firm and could enter contracts binding the *societas publicanorum*, thus reducing decision-making transactional costs and granting managerial dynamism. In substance, the *manceps* was an archetype of a modern general partner in a limited partnership (or an *accomandatario,* in the case of present day *società in accomandita semplice* or *società in accomandita per azioni*).[401] In fact, the *societas publicanorum* represents the archetype of modern business legal entities, featuring some traits of limited partnerships and some traits of corporations.[402]

The assessment of a *mancep*'s personal qualities and their persistence over time was crucial in order to organize a firm by separating equity holders and controllers, whose qualities provided the requisite security to protect equity and non-equity-coventurers' firm-specific investments. In this context, given the appointment of delegated control to the *manceps*, their death initially terminated the business organization.[403] Indeed, if the deceased was responsible for the formation of such a business organization (or if it could not be managed without him), the firm dissolved. Thus, the death of the *manceps* would spell the end of the partnership.

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[398] *See* Malmendier, *supra* note 396, at 37.

[399] Interestingly, R. Badian claims that Festus is incorrect in his etymological claim, but provides no alternate origin of the word *manceps*. *See* BADIAN, *supra* note 295, at 136.

[400] Gaius remarks that, "*Quibus autem permissum est corpus habere collegii societatis sive cuiusque alterius eorum nomine, proprium est …habere…actorem sive syndicum, per quem tamquam in re publica, quod communiter agi fierique oporteat, agatur fiat.*" ("Those organizations who are granted the right to incorporate, either as *collegium* or as *societas* or in any other form, typically have a representative or syndic, through whom, just like in a state, everything that needs to be done and needs to happen for the community gets done and happens.") G. DIG. 3:4:1:1.

[401] *See* Hansmann, Kraakman & Squire, *supra* note 153, at 1361.

[402] *See id.* at 1360–1361; *see also* Malmendier, *supra* note 396, at 36-37.

[403] *See* Malmendier, *supra* note 396, at 36-37.

On the other hand, the dissolution of the *societas publicanorum* upon the death of the *manceps* was not in the best interest of either the *socii* or the Roman government as long as another person could replace the *manceps*.[404] The Roman legislature overcame this predicament. According to paragraph 46 of the *lex portorii Asiae*, in 57 B.C., the consuls Nero and Lucius Calpurnius Piso announced a twenty-day *manceps* transitional period, during which the members of a *societas* could select a new *manceps* to replace a deceased one.[405] Thus, the *socii* of a *societas publicanorum* "had the option to substitute the *manceps* with another person for a limited period after contract conclusion."[406] Annual changes of the *manceps* were later allowed from 5 A.D. onward.[407]

This allowed for continuity of a firm and stability of agreements between *societates publicanorum* and the government. In fact, as Malmendier points out, "that way, the censors established contractual continuity of the relationship between a *societas publicanorum* and the government despite the replacement. Given Rome's refined law of obligations, this 'inconsistency' is a clear indication that the *societas publicanorum* is acknowledged as a separate legal entity."[408]

In addition, according to Paulus, an *actio pro socio* against a *societas publicanorum* did not necessarily terminate the business organization.[409] This specific form of *actio pro socio* was called *actio pro socio menente societate*,[410] and it contributed to shaping the *societas publicanorum* as an independent legal entity with continuity and stability in its transactions.

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404 *Id.*
405 *Id.*
406 *Id.*
407 *Id.*
408 *Id.*
409 *See* THE DIGEST OF JUSTINIAN, *supra* note 62. ("*Nonnumquam necessarium est et manente societate agi pro socio, veluti cum societas vectigalium causa coita est propterque varios contractus neutri expediat recedere a societate.*" ("Occasionally it is necessary to go to court against a partner, but keep the partnership alive; for example when a partnership is formed for tax collection and, because of the various contracts, it suits neither party to withdraw from the partnership.")) D. 17, 2, 65, 15.
410 Malmendier, *supra* note 402, at 36.

Furthermore, as result of asset partitioning and centralized management, *societates publicanorum* could issue transferable shares,[411] called *partes*[412]. In other words, shareholding became fungible and provided a class of equity-holders with financial claims and limited liability, but not with managerial say.[413]

In particular, as confirmed in Cicero's second speech against Verres,[414] shareholders frequently traded their shares after the government awarded a *societas publicanorum* a contract. [415] Given the organizational structure of the *societas publicanorum,* as recounted by Rostovtzeff, "it was even possible for outsiders to invest capital in the *societas* by purchasing share certificates which circulated on the financial markets."[416]

Polybius claims that in the second century B.C., nearly every Roman was involved in the *societates publicanorum*.[417] Cicero confirms that many citizens held shares in these business organizations.[418]

On this ground, the *societas publicanorum* featured centralized management, tradable shares, and protected the firm from the fate and will of the *socii*, which are traits that are characteristic of the modern corporate form. Consistently, Gaius identified the *societates publicanorum* among the

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411 Further strengthening the similarities between modern shares and *partes* is that *partes* had fluctuable prices, contrary to the claims of P.W. Duff, who claimed *partes* were simply loans with "variable interest rate[s]." This is known from Cicero, who mentions *partes illo tempore carissimae*, shares that were highly valuable at the time. This implies that share prices were subject to a business venture's profitability, as are today's stocks. Further similarities between the *societates publicanorum* and the listed corporations have caused some to speculate that Rome was host to a stock market system. Although the extent of a Roman stock marketis unknown, it is clear that participation in the *societas publicanorum* was common among the Roman populace. See Malmendier, *supra* note 402 at 38.

412 See CICERO, PRO LEGE MANILIA. PRO CEACINA. PRO CLUENTIO. PRO RABIRIO PERDUELLIONIS REO 2.6.

413 *See* Hansmann, Kraakman & Squire, *supra* note 153, at 1358.

414 Cicero implies the transferability of shares when he quotes an exceptional restriction: *Qui de L. Marcio M. Perperna censoribus redemerit . . . socium non admittito neve partem dato neve redimito*. *See* CICERO, SECOND IN VERREM 1.55.143.

415 Such trades frequently occurred near the Temple of Castor on the Forum Romanum. See MICHAEL ROSTOVTZEFF, THE SOCIAL AND ECONOMIC HISTORY OF THE ROMAN EMPIRE 31 (1957).

416 MICHAEL ROSTOVTZEFF, GESCHICHTE DER STAATSPACHT IN DER RÖMISCHEN KAISERZEIT BIS DIOKLETIAN 372 (1902); *see also* REINHARD ZIMMERMANN, THE LAW OF OBLIGATIONS: ROMAN FOUNDATIONS OF THE CIVILIAN TRADITION 468 (1996).

417 POLYBIUS, HISTORIA 6.17.3.

418 CICERO, PRO LEGE MANILIA. PRO CEACINA. PRO CLUENTIO. PRO RABIRIO PERDUELLIONIS REO 2.6.

organizations with a *corpus*.[419] Furthermore, Cicero implied, and the Digest confirmed,[420] that the *societates publicanorum* was a legal entity.[421]

To summarize, "by the first century B.C., the largest societates publicanorum appear to have resembled the modern public company in both size and structure, with 'multitudes' - presumably hundreds - of limited partners who could trade their shares on a market similar to a modern stock exchange."[422]

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419 G. DIG. 3:4:1:1
420 DIG. 46, 1, 22.
421 CICERO, AD FAMILIARES 13.9.2.
422 Hansmann, Kraakman & Squire, *supra* note 153, at 1361.

B. Traits of a Corporation

i. From Roman to American Corporations

As Chancellor Kent remarked, the abilities and incapabilities of corporations under English Law are very similar to those of corporations under Ancient Roman Law.[423] This is largely attributable to the fact that the fundamental principles of law applicable to Common Law corporations were borrowed from the policy of governmental corporations established by the Romans in Britain and in other colonies.[424]

A parallel can be drawn between the role of corporations in enhancing the growth and expansion of the economy, well-being, and power of the state in Ancient Rome and in the United States. As was the case with *societates publicanorum* in Ancient Rome, from the founding of the United States onward, corporations were used as an arm of the American government to build the nation.[425] Since the origin of the country, corporations have been chartered at unparalleled rates in order to facilitate the growth of the nation, both physically through public works projects (roads, waterways, and bridges) and economically (manufacturing, the insurance industry, and banking).[426]

Moreover, both ancient Romans and early Americans sought to evaluate the merits of granting business separate legal entity status. Under the corporate authorization regime, the legal personality was related to an upfront assessment of the public interest for which the corporation was chartered, in line with the tradition of the Roman *societas consensu contracta*. Thus, corporations were limited to activities involving promotion of the public good.[427]

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[423] JAMES KENT, COMMENTARIES ON AMERICAN LAW, VOL. 2 269 (1827)

[424] *See* WILLIAM L. BURDICK, THE PRINCIPLES OF ROMAN LAW AND THEIR RELATION TO MODERN LAW 279 (1938).

[425] *See* Ciepley, *supra* note 72.

[426] *See id.*

[427] KLEIN, COFFEE JR., & PARTNOY, *supra* note 7, at 112.

However, by the mid-19th century, after general incorporation laws passed, the new, mainly private status of corporations permitted a wider range of corporate purposes.[428]

Indeed, private corporations could now engage in any legal activity.[429] Americans no longer conceived corporations as "indirect arms of government", which diminished their regulation.[430]

Nevertheless, corporations continue to feature the typical legal and organizational features of their original public-interest-oriented counterparts including recognition as distinct legal entities.[431]

The following section explores this continuity, which allows us to recognize the organizational defects that arise when a private interest-driven party, a shareholder, is able to gain control over a legal entity whose traits were conceived to enhance public good besides promoting private enrichment.

ii. Basic Features of Business Corporate Entities

A corporation is ultimately the organization of a firm's legal rights and responsibilities in a juridicially-created, artificial legal entity. [432]

Corporate entities are typically described using five main legal features: (i) separate entity, (ii) limited personal liability for those who participate in the corporation, (iii) delegated management, (iv) transferable shares, and (v) perpetual life.[433] These five legal characteristics can be re-organized and condensed into three with some taxonomy: (i) separate entity or perfect asset partitioning, (ii) delegated management, and (iii) free transferability of shares.[434]

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428 *Id.* at 112–113

429 *See* Ciepley, *supra* note 72.

430 *See* Ciepley, *supra* note 371, at 112-14.

431 *See* Hansmann, Kraakmann, & Squire, *supra* note 153, at 1360-61.

432 *See* Blair & Stout, *supra* note 12, at 266; *see generally* Ciepley, *supra* note 57.

433 S.A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 891—92 (2006); Lynn A. Stout, Corporate Entities: Their Ownership, Control, and Purpose (unpublished manuscript provided by the Author); Stout *supra* note 31; *see also* Andrew A. Schwartz, *The Perpetual Corporation*, 80 GEO. WASH. L. REV. 764 (2012).

434 *See* Lynn Stout, *Corporate Entities* (unpublished manuscript).

We can describe the first essential feature of the corporate form with two different concepts. First, it intrinsically effects the legal personality technology[435]: the separate entity status or perfect asset partitioning.[436] Corporations can own assets, bear liabilities, exercise rights as well as file or defend lawsuits in their own name.[437] The separate entity status causes such effects by virtue of the legal personality that entail the creation of an independent pattern of rights and responsibilities or by perfect asset partitioning, which explains the effects of the legal personality, i.e. the reciprocal severing of assets and liabilities of the members of the corporation from those of the corporate entity.

The second feature is functional to separate entity status and asset partitioning: delegated and centralized management. Because corporations, on one hand, own assets, bear liabilities, and exercise rights in their own name, and, on the other hand, are not natural persons (and thus are incapable of making decisions or taking action), they require an efficient organization of decision-making power[438] Thus, the control rights relinquished by the equity-members are pooled together and entrusted to a specific organization's body, the board of directors, which in turn often further delegates part of the operations according to the hierarchical system that also characterizes the management of corporations.[439]

The third intrinsic legal feature of corporations is functional to the perfect asset partitioning and is interlocked with delegated management: share transferability.[440] Shareholders can buy, sell of gift share certificates without consequences on corporate assets and liabilities. In turn, shareholders

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[435] *See* Ron Harris, *The Transplantation of a Legal Discourse: Corporate Personality Theories from German Codification to British Political Pluralism and American Big Business*, 63 WASH. & LEE L. REV. 1421 (2006).

[436] *Id.*

[437] *See* Stout, *supra* note 433.

[438] *See* WILLIAMSON, *supra* note 10, at 79; Grossman & Hart, *supra* note 15, at 716; Robé, *supra* note 31, at 28-29; Rajan & Zingales, *supra* note 37, at 422.

[439] *See* Blair & Stout, *supra* note 12, at 287.

[440] *See* Stout, *supra* note 433.

exercise the rights they have in connection with their ownership of shares; they do not own the corporation or its assets (and cannot sell them *pro-quota*).[441]

These three legal features of corporations give rise to another crucial feature of corporations: their perpetual life ("or the fact that the entity's existence does not end automatically upon the death, resignation, or bankruptcy of one of its owners"[442]). Moreover, although Blackstone described the perpetual succession as the defining characteristic of a corporation,[443] it seems reasonable to consider the perpetual existence of corporate entities to be a practical (or organizational) feature caused and permitted by the three legal characteristic mentioned above, rather than a legal characteristic itself.

With respect to the taxonomy among the traits of corporations, Lynn Stout has remarked that "[o]nly legal personality and delegated management are always found in the corporate form. A corporation without legal personality is an oxymoron, and as a legal entity, a corporation must delegate and rely on natural persons to make decisions and act in the entity's name."[444] In fact, those two traits substantially characterized the original corporations developed within the Ancient Roman system.[445] However, if we add a business purpose to the equation, free transferability of shares becomes an essential legal feature to permit circulation of interests connected to an investment once the initially contributed assets are locked into the corporation. It combines the perpetual existence of the legal entity with asset lock-in and transforms future returns into present-day wealth.[446]

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[441] "In legal terms, shareholders don't own the corporation (they own securities that give them a less-than-well-defined claim on its earnings)." Justin Fox & Jay W. Lorsch, *What Good are Shareholders?*, HARV. BUS. REV. 52 (2012). For an insightful investigation, see STOUT, *supra* note 29, and Robé, *supra* note 31, at 8.

[442] *See* Bank *supra* note 48, at 890.

[443] WILLIAM BLACKSTONE, COMMENTARIES 468 (1769)

[444] *See* Stout, *supra* note 433.

[445] *See* Hansmann, Kraakman, & Squire, *supra* note 153, at 1360-61.

[446] See Stout, *supra* note 31.

iii. Separate Entity and Asset Partitioning: Two Sides of Legal Personality

The most essential legal feature of a corporate entity is legal personality.[447] Indeed, this feature is what makes the *societas publicanorum* the archetype of the corporate form.[448]

When the initial equity members charter a corporation, the business organization becomes a (fictitious) separate entity. Thus, the firm is organized as a distinct legal entity, separate from any of its investors or managers. Corporations can buy, sell, or hold property,[449] as well as make contracts, enter transactions, sue, and be sued in their own names.[450] Equity members have no power to act on behalf of the corporate entity *qua* shareholders.[451]

As separate entities, corporations' assets and liabilities are completely distinct from those of their members (e.g. those of shareholders and managers)[452]: this legal feature is referred to as perfect asset partitioning.[453] In other words, asset partitioning is the immediate result of the distinct decisionmaking authority and legal capabilities of corporations (i.e. the ability to bond its assets when the decisionmaking authority takes place) and this happens because of the recognition of a legal personality.[454]

Perfect asset partitioning is two-fold: members of corporate entities are not held personally liable for the debts or liabilities of the corporation—this aspect is referred to as

[447] *See* Stout, *supra* note 433.

[448] *See* Hansmann, Kraakman, & Squire, *supra* note 153, at 1360-61; *see also* Malmendier, *supra* note 402, at 31–42.

[449] Corporations are also given the right to own shares of other corporations. *See* WILLIAM G. ROY, SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL CORPORATION IN AMERICA 172 (1997).

[450] *See* Blair, *supra* note 58, at 391; Stout, *supra* note 433. ("Legal personality explains a number of otherwise-puzzling elements of corporate law, for example the idea that directors can owe fiduciary duties of loyalty and care to an artificial person. It also explains why jurisdictions tax the incomes of corporate entities, then also tax corporate distributions to shareholders."); Blair & Stout, *supra* note 12, at 266.

[451] *See* Stout, *supra* note 433.

[452] "When a firm is organized as such an entity, the assets owned by that entity in its own name become the designated separate pool of firm assets." *See id.*

[453] *See* Hansmann & Kraakman, *supra* note 8, at 393 ("[E]stablishing this separation is the principal role that organizational law plays in the organization of enterprise. More particularly, our argument has four elements: (1) that a characteristic of all legal entities, and hence of organizational law in general, is the partitioning off of a separate set of assets in which creditors of the firm itself have a prior security interest; (2)that this partitioning offers important efficiency advantages in the creation of large firms; (3)that it would generally be infeasible to establish this form of asset partitioning without organizational law; and (4)that this attribute—essentially a property attribute—is the only essential contribution that organizational law makes to commercial activity, in the sense that it is the only basic attribute of a firm that could not feasibly be established by contractual means alone.").

[454] *Id.* at 391.

"defensive asset partitioning"[455] or, more commonly, "limited liability"—and participants and third parties are assured that the pool of assets used in the business will be available to meet the needs of the corporation (e.g., its creditors).[456] Thus, these assets are shielded from creditors and made available to shareholders only according to a legal framework that grants precedence to corporate creditors[457]—"affirmative asset partitioning"[458] or "assets lock-in."[459]

In more detail, asset lock-in[460] provides two effects.[461] The first effect, sometimes referred to as "entity shielding,"[462] ensures that the creditors of a member of a corporation (e.g., a shareholder, director, or employee) cannot take corporate assets to satisfy the member's personal debt.[463] Thus, a shareholder's or director's creditors cannot claim the corporation's assets.[464] In addition, if the corporation is liquidated, the creditors of the corporation will have priority over personal creditors of shareholders.[465]

The second effect is that since shareholders relinquish property rights on the assets contributed to the corporation and do not have control rights over the assets generated by the

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455 *See id.*, at 427..

456 *See* Blair & Stout, *supra* note 12, at 266.

457 *See id.*; *see generally* Ciepley, *supra* note 57.

458 Hansman & Kraakman, *supra* note 8 at 394–95.

459 *See* Blair, *supra* note 58, at 391.

460 "This distinguishing characteristic is the corporation's ability to commit both capital and the earnings from capital to the firm so that it may not be recovered by shareholders, or the creditors of shareholders, in the absence of action by the firm's board of directors." *See* Bank, *supra* note 48, at 891–92.

461 Contractual agreements among equity members or between equity members and creditors cannot easily mimic the effects of asset lock-in due to a free-riding problem among the equity-members (and, plausibly, among creditors) that exposes the company's assets to risk for personal gains. Thus, continuity, direct agency, limited liability and entity shielding need to be established by law. Conversely, the complementary effect of asset partitioning, namely limited liability, can be more easily recreated via contracts. *See* Hansman & Kraakman, *supra* note 8, at 387–440.

462 *See* Hansmann, Kraakman, & Squire, *supra* note 153, at 1356.

463 *See* Hansman & Kraakman, *supra* note 8 at 402 ("In the absence of affirmative asset partitioning, creditors of any single owner would have the right to proceed against that owner's share of the firm's assets in case of the individual's insolvency. As a consequence, potential creditors of the firm itself would have difficulty determining the appropriate terms on which to extend credit. Intimate familiarity with the firm's own assets and business affairs would not suffice to determine the firm's creditworthiness; knowledge of the personal creditworthiness of each of the firm's owners would be necessary as well. Moreover, if a creditor's relationship with the firm were to extend over any considerable period of time, the creditor would need to keep monitoring the creditworthiness, not only of the firm itself, but also of all of its individual owners.").

464 *See* Jean-Philippe Robé, *supra* note 31, at 28–29; *see generally* Blair & Stout, *supra* note 12.

465 "This result is reached without the corporate creditors perfecting any security interest in the corporate assets" KLEIN, COFFEE, JR., & PARTNOY, *supra* note 7, at 108.

corporation, they do not have a general claim on assets of the corporation.[466] In other words, assets belong to the corporation and not to the individual shareholders.

Directors, shareholders, or employees "lack the power to extract those assets for themselves at will."[467] In particular, shareholders are not entitled to the return of their capital—in the form of their contribution—or the earning from their investments—in the form of dividends[468]—during the course of business.[469]

This reduces the risk of opportunistic or ill-timed demands for distributions, or—more generally—asset dilution by actions of the shareholders.[470] Thus, asset lock-in allows firms

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[466] *See* Bank, *supra* note 48, at 913–14 ("The features of the early corporation that supported capital lock-in have remained remarkably constant in modern statutes. Dividends continue to be subject to tight controls, and investors do not have the right to demand repayment of their initial investments. Under the Delaware statutes that govern the majority of public corporations, the directors are empowered with the right to allocate amounts received in exchange for stock as capital or surplus. Dividends may be paid out of surplus or the current or prior year's profits, but not out of capital. Moreover, under both the Model Business Corporation Act ("MBCA") and Delaware law, the decision to declare a dividend is left to the sole discretion of the board of directors. As in the nineteenth century, directors may be held liable for the payment of unlawful dividends. Stockholders also lack the power to force dissolution as a method of reclaiming their invested capital. Under both Delaware law and the MBCA, a resolution to dissolve the corporation must be approved by a majority of the board of directors as well as the stockholders. Moreover, under Delaware law, in the absence of the action of the board, dissolution must be approved by the unanimous consent in writing of all of the stockholders. Thus, by contrast to at least the general partnership and the limited liability company, the corporation is still the most effective device for locking in the capital supplied by investors.").

[467] *See* Stout, *supra* note 31 ("Lock-in can be defeated by a controlling shareholder").

[468] For a comparative perspective, it must be noted that under certain jurisdictions, such as under Italian Corporate Law, shareholders resolve on the distribution of dividends. *See* CAMPOBASSO, *supra* note 204, at 493.

[469] *See* Bank, *supra* note 48, at 908-09 ("[A] shareholder would only recover his capital and pro rata share of the earnings from capital upon the dissolution of the corporation. Unlike the partnership, though, where the vote of one withdrawing partner [as otherwise mentioned with respect to the societas consensus contracta, eds.] might cause dissolution, it typically took a vote of two-thirds of the shareholders for the corporation to dissolve before the expiration of its charter.").

[470] Lynn Stout points out how effective asset lock-in is actually a provision in the higher interest of shareholders rather than a disadvantage imposed on them in order to benefit different constituencies:

> Let us first consider an important but counterintuitive advantage of locking assets into a corporate entity: it encourages aggregated investment by reducing shareholders' risk that they will harm each other. To understand that risk, imagine a railroad company that lacked asset lock in, so that each shareholder could withdraw her proportionate interest in the railroad's assets at any time, just as partners can withdraw their interest from a partnership. Such a railroad would be constantly exposed to the danger that a significant shareholder might demand the return of her interest. Unless the railroad happened to have a lot of cash on hand, it might be forced to sell essential assets to meet such a demand, destroying the value of the enterprise. And, as Blair has explained, shareholders might very well make such demands, either because they suddenly find themselves in need of cash or (more opportunistically) because they hope making a demand that threatens the enterprise will give them leverage to extract valuable concessions from their fellow shareholders. Alternatively, as Henry Hansmann and Reinier Kraakman have pointed out, the creditors of a shareholder who becomes insolvent might make similar claims.

Stout, *supra* note 31.

organized in a corporate form[471] to protect "firm-specific" assets that would lose much of their value outside the firm (and encourage corporate stakeholders to make their own beneficial firm-specific investments[472]) and permits the pursuit of uncertain or long-term projects[473] with less fear of disruption.[474]

According to Lynn Stout:

> [U]nlike entity shielding, which is inherent in the corporate form, asset lock-in depends, as a practical matter, on the degree to which the corporation's board can resist the demands of natural persons who want the corporation to distribute its assets (for example, shareholders seeking dividends, or executives or employees seeking larger salaries).[475]

Although from a theoretical point of view, the assets and liabilities of the members are separated from those of the corporation, when members can exercise control rights over the assets that compose the firm, they gain a position that allows them to unlock the corporation's assets.[476] This ultimately explains the fiduciary duties framework that regulates the operations of the board of directors and of controlling shareholders. On this ground, it becomes relevant to start to consider whether the fiduciary duties framework conceived for the members might be applied as-is to controlling shareholders or to other subjects who, gain *de facto* control (or influence), can control the assets (or affect them through business decisions)—a topic discussed in the first section of next chapter.

Another effect of the separation between assets and liabilities of the corporation from those of its members is its ability to enter transactions and be a party to a legal action in its own

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471 *See* Hansman & Kraakman, *supra* note 8 at 435 ("Strong-form legal entities, which are characterized by liquidation protection from the owners' personal creditors, also typically provide for substantial liquidation protection from the owners themselves. Or, put differently, the liquidation powers of an owner's personal creditors are generally the same as those of the owner himself. For example, since personal creditors of a bankrupt corporate shareholder step into the bankrupt's role as shareholder, those creditors can force liquidation of the corporation's assets only if the shareholder held enough shares in the corporation—generally fifty percent—to have been able to force liquidation himself.").

472 *See* Blair & Stout, *supra* note 12, at 287; Blair, *supra* note 58 at 391.

473 *See* Stout, *supra* note 31.

474 *See id.*

475 *See id.*

476 *See id.*

name.[477] This allows limited legal responsibility arising from these corporate contracts and legal actions to the corporation's assets, as if it were a stand-alone natural person. According to this phenomenon, shareholders, as well as other persons associated with a corporation (e.g. directors and executives) can be excluded from liability for a corporation's acts. Put differently, shareholders enjoy "limited liability."

Shareholders' limited liability is particularly important to public corporations because it would be much more difficult to develop an active market for shares if shareholders were personally liable for a corporation's acts.[478] They would need to closely monitor managers' behavior and the wealth and creditworthiness of other shareholders.[479]

Nowadays, the limited liability of corporate shareholders is considered[480] (one of) the principal legal feature(s) of corporations.[481] However, at the beginning of the twentieth century, limited liability was considered "incident to most private corporations, but . . . not essential to corporate existence."[482] Moreover, many jurisdictions—such as Great Britain and California[483]—adopted a waivable limited liability relatively recently.[484]

Additionally, in some circumstances, limited liability for the members of corporations can be defeated. With respect to shareholders, when some requirements are met, the "piercing the corporate veil" doctrine allows creditors of the corporation to access the controlling

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477 *See* Stout, *supra* note 433.

478 Passive investment would be limited only to high-risk takers if limited liability is not provided to corporations.

479 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 41–43 (1991). For an overview of the advantages of limited liabilities, *see* Hansmann & Kraakman, *supra* note 8 at 424–27.

480 *See* Blair, *supra* note 58 at 391–92 ("Some legal scholars have stressed the important role played by limited liability in allowing business corporations to attract capital in the form of modest investments by many small investors. Without minimizing this important role, I stress in this Article the role played by the other side of asset partitioning, which I call 'resource commitment.' Hansmann and Kraakman have recently argued, similarly, that "the truly essential aspect of asset partitioning is . . . the reverse of limited liability—namely, the shielding of the assets of the entity from claims of the creditors of the entity's owners or managers.").

481 And so since the second half of the former century. *See* HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 78 (1961).

482 WILLIAM L. CLARK, JR., HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 6, 14– 16 (1987).

483 Great Britain extended limited shareholder liability to companies with more than 25 members with the Limited Liability Act 1855, while limited shareholder liability was not a feature of California corporations until 1931. *See* Mark Weinstein, *Limited Liability in California 1928-1931: It's the Lawyers*, 7 AM.L. & E. REV. 439 (2005).

484 *See* Stout, *supra* note 433.

shareholder's personal assets.[485] Other members, such as corporate directors, executives, and employees are required to act in compliance with a specific legal framework and they may incur personal liability when they exercise their corporate powers in disregard of that framework.[486].

As a final remark, perfect asset partitioning—namely, asset lock-in and limited liability—consent to pull together, lock-in and entrust the board of directors with investments by multiple investors does not take into account the qualities of the latter. In fact, if corporations were not provided with asset lock-in, the will (e.g., to withdraw an essential asset or the money earned to carry out the business) and fate (e.g., the insolvency of an equity member) of the shareholders would have affected the existence of the firm in potentially lethal fashion. Thus, this feature is a groundbreaking limitation in raising capital.[487] Likewise, if corporations did not provide shareholders with limited liability, the required monitoring cost over the management as well as over the solvency of the other equity members would disincentivize equity capital investment.

Moreover, the shareholder base would have been restricted, because they would have had to select only equity coventurers with similar assets and risk preferences.[488] In addition, the evaluation of the risk factor for equity-coventurers would depend on the personal situation of the equity-member; personal wealth, debts, marital and family status, health, intrinsic risks, together with personal qualities are all components of the estimation of solvency.[489] A potential transfer of the equity-interest *inter vivos* or *mortis causa* would dramatically affect the risk exposure of the equity-coventurers.[490] As a result, unlimited liability implies a limitation in share liquidity.

Furthermore, absent a stable and controllable pool of assets, liabilities and contracts partitioned from the equity-members, debt financing becomes difficult.[491]

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485 *See* Hansmann & Kraakman, *supra* note 8, at 427.
486 *See* Stout, *supra* note 433.
487 *See* Hansmann & Kraakman, *supra* note 8, at 402–03 (discussing the relevance of affirmative asset partitioning).
488 *See id.*, at 424.
489 *See id.*, at 424.
490 *See* Robé, *supra* note 31, at 21.
491 *See id.*

In short, perfect asset partitioning is the "modern" organizational alternative to the Ancient Roman *fraternitas* among the *socii*. It represents a shift from relying on the personal qualities of the equity coventurers to the neutralization of the effects that those qualities could have had on the enterprise.

iv. Delegated Management

Corporations have to manage assets, workforce, and business strategies. As opposed to natural persons, however, corporate entities are unable to make decisions or take action by themselves.[492] Thus, they must delegate control rights—derived from the relinquishment of equity members' control rights over the firm's assets and from contracts with other stakeholders—to natural persons who carry out decisions on behalf of, and formulate the will of, the business organization. Indeed, the organization and allocation upon natural persons of this decisionmaking power (known as corporate governance) is intrinsic to the corporate form.

The corporate governance model inherent to corporations is the delegation of control over the firm to the board of directors. Thus, the members of the board of directors owe fiduciary duties to the corporation, which, as a legal entity, entrusts the members of the board with the care of the firm and the control rights over it.

With extreme simplification, the reason for entrusting the board of directors with control rights is twofold: organizational and economic.[493]

The principal organizational reason for doing so is that a business form structured around the legal personality requires a stable decisionmaking authority and body, which is insulated from the events that happen to shareholders and to other non-equity-coventurers.[494]

[492] *See* Stout, *supra* note 31.
[493] *See* Stout, *supra* note 433.
[494] *See id.*

Complementarily, assigning the control rights to the board of directors—a third party, different from shareholders and the other stakeholders—permits the corporation to achieve two economic goals.[495] First, a better distribution of the profit stream among shareholders and other stakeholders in order to attract the best (equity and non-equity) investment-contributors.[496] Second, to lock-in capital in order to pursue long-term projects—while transforming future profits into present value.[497].

Corporate law also allows the board to distribute returns among the multiple team members of the firm. This is preferable to both shareholders and non-equity-coventurers. They both restrict their own power, but at the same time limit their risk of falling victim to opportunistic behavior.[498] As a result, investments that may be discouraged by simple formal contracting are instead encouraged by the involvement of a board of directors.[499]

The board acts as a mediating force by making it difficult for any party to withdraw resources from the corporation.[500] Requests for dividends for shareholders, raises for executives, and debt restructuring for creditors all must channel through the board with sound reasoning. This hurdle discourages rent-seeking and other opportunistic behavior.[501]

In addition, professional management allows corporations to be managed by individuals whose qualities and skills (trustworthiness, professional expertise, outstanding curricula, etc.) are assessed *ex ante,* in order the select them.

Such a corporate governance pattern ultimately depends upon its insulation from shareholders and other stakeholders. Thus, only a board-controlled corporation—in which the

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[495] *See* Rajan & Zingales, *supra* note 37, 422.

[496] Because of asset lock-in, shareholders and other stakeholders are more likely to make specific investments in corporate production. *See* Blair & Stout, *supra* note 12, at 287.

[497] *See also* Stout, *supra* note 31.

[498] *See* Stout, *supra* note 88, at 677.

[499] *See id.*

[500] *See* Blair & Stout, *supra* note 12, at 290.

[501] *Id.* at 286.

ownership and control is separate[502]—is effectively consistent with this corporate governance system.[503]

Therefore, only publicly held corporations with dispersed shareholders can provide the economic context to effectively support such a corporate governance model.

In fact, when a shareholder gains a controlling position, even if the legal separation between ownership and control takes place, in practice, this shareholder re-gains control over the firm,[504] which directly implicates both the organizational and economic advantages described above. As extensively remarked in the third section of this chapter, shareholders who are able to regain control over the firm (apart from the members of board), are not subject to a process of assessment of her personal qualities and selection.

v. Free Transferability of Shares

The possibility that a shareholder gains a controlling position is ultimately related to the third fundamental legal feature of listed public corporations: the intrinsic free transferability of shares and its accompanying rights (e.g., to vote, receive dividends, and inspect documents).[505]

The free transferability of shares is crucial to asset lock-in: it allows a shareholder to convert his interest in a corporation into cash by selling his stock without affecting the assets committed to a business project or, more generally, to the enterprise.

Moreover, listing the shares on a well-organized stock exchange within a trading context characterized by effective disclosure and antifraud rules, as well as a fundamental-value efficient market,[506] free transferability of shares permits: (i) enhanced liquidity (essential to large-scale

[502] BERLE & MEANS, *supra* note 57, at 222.
[503] *See* Stout, *supra* note 31.
[504] In fact, directors could feel threatened with replacement if they refused to comply with the controlling shareholder's demands. *See* BERLE & MEANS, *supra* note 57, at 222.
[505] *See* Hansmann & Kraakman, *supra* note 8, at 434 (discussing transferability of contract rights).
[506] *See generally* Gilson & Kraakman, *supra* note 506.

investment), (ii) the transformation of future profits into present-day value, and (iii) board-control of the firm.[507]

Nevertheless, listing shares publicly is the logical assumption of the corporate governance defect discussed in this work: the potential acquisition of control or otherwise influential position by shareholders harmful to the corporation (and thus for other shareholders and stakeholders), and, in turn, for more expanded socio-economic *quae*, such as the economies of geo-political regions that the business of a corporation affects.[508] Indeed, it becomes possible for any acquirer to become a controlling or otherwise influential shareholder. This permits an unselected party to gain control of, or have a material influence on, the corporate firm and thus to manage assets and affect the personal interests of the constituencies—in particular, all the other equity and non-equity-coventurers.

vi. Potential Perpetuity

The organizational effect of a business form characterized by perfect asset partitioning, delegated management, and free-transferability of shares is the ability to outlast its human founders. Once the corporation is created, it can exist in perpetuity.

In fact, although the lifespan of a corporation can be restricted *ex ante* by its corporate charter or terminated as an effect of a merger, dissolution, insolvency or—in extreme circumstances—by judicial decree,[509] corporations are potentially eternal.[510]

As discussed in the former chapter, longevity and stability of the firm were the crucial traits that led to the creation of corporate entities in Ancient Rome.[511] The need to support long-

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507 *See* Stout, *supra* note 31.

508 Depending on the systemic relevance of the corporation, the effect could potentially have a global scale. *See generally* STOUT, *supra* note 29.

509 Typically on a finding of deadlock or oppressive behavior by the controlling shareholders. *See* KLEIN, COFFEE, JR., & PARTNOY, *supra* note 7, at 109.

510 *See* Ciepley, *supra* note 371.

511 *See supra* Chapter 2, Section II.

term projects and sizable enterprise ultimately lead to the rise of the *societas publicanorum* through borrowing the legal personality technology from the system of government. .

SECTION II. CORPORATIONS AND THE PERSONAL QUALITIES OF SHAREHOLDERS

A. Shareholders and Corporations

i. Characteristics of Corporations

Since the Ancient Roman *societates publicanorum*, corporations have muddled the distinction between public and private entities.

On one hand, corporations seem to be public entities due to their fundamental features —in particular, legal personality and delegated management—that the government provided, based on the model of the Ancient Roman system of municipalities.[512]

On the other hand, they seem to fall into the private realm, because private parties who can select the management without interference from the government and who hold a private interest in the performance of the corporate business entity promote, organize, and finance them.[513]

Different aspects of a corporation may be characteristically public or private, yet neither term successfully encapsulates the notion of a corporation as a whole. According to Ciepley, they consist of a *tertium genus*, neither public nor private, but "corporate."[514] Surely, besides serving shareholders' interests, they can enhance the present-day public good by developing the economy and providing services, goods, and infrastructure to society, as well as jobs. In addition, they may benefit future generations by making life-improving projects possible and desirable for current investors through the capital markets.[515]

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512 *See* Ciepley, *supra* note 57, at 152.

513 For a discussion of early corporations, *see generally* Ann M. Carols & Stephen Nicholas, *Giants of Earlier Capitalism: The Chartered Trading Companies as Modern Multinationals*, 62 BUS. HIST. R. 398 (1988).

514 For a categorization of the law applied to corporations under either the public or the private realm, *see generally* JÜRGEN HABERMAS, THE STRUCTURAL TRANSFORMATION OF THE PUBLIC SPHERE: AN INQUIRY INTO A CATEGORY OF BOURGEOIS SOCIETY (1989).

515 Stout, *supra* note 31.

In fact, potential perpetuity, together with asset partitioning, share transferability, and delegated management, make corporations the most suitable business organizations for long-term and large-scale—potentially intergenerational—projects and enterprises.[516]

In addition, within a relatively fundamental value efficient market, corporations can pursue projects that generate profit stream in the future[517] while providing present-day shareholders with value.[518]

These mechanics, however, assume that the market is efficient.[519]

ii. Fundamental Value Efficient Markets and Corporations

A fundamental value efficient market describes a market in which the market price of a company's shares incorporates all information relevant to determine its value, reflecting future expected economic returns for shares' prices in the best possible and most rational way.[520]

The efficient capital markets hypothesis, however, suggests just this: that a company's market share price does not significantly deviate from fundamental value.[521] In reality, investors assess shares value by discounting suboptimal efficiency, and taking into account irrational—sometimes idiosyncratic —factors.[522]

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516 Lynn Stout points out how the perpetuity of the corporate form permits projects over multiple human generations: The Veneranda Fabbrica, for example is a corporate entity that has been building and maintaining the Cathedral of Milan for over 600 years. *See* Stout, *supra* note 31. Similarly, Schwartz remarks how the Hudson's Bay Company was incorporated in 1670 and still operates today. *See* Schwartz, *supra* note 433.

517 To measure benefits of future investments, present shareholders can use a rough correlation between price and value. For example, Lynn Stout clarifies that a future investment remains attractive when the market calculates future benefits of self-driving cars at $1 trillion or $2 trillion, while the required investment is merely $100 billion. To be able to shift wealth backwards in time, the public business corporation's capacity to transform future profits into current share prices does not need to be flawless. A noisy correlation between price and a value does create the risk that, if the present generation of shareholders has the ability to unlock capital and extract assets from the corporation, shareholders will exercise this ability in ways that defeat the corporation's ability to transfer resources into and make investments for future generations. *See* Stout, *supra* note 31.

518 *Id.*

519 *Id.*

520 *See generally* Lynn A. Stout, *The Mechanisms of Market Inefficiency*, 28 J. CORP. L. 635 (2003).

521 *See id.*

522 *See generally* Stout, *supra* note 520.

It is quite common for finance economists today to spend a significant amount of their time searching for a substitute for efficient market theory to explain effectively why market prices fail to reflect true share value. Some proposed theories include the "limits of arbitrage," which claims that share prices are slow and ineffective in reflecting some market information; "behavioral finance," which relates distorted prices to human emotions; and, in particular, "heterogeneous expectations," which discusses the prospect of disagreement among investors.[523]

Thus, the market price could potentially mislead a shareholder into voting for policies and strategies that favor increased speculative components. Accordingly, management of such public corporations would have the incentive to act in a manner that increases overall market speculation.[524]

Research has found that managers of private corporations are both more inclined to invest in long-term projects and more responsive to investment opportunities than managers of publicly held corporations.[525] The conclusion we may draw from this study is that present-mindedness in terms of share price has caused managers of public corporations to abandon long-term investments in favor of short-term investments.

Heterogeneous expectation models help clarify the counterproductive short-term decisions that shareholders and managers often make. During periods of increased speculation, managers considering present shareholders' stock values will liquidate surplus, overpriced shares, "which has the effect of lowering the company's cost of capital and [ ] approv[ing] increased capital expenditures."[526] Notably, Stavros Panageas claims that this actually increases both the fundamental value of a corporation, and the speculative portion of the share price in the eyes of

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[523] *See* STOUT, *supra* note 29 at 63-65.
[524] *See id.*
[525] *See* John Asker, Joan Farre-Mesna & Alexander Ljungqvist, *Does the Stock Market Harm Investment Incentives?* 2 (ECGI FINANCE WORKING PAPER NO. 282, 2010), *available at* http://ssrn.com/abstract_id=1603484.
[526] Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1385–86 (2010).

present shareholders, providing them with higher profits upon the sale of the shares to more optimistic investors.[527]

Thus, as described in the following section of this chapter, managers feel pressure to adopt strategies (both financial and structural, such as share repurchases, or elimination of research and development) that raise share price in the short term, but are harmful to the firm's long-term prospects.[528]

Notwithstanding market inefficiency and conflicts in assessing expectations, over the long run, if stock markets are subject to antifraud and disclosure rules, to some extent, they are still fundamental value efficient.[529] As Fischer Black put it, capital markets are arguably efficient by a factor of only two, so that "price is more than half of value and less than twice value."[530]

iii. Benefits of Separation between Ownership and Control

Efficient financial markets play a crucial role in causing the practical phenomenon that, Berle and Means describe as the separation between ownership and control.[531]

The decision-making power lies in the hands of the board of directors—which has rather free reign over the firm—only if such power is not ultimately subject to the influence of shareholders. Thus, although closely held corporations, as well as listed corporations controlled or influenced by shareholders, share the same pattern of legal features as publicly held corporations, they do not enjoy the same separation between ownership and control.

527 Stavros Panageas, *The Neoclassical Theory of Investment in Speculative Markets* 17 (Apr. 2005), *available at* http://ssrn.com/abstract=720464.

528 STOUT, *supra* note 29, at 63–68.

529 *Id.*, at 65.

530 Fisher Black, *Noise*, 41 J. FIN. 529, 533 (1986).

531 BERLE & MEANS, *supra* note 57, at 112. Due to the difficulty that an average shareholder would have in influencing the election of the board's members, the boards of large corporations are often self-propagating. This is a factor that furthers the separation between ownership and control and increases agency costs. KLEIN, COFFEE, JR., & PARTNOY, *supra* note 7, at 109.

In corporations, the distinction between ownership and control is not a weakness, but rather a vital advantage over other forms of business.

First, entrusting the board with unhindered control protects firm-specific investments, thus incentivizing shareholders and non-equity-coventurers to contribute beyond mere contractual protection.[532] Without delegating decision-making authority to the board, the fate and will of equity-members could cause the dissolution of the business organization.[533]

Second, shareholders, unable to obtain dividends or a share repurchase, could convert their firm-specific investments into cash by selling their shares on reasonably fundamental value efficient stock markets—improved with disclosure and antifraud rules by the Securities Act of 1934.[534]

Lastly, following the previous two effects, business corporations could carry out long-term and large-scale projects and transport future profit streams into present-day value.[535] Corporations could serve the interests of shareholders while providing customers with goods and services, creating jobs, and transferring wealth from present to future generations (and vice versa) by using a board-controlled corporation as a "value time machine."[536]

Three basic elements give rise to such a phenomenon: the inherent legal features of corporations (*in primis*, the legal personality), the dispersion of shares, and a legal framework that favors board control.

Such was the context during Managerialism[537] and a large part of the twentieth century. Corporations were board-controlled and shareholders (given limited voting power and collective action obstacles) were nearly powerless; indeed, the helm of the corporation was firmly in the

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[532] *See generally* Blair & Stout, *supra* note 12.
[533] *See* Stout, *supra* note 31.
[534] *See id.*
[535] *See id.*
[536] *See id.*
[537] *See* GERALD DAVIS, MANAGED BY THE MARKETS: HOW FINANCE RESHAPED AMERICA (2009).

board's hands. Effective asset lock-in, combined with the development of financial markets by virtue of the passage of the Security Act, produced the aforementioned positive results.

iv. From Managerialism to Shareholder Empowerment

In fact, the concept of a corporation, both legally and economically, was quite different at the time of the American War of Independence than it is today. During that period, English law restricted the corporate status to firms given charters coming directly from the king. As such, corporations were generally limited to specific purposes, such as advancing international trade, establishing colonies, or extracting natural resource en masse.[538]

The shift in attitudes regarding corporations in the mid-1800s, though necessary, was mired with debate. Gradually, corporations evolved into their current day form, rather than a specialized creature of the state. Thus, the timeframe between 1844 and 1875 saw the movement of free incorporation achieve free chartering in Europe and America.[539]

In particular, in the United States, the privilege of being granted the legal personality technology was the result of the Jacksonian effort to enable free corporate chartering.[540]

The American conceptualization of the corporate form continued to change in the late-1800s and early-1900s. This was due to increased specialization of the role of the manager within American railroad, telegraph, and steel corporations. According to Alfred Chandler, by the end of

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538 For a comprehensive analysis of the status and role of early corporations in international law with specific regard to colonialism, see MARK F. LINDLEY, THE ACQUISITION AND GOVERNMENT OF BACKWARD TERRITORY IN INTERNATIONAL LAW 94 (1926).

539 In particular, free incorporation was established from 1863 through 1867 in France, from 1844 through 1862 in the United Kingdom, from 1860 through 1875 in the United States, and 1870 in Germany. P.S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 597, 1985 (1979). With specific regard to the role of free incorporation in the United States, see JAMES WILLARD HURST, LAW AND THE CONDITIONS OF FREEDOM IN THE NINETEENTH-CENTURY UNITED STATES (1956).

540 *See* Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1057, 1100-01 (1980).

World War I, American industrial corporations shifted from externally to internally managed entities, under the control of various highly educated and specialized managers.[541]

During Managerialism and for a large part of the 1900s, the financial and legal framework, as well as the social *Weltanschauung*, permitted firms to embark on intensive long-term research and development that produced groundbreaking innovations.[542]

Consistent with the original nature of corporations in Ancient Rome, the board of directors was not to be servants of shareholders: "Rather, they saw themselves as trustees or stewards of great economic institutions that had important public functions. These included not only providing returns to equity investors, but also serving the needs of customers, employees, suppliers, creditors, and the nation as a whole."[543]

A public corporation is a conglomerate of inputs (investments and efforts; equity and debt capital; ideas and knowledge; work and time from executives and employees) systematically organized for productive activity.

In this socioeconomic context, boards' members and managers used to undertake a mediating role by controlling the firm and redistributing the profits produced by the firm among shareholders, employees, creditors, and other stakeholders.[544]

When deciding whether to pay dividends, recapitalize in favor of debtholders, or engage in mergers or asset sales that affect employees and the local community, members of the board had the requisite discretion to pursue long-term projects and more comprehensive consideration than merely maximizing shareholder value.[545]

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[541] AFLRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977); *see also* KLEIN, COFFEE, JR., & PARTNOY, *supra* note 7, at 115-16.

[542] Recent history provides a number of examples of corporations investing in long-term research and development that eventually paid off: the personal computer (IBM), the laser (AT&T), the transistor (AT&T), the digital camera (Kodak), various polymers (DuPont), and the copy machine (Xerox). *See* Stout, *supra* note 31.

[543] "Managerialism allowed public companies to be run with a forward-looking focus that led to a wide variety of technological breakthroughs we still benefit from enormously today." STOUT, *supra* note 31.

[544] *See* Stout, *supra* note 31.

[545] *See* Blair & Stout, *supra* note 12 at 290.

In accordance with such a *Weltanschauung*, the law treats directors as fiduciaries of the entire corporate entity that, as a legal person, entrusts them with the control rights over the firm.[546]

Such an approach ultimately agrees with team production theory—the idea that corporations operate best and contribute the most when directors pay attention to the corporate good, beyond simply the interests of equity investors.[547] Healthy relationships among all coventurers enables long and sound corporate existence. This also permits corporations to continue to produce wealth for future stakeholders.[548]

v. Shift to Shareholders' Primacy

By the end of the 1900s, investors paid increased attention to empire-building agency costs. These costs were ultimately due to the potential negative aspects of the self-perpetuating board, and were characterized by very low management turnover rates, selection of directors by other managers, and a resulting context in which shareholders could not monitor the board. [549]

When self-interested managers divert resources toward empire-building strategies at the expense of all equity and non-equity-coventurers, however, separation between ownership and control potentially becomes a dangerous feature of publicly held corporations.

American federal law reacted to such risks by embracing increased policing of boards of directors, either by giving shareholders more power to remove duty-shirking or rent-seeking directors, or by binding director pay to share performance.[550] Such an approach is based on the misplaced conceptualizations of shareholders as owners[551] and only residual claimants of

546 *See id.*
547 *See id.*
548 *See* Stout, *supra* note 31.
549 KLEIN, COFFEE, JR., & PARTNOY, *supra* note 7, at 109.
550 *See* Stout, *supra* note 31.
551 *See* Michael C. Jensen, *Paying People to Lie: The Truth About the Budgeting Process*, 9 EUR. FIN. MGMT., 379 (2003).

corporations, and the theoretical support of shareholders democracy and shareholder value maximization.[552]

In particular, the amendment of proxy rules in 1992 enabled shareholders to promote proxy campaigns with increased ease.[553]

From a different perspective, in an attempt to reduce agency costs and compensate executives based on performance of the firm, in 1993, United States Congress mandated that, in order for a public corporation to achieve complete tax deductibility, firm executive salaries must be tied to objective performance.[554] Naturally, the most common standard against which to measure performance was share price. As a result, firm executives shifted from being corporate stewards, able to mediate the interests of disparate corporate constituencies, and look beyond merely the shareholders' interests in order to pursue long-term projects.[555] Thus, directors lost their independence in assessing corporate strategies and profit distribution.

The shift from Managerialism to shareholder primacy resulted in corporate governance that sought, as its primary motivation, maximizing shareholder value.[556]

As a result, managers of public corporations consider the firm's impact on non-shareholding stakeholders (e.g., corporate creditors) to be less important[557] and instead focus on maximizing current shareholder value.[558]

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552 *See* STOUT, *supra* note 29, at 15.
553 *See* Stout, *supra* note 31.
554 *See* Stout, *supra* note 31.
555 *See* Edward Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907 (2013).
556 *See See* STOUT, *supra* note 29, at 16.
557 Perfectly fundamental value-efficient markets still do not solve the problem of corporate externalities, or the possibility of ex post shareholder opportunism that Blair and I explored in *A Team Production Theory of Corporate Law*. It should also be noted that tying executive pay to shareholder returns does not necessarily serve shareholders prosocial interests. *See* STOUT, *supra* note 29 (discussing the likelihood that nonpsychopathic shareholders care about more than financial performance).
558 Rock, *supra* note 555, at 1988.

The corporate governance model based on ceding control of the corporation to a third party[559] that is detached from the interest of only one type of coventurer, namely the board of directors, has therefore become ineffective.

Moreover, given that share price is not a perfectly accurate indicator of performance,[560] assessing the value of management on the basis of share price creates at least two distinct distortions aside from luring managers into adopting a shareholder-like attitude.

First, shareholders may be tempted to terminate managers for underperformance when shares price drops due to external circumstances that are not within the manager's control.

Second, managers may falsely claim responsibility for good fortune and demand increased compensation if the share price rises due to factors independent of their actions.

From a different standpoint, increased shareholders' power is not without its disadvantages. The shareholders themselves can act only in their own self-interest, impose costs from promoting these self-interests, and advocate inefficient and inappropriate governance structures.[561]

The stable center of decision-making power that Ancient Roman entrepreneurs intended to remedy the instability and ineffective decision-making system of the *societates consensu contractae*, which they eventually obtained through the legal personality, is an intrinsic feature of the corporate form. It is ultimately meant to create a controlling body that features the personal qualities of the managers of which the body consists. As pointed out in the first chapter, the selection shifts from a horizontal axis among equity-coventurers to a vertical axis between the equity-members and management in this system.[562] Thus, a context in which any investor (even a

[559] See Rajan & Zingales, *supra* note 37, at 422.
[560] For example, a global market downturn could lower the share price of a firm despite no wrongdoing by the manager, while a general upsurge in the market would increase the price of the shares.
[561] See Rock, *supra* note 555 at 1926.
[562] See *supra* Chapter 1 Part IA.

fool or knave), can increase his governance influence in the firm by simply buying shares frustrates the security that is based on *ex ante* assessment of controllers' personal qualities.[563]

[563] See *infra* Chapter 3 Part III.

B. Shareholders' Qualities

i. Shareholders' Heterogeneity

Shareholders feature specific personal qualities, preferences, and financial views. In recent years, scholars, consulting firms, and other relevant players in the financial sector have proposed various categories of shareholders on the basis of their characterizing traits. The common structure of the taxonomy applied to shareholders is binary: short-term shareholders are opposed to long-term shareholders as inside shareholders are to outside shareholders. Nevertheless, strictly binary categorization fails to capture the complexities shareholders' business vision, risk aversion, and governance engagement propensity. For example, a shareholder who is concerned with ethics might be more engaged in the governance of a corporation in order to influence its morality in a way that cannot be explained under a mere binary categorization.

Moreover, some of the binary categorizations acquire new labels, such as "intrinsic" or "transient" shareholders.[564] In this categorization, an "intrinsic" shareholder features a quasi-undiversified portfolio and a long-term ownership pattern, while a "transient" shareholder features a diversified portfolio and short-term investments.[565] With this in mind, although many dichotomous pairs of personal qualities can describe shareholders, the two most relevant to this work are mentioned below.

564 According to McKinsey & Company's categorization, shareholders fall into three classes: instrinsic investors, mechanical investors, and traders, and McKinsey & Company claim that intrinsic investors are the class corporations should attempt to attract, given that these are the shareholders that "[s]upport the . . . management and strategy through short-term volatility." Robert N. Palter et al., *Communicating with the Right Investors*, *in* MCKINSEY ON FINANCE: THE ENDURING VALUE OF FUNDAMENTALS, 40, 57, 58–59 (2011); *see also* Tamara C. Belinfanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789, 820 (2014).

565 Brian Bushee, besides creating these labels, remarks that "[t]he disproportionate presence of transient institutions in a company's investor base appears to intensify pressure for short-term performance while also resulting in excess volatility in the stock price." Brian Bushee, *Identifying and Attracting the "Right" Investors: Evidence on the Behavior of Institutional Investors*, 16 J. APP. CORP. FIN. 28, 29 (2004).

ii. Short-Term versus Long-Term Shareholders

One of the most significant schisms between different types of investors in public companies revolves around the timeframe within which the shareholders expect to hold shares and meet their investing goals. These differing expectations heavily affect the divergent ways in which shareholders make investing decisions and express preferences within a corporation, whether for long-term or immediate gains. For example, a short-term shareholder would seek to buy and sell stocks rapidly over a brief period in an effort to predict and profit from market movements, whereas a long-term shareholder would be more interested in maximizing long-run (industrial) value.[566]

A common example of short-term shareholder investing can be seen in the shareholding patterns of hedge funds, which tend to focus only on current market price of a company's stock. Such shareholders are "primarily financial engineers interested in the largest possible profit in the shortest period of time."[567] This focus causes hedge funds to prefer that corporate management make decisions that will maximize short-term profits, at the expense of potential long-term projects. Thus, simple expedients, such as moving expenses from the current year to the future or moving revenues from the future to the present[568] can fictitiously generate a raise in share price.[569] In other words, short-term shareholders tend to sacrifice industrial projects in order to achieve a prompt financial gain.[570]

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566 *See* Anabtawi, *supra* note 121, at 579. For further examples of differing investment time scopes, see the cases of Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919), and Hart v. Comm'r, 73 T.C.M. (CCH) 1684 (1997).

567 Robert G. Kirby, *Should a Director Think Like a Shareholder? (It Depends on Who the Shareholder Is)*, DIRECTORSHIP, June 1996, Supp., at 6-1.

568 Jensen, *supra* note 551, at 387; *see also* Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 181–82 (1991).

569 "According to the efficient capital markets hypothesis (ECMH), the price of a firm's stock at any given time accurately reflects all available information about the company. If the ECMH accurately described stock prices, then short-term stock prices would reflect investors' fully informed mean estimates of the fundamental, or long-term, value of securities. *The maximization of short-term value would then be consistent with long-term value maximization*. . . . Although there is still believed to be some relationship between short-term stock prices and fundamental value, that relationship is now understood to be extremely loose." Anabtawi, *supra* note 121, at 581 (emphasis added).

570 STOUT, *supra* note 29, at 63.

Shareholders with different time-perspectives also have conflicting visions the function of management. Long-term shareholders likely support investments in employees' skills, research and development of new products, as well as supplier and customer satisfaction.[571] Short-term shareholders, conversely, would favor strategies like selling assets, using cash reserves to repurchase shares, or cutting costs.[572]

Moreover, short-term investors usually feature other qualities that distinguish them from long-term investors. In particular, short-term activist hedge funds typically concentrate their stock portfolios on just a few corporations, while long-term retail shareholders diversify their investments.[573]

iii. Diversified versus Undiversified Shareholders

The extent to which shareholders have a diversified portfolio can also influence investment choices and preferences in corporate management. The most diversified investors are the so-called "universal owners," who have holdings across a large swath of the stock market. Hawley and Williams point out, "the quintessential universal owners are the largest of the public and private pension funds," characterized as having investment portfolios that consist of a broad cross-section of the economy.[574] "Universal owners can be contrasted with undiversified shareholders, such as inside shareholders[575] and founding-family shareholders,[576] who have their wealth disproportionately invested in a given company."[577]

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[571] *Id.*, at 69.

[572] William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1401 (2007).

[573] STOUT, *supra* note 29, at 70.

[574] JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 3 (2000); *see also* Simon Deakin, *The Coming Transformation of Shareholder Value*, 13 CORP. GOVERNANCE 11, 16–21 (2005).

[575] *See generally* Ronald C. Anderson & David M. Reeb, *Board Composition: Balancing Family Influence in S&P 500 Firms*, 49 ADMIN. SCI. Q. 209 (2004).

[576] *See id.*, at 209. Anderson & Reeb note, "[F]ounding families have substantial stakes in roughly one-third of the largest U.S. companies."

[577] *See* Anabtawi, *supra* note 121 at 584; *see also* Anderson & Reeb, *supra* note 575, at 209 (examining the influence of founding families on firm performance); *and* Chamu Sundaramurthy & Douglas W. Lyon, *Shareholder Governance Proposals and Conflicts of Interests Between Inside and Outside Shareholders*, 10 J. MANAGERIAL ISSUES 30 (1998) (exploring the

In general, the diversification of a shareholder's portfolio leads to specific preferences in risk-taking decisions made by management. Because a diversified shareholder can eliminate firm-specific risk—that is, the risk of a company's experiencing a non-market-related shock—through investing in an array of companies that, on average, balance the risk of negative firm-specific shock with positive firm-specific effects occurring in a different company—the highly diversified "universal" owner would likely prefer that a firm's management take on greater risk with greater potential return.[578]

On the other hand, the undiversified investor would have opposite preferences regarding the firm's risk-taking because he or she is not impervious to negative firm-specific shocks. Thus, the undiversified shareholder is very sensitive to the fortunes of the firm and would prefer safer, more certain returns with lower risk, even if those returns were also lower. It might be reasonable to observe that the degree of risk aversion might be ultimately determined by the intrinsic characteristics of a shareholder rather than by the composition of their share portfolio. Another explanation of risk aversion can be found in the wealth of a shareholder, regardless of the extent of their investment in shares of different corporations. In fact, a wealthy shareholder might simply have investments in forms other than corporate stock, including cash, real estate, and corporate bonds. As a result, their interests would still be diversified.

A specific type of undiversified shareholder is the activist hedge fund, which concentrates its interest in a few corporations and spends its time, effort, and money necessary to become involved in the firm's affairs. Besides their engaging in the firm's governance, activist hedge funds typically hold the shares for a short amount of time.[579]

In the words of Lynn Stout:

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conflict of interest between internal and external shareholders within the context of shareholder-sponsored proposals to repeal antitakeover provisions).

[578] *See* RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 95–97 (1993).

[579] STOUT, *supra* note 29, at 70–71.

> [T]he manager of an undiversified hedge fund—whose human capital also is bound up in his portfolio's performance—comes as close as any living entity can to the Platonic ideal of the undiversified shareholder who cares only about the price of a single company's equity. As a result, hedge fund managers' interests and universal owners' interests often clash.[580]

The hedge fund will pressure the corporation to take extreme risks in order to raise stock prices in the short-term even if it hurts the long-term growth of the firm, and thus long-term shareholder value, bond valuation, and the interests of other stakeholders.

On the contrary, diversified retail investors are typically characterized by rational apathy.

580 *Id.* at 92.

SECTION III. DEFECTIVE CORPORATE GOVERNANCE

A. Shareholders' Governance Power

i. Shareholders Influence in Berle and Mean's Day

While delegating control rights to the board is an intrinsic feature of business corporate entities, individual or controlling groups who have not gone through a process of selection and appointment can in some circumstances achieve the power to practically exercise control over the firm. As Berle and Means point out in their 1932 book *The Modern Corporation & Private Property*, primarily known for the theory of separation between ownership and control in publicly held corporations, the achievement of *de facto* control by parties not formally entrusted with such control is an issue the law has not dealt with in a thorough manner.[581]

In particular, Berle and Means provide a list of cases and devices to point out how – even during Managerialism—shareholders were able to organize control over the board.

According to them, the first situation where organized shareholders exert *de facto* control and direct influence over corporate management dates back to the late 19th century. At that time, the voting trust came into existence. The voting trust is a mechanism that allows a select few individuals to control the voting rights of a corporation.[582]

Through this mechanism, the agreeing shareholders re-achieved control over the firm by virtue of their organized power to elect and fire the board of directors. The "Shepaug Voting Trust Cases" of 1890 serve as a perfect example of this.[583] A Connecticut Court addressed a case in which a voting trustee forced the corporation to enter into construction contracts that would

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581 *See* BERLE AND MEANS, *supra* note 57, at 207.

582 *See genrally* Henry W. Ballantine, *Voting Trusts, Their Abuses and Regulation*, 21 TEX. L. REV. 139 (1942); *and* Henry W. Ballantine, *Voting Agreement or Voting Trust? A Quandary for Corporate Shareholders*, 10 STAN. L. REV. 565 (1958).

583 Bostwick v. Chapman, 60 Conn. 553 (1890); Starbuck v. Mercantile Trust Co., 60 Conn. 553 (1890).

provide substantial personal profit to the members of the committee that selected the trustee.[584] The court responded by invalidating the construction contracts and giving relief to the corporation, as it was clear that private benefits extraction was the primary motivator.[585]

Shortly after this, the law faced a similar but less open-and-shut case of assessment of control in which shareholders privately agreed to vote shares to suit their own interests.[586] The goal of the agreement was to create a "dummy" board of directors that would obey the shareholders and implement their interests instead of pursuing the interests of the corporation itself.[587] In that context, judging the contract between the corporation and the shareholders, the Circuit judge, Mr. Taft, remarked: "The vice of such contracts is . . . that they are contracts made buy a corporation with one who exercises such an undue influence over the directors . . . that is inequitable and unconscionable for him by such influence to secure individual profit to himself at the expense of the corporation and its other stockholders and bondholders."[588]

This originated the debate on whether or not—and to what extent—shareholders could agree among themselves to dominate management.[589]

As Berle and Means remark:

> [I]t needs no agreement to make a director who is dependent on the will of one or two shareholders into a dummy. He is a dummy not because of a contract but because of his nature. First-rate men will never be dummies; third-rate men can never be prevented from being dummies where they are in fact dependent on the will of a small group even though no precaution is taken by contract to make them so.[590]

In this regard, while upsetting a contract in *New York Co. v. Bermuda-Atlantic S.S. Co.*,[591] Judge Cardozo commented, "where an individual or group had in fact exercised the power of

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584 *Id.*
585 *Id.*
586 Central Trust Company v. Bridges, 57 Fed. 753, 766 (U.S.C.C.A., 1893).
587 *Id.*
588 *Id.*
589 BERLE & MEANS, *supra* note 70, at 209.
590 *Id.* at 210.
591 New York Co. v. Bermuda-Atlantic S.S. Co., 211 Fed. 989 (1913).

management they must be governed by the same standards of conduct as those applied to the formal management even though they do not assume the title."[592]

In the aftermath of the aforementioned cases, Berle and Means observed, "a parent corporation which has dictated a course of action by a subsidiary is both liable as manager and may even be held liable as a principal in the transaction."[593]

In the same vein, courts have made efforts to enforce rules that discourage the influence of controlling groups upon directors. For example, most modern courts agree that a director is not permitted to sell his power within the management of a corporation, nor is it legal for him to enter into a position that may sway his role within management.[594] Similarly, a director cannot be bribed to resign,[595] and shareholders may not sell their vote for director selection.[596]

From a different standpoint, when controlling shareholders sell their stock for double the going-rate of the share price, it is said that they are not merely selling their stock, but also their controlling power, making "control" a distinct, valuable asset. "[I]n effect, a position of 'control' is a valuable piece of property to its holder, and so regarded, its value arises out of the ability which the holder has to dominate property which in equity belongs to others. And the law thus far has been unable to deal with the situation."[597] Legal theory, for quite some time, has dealt with control in this manifestation of inducing and influencing directors. In the 1930s, Berle and Means acknowledged that "individuals who actually induce management action are themselves liable as managers, [and] subject them[selves] to the fiduciary obligations which are imposed on the directors themselves.[598]

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[592] *Id.*
[593] BERLE & MEANS, *supra* note 57, at 210.
[594] VICTOR MORAWETZ, A TREATISE ON THE LAW OF CORPORATIONS 519 (1886).
[595] *See* Forbes v. McDonald, 54 Calif. 98 (1880); Bosworth v. Allen, 168 N.Y. 157 (1901).
[596] Jones v. Williams, 139 Mo. 1 (1891).
[597] BERLE & MEANS, *supra* note 57, at 217.
[598] Southern Pacific Railway Co. v. Bogert, 250 U.S. 483, 492 (1919).

The logic of this rule is sufficient to cover all situations, because, in theory, wherever management is in fact acting at the behest of an identifiable "control," the "control" can be dealt with exactly as though it were a manager.[599] The device used for "control" seems to be immaterial—whether it is a voting trust, domination by a stockholder, or even domination by a creditor."[600]

In summary, in the days of Managerialism, Berle and Means very clearly suggested that, regardless of the volume of shareholding or the device applied to exert influence over the board, shareholders are able to make the board (or some of its members) a dummy, and that when an individual shareholder or an organized group of shareholders induces management action, they should be held liable as managers and as a principal.[601]

In addition, standards of conduct must apply to the individual shareholder or organized group of shareholders who induce management.

The following pages focus on the enhanced power of shareholders to influence management and on the defect that the failure to assess these *de facto* controllers causes.

The next chapter is about policies to adjust such a governance flaw that advances the speculation that when a shareholder determines corporate decisions, even in the absence of actual self-dealing, the standard of review to be applied by the courts should not be the business

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599 *See* Thomas v. Matthew, 94 Ohio St. 32 (1916).

600 BERLE & MEANS, *supra* note 57, at 212–13. The Authors also specify that extreme cases of this applied principle are dangerous. The classic example of this is *Farmers' Loan & Trust Company v. New York & Northern Railway*, in which the New York Central railroad acquired control and most second mortgage bonds of its competitor, the New York & Northern Railroad. New York Central then defaulted on the bonds and began foreclosure proceedings. While a stockholder filed an injunction and was supported by a ruling from the New York Court of Appeals, New York Central continued with the foreclosure. Despite the protests of the appealing stockholder, the Court of Appeals ruled that only the New York & Northern, as the negatively impacted organization, had legal basis to complain. It was clear, however, that the New York & Northern would not do that, as it was a puppet of the New York Central. Even if, for whatever reason, the New York & Northern did file suit against New York Central, the damages awarded would still be under the control of the New York Central because they were the New York & Northern's majority stockholder. Farmers' Loan & Trust Company v. New York & Northern Railway, 150 N.Y. 410 (1896). *See also id.*, at 213—14.

601 *Id.*

judgment rule, but rather a heightened standard, such as the entire fairness or compelling justification standard.

ii. Present-Day Governance Pressure: A Convergence of Shareholders and Share-Performance-Incentivized Managers

The legal and economic framework has significantly evolved since the period during which Berle and Means wrote their famous book.

From a financial point of view, shareholders shifted from being individuals, for the most part, to being institutional investors, typically pension funds, mutual funds and hedge funds, which aggregate the wealth of multiple individuals.[602] Because of aggregated wealth, institutional investors are able to take a far larger position in the targeted corporations.[603] In this different financial scenario, collective action problems have become manageable for institutional investors, who are today the dominant shareholders and know one another.[604]

From a legal perspective, shareholders' ability to influence transactions and corporate policy in publicly traded companies was significantly enhanced in 1992 when the SEC amended its federal proxy regulations for the express purpose of permitting large shareholders to exercise their voting power effectively.[605] The amendment provided shareholders with more freedom to make public statements (e.g. speeches, press releases, newspaper advertisements, broadcast media, and internet communications), making it much easier for investors to coordinate with each other and combine their individual holdings into a single, larger, and more powerful voting bloc.[606]

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602 *See* STOUT, *supra* note 29, at 92.

603 *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1276 (2008).

604 *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567 (1990).

605 Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681–89 (2007).

606 *Id.*, at 686–97.

Moreover, the development of shareholding advisory services has provided a *de facto* aggregation of voting power. Shareholder advisory firms, such as ISS Governance Services, provide institutional investors' managers with advice on how to vote on matters ranging from director elections, approval of antitakeover defenses, or the sale of the entire firm.[607] The development of shareholder advisory services partially reduces the collective action problem, while an enormous number of votes are cast by delegation, thus creating a *de facto* aggregation of voting power.[608]

Hedge funds, in particular, have emerged in recent years as potentially very active shareholders, using their shareholder status to aggressively pursue specific corporate actions and grow in power.[609]

This development of shareholder activism has traditionally been thought to exert a positive influence on the corporation, assuming that shareholders collectively have the same (or similar) interests when it comes to management. However, as described above, shareholders feature heterogeneous characteristics and idiosyncratic interests, so that the qualities and interests of one shareholder or group of shareholders can conflict with the qualities and interests of others. In this context, the ability of some shareholders to protect and pursue their personal and private interests can be detrimental to the interests of other shareholders and the corporation as a whole.[610]

Hedge funds pressure managers into pursuing corporate transactions that are often especially beneficial to the activist—not necessarily *strictu sensu* conflicted, but fitting the specific characteristics of their investment visions and financial strategies, while ignoring or even harming the interests of other shareholders and the corporation itself.[611]

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[607] *See* Anabtawi & Stout, *supra* note 603, at 1277.

[608] *See id.*

[609] Mara Der Hovansian, *Attack of the Hungry Hedge Funds*, BUS. WK. 72 (Feb. 20, 2006).

[610] Anabtawi & Stout, *supra* note 603, at 1258–61 ("[A]ctivist shareholders can have serious conflicts of interest with other shareholders arising from their other relationships with the firm, from their investments in derivatives or securities issued by other corporations, from their investments in other parts of the firm's capital structure, and from their short-term investment focus.").

[611] *See* Anabtawi & Stout, *supra* note 603, at 1278.

In such a legal and financial scenario, the corporate entity evolves so that the dominant forces within the corporation are typically not selected directors or officers, but rather are individuals or controlling groups who have not gone through a process of assessment.

Additionally, corporate executives are compensated in a manner similar to the way in which shareholders are compensated, unlike their remuneration in the past.[612] This corrupts the insulation of the board from the interests of equity and non-equity coventurers, causing managers to think in a shareholder-like fashion.

The combination of shareholder empowerment with share-performance-based incentives for the management has caused the phenomenon that Edward Rock termed "shareholder-centric reality," shifting the weight in corporate governance.[613]

iii. Shareholder-Centric Reality Problems: From Conflicted Transactions to Short-Termism

In a shareholder-centric scenario, different from the context described by Berle and Means, the issues related to shareholders' meddling and directors thinking like shareholders, in the governance of corporations have significantly evolved.

First, from a theoretical point of view, when directors' remuneration is tied to share performance, the position of the board of directors shifts from an independent, third party whose interests differ from the specific investments of equity and non-equity-coventurers, to a party that is equally as interested in the performance of shares as shareholders themselves.[614]

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612 *See* Rock, *supra* note 555.
613 *See generally id.*
614 *Id.*

Second, in an era in which shareholders enjoy power as never before,[615] the distinction between controlling and non-controlling shareholders, while relevant to Berle and Means,[616] is blurry and does not describe the current corporate reality.[617]

Often, only "controlling" shareholders are deemed to be in a position in which they can dictate the business decisions and transactions of a corporation and, particularly, the membership of its board of directors.[618] Thus, controlling shareholders are precluded from using their power over the board of directors to dictate corporate action in order to generate private economic benefits at the minority's expense.[619] In addition, controlling shareholders are prohibited from acting in self-interested transactions, such as "freeze-out" mergers (though, a controlling shareholder can escape liability by showing that, while the transaction may have been motivated by a conflict of interest, it was nonetheless "intrinsically fair" to the corporation and other shareholders).[620]

Nevertheless, shareholders with smaller stakes but activist attitudes may still be able to influence corporate officers and directors using more sophisticated methods.[621] Even a 2% "swing vote" can sometimes control the outcome of a corporate voting contest.[622] Furthermore, if a minority activist shareholder were to focus all of its attention on a single matter, the shareholder may be able to exercise significant influence on a company's actions. Yet under the current fiduciary duty scheme, courts tend to engage in a "cautious, detailed factual analysis" when the case involves

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615 Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 995–98 (2010).

616 *See* BERLE & MEANS, *supra* note 57, at 207-10.

617 *See* Anabtawi & Stout, *supra* note 603, at 1296.

618 *See* Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Investors?*, 60 BUS. LAW. 1 (2004); *see e.g.*, Weinstein Enterprises Inc. v. Orloff,870 A.2d 499 (Del. Ch. 2005); Ivanhoe Partners v. Newmont Mining Corp ., 535 A.2d 1334 (Del. 1987).

619 *See e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471–72 (Cal. 1969) ("Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately.").

620 Anabtawi & Stout, *supra* note 603, at 1266. "Intrinsic fairness" encompasses both substantively fair terms and procedurally fair bargaining. Weinberger, 457 A.2d.

621 *Id.* See *supra* section in this chapter, Part II.

622 *See* Anabtawi & Stout, *supra* note 86, at 1301.

shareholders owning less than a majority stake, the touchstone being whether or not those shareholders have enough clear voting power to influence membership on the board of directors.[623] It might be said that the pressure an activist shareholder can exercise on management is not necessarily based on merely voting power, but instead on other sophisticated techniques with which to influence corporate actions.[624]

In this context, not only controlling shareholders, but also activist minority shareholders, can extract private benefits from the corporation's activities.[625] This work, however, aims to point out on a broader basis the risks that shareholders' influence over governance entails. Given that anyone, even fools or knaves, can buy shares on financial markets, shareholders can harm other shareholders, stakeholders of different kinds, and the corporation itself, not only in occasions of extraction of private benefits but also in cases of determination of corporate strategies and actions, which do not feature conflicts of interest in a strict definition. In fact, as described above, shareholders have heterogeneous qualities, expectations, and investment strategies. In an organization based on the investments of multiple shareholders and constituencies of other natures, the upfront, quality-based selection of the controllers is essential to safeguard effective stewardship of the corporation.

In a present-day context, however, shareholders who are able to gain an influential position regardless of their formal controlling position can determine the corporate actions. For example, given that diversified retail investors seldom have a big enough stake concentrated in a corporation to make it rational to monitor the management decisions of a corporation and that mutual funds mostly vote as advised by RiskMetrics' Institutional Shareholder Services (ISS),

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[623] *See* Anabtawi & Stout, *supra* note 86, at 1282.
[624] *See generally id.*
[625] *See generally id.*

which is generally oriented toward short-term performance, activist hedge funds run the show, so to speak, of influencing governance (toward short-termism).[626]

iv. Short-Termism

The influence of activist hedge funds, combined with the partial failure of the market in forming share pricing that reflects long-term projects,[627] and with share performance-based incentives for directors, have caused the phenomenon known as short-termism.[628]

Indeed, when activist hedge funds have a short-term investment perspective and are able to influence corporate behavior, boards of directors who are compensated based on share performance can see their interests align with those of activist investors.

Moreover, market undervaluation of long-term projects could result in shareholders advocating for abandoning long-term projects because future profits are then discounted below their true value. Lowered share price would reflect this undervaluation.[629]

In fact, underpricing in the secondary share market gives shareholders, even when not necessarily intrinsically short-term oriented, reason to pressure the board of directors for immediate profits.[630] Thus, unlocking corporate assets—an action far less efficient than allowing the assets to remain invested in long-term projects, or even liquidating the entire firm in extreme instances—might in the shareholders' best interest because it results in the payment of dividends or in the market's appreciation of the shares.[631]

Even a temporary undervaluation of a firm's shares would trigger short-term-minded shareholders to demand the desertion of long-term projects in favor of short-term profits.

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[626] Stout, *supra* note 29, at 70–71.
[627] *See also* Stout, *supra* note 520, at 685.
[628] *See* STOUT, *supra* note 29, at 66–71.
[629] *See id.*
[630] *See id.*
[631] *Id.*

Moreover, undervaluation of a corporation's shares is detrimental to shareholders with the long-term in mind because an undervalued firm attracts the attention of outside short-term investors such as hedge funds.[632]

Against these odds, shareholders' natural predisposition for longer-term projects and their long-term cognitive ability, together with incentivizing long-term investment, plays a crucial role in readjusting a rational and healthy direction for a corporation's undertakings.

With such a substantial portion of a corporation against long-term projects, although directors must decide "whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprises in which they have bought shares, but only in a quick profit on the sale of those shares,"[633] directors and executives will likely avoid making long-term investments to begin with. Indeed, they know that even a relatively short period of any substantial undervaluation of shares would cause multiple parties to call for the abandonment of the long-term project.

v. Psychopathic Shareholding

Another result of the lack of shareholder selection on the part of corporations (or anyone else, for that matter) is that a bad reputation is rarely, if ever, a disadvantage for a shareholder. In fact, shareholders may even benefit from engaging in behavior that typically 'earns' a bad reputation.

Assuming that a hedge or mutual fund is involved in the investment process requires considering three parties: (i) the corporation, (ii) the fund, and (iii) the individual investor in the

[632] *See id.*
[633] *See generally* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 104 (1979).

fund. It follows that there exist two selection processes: (i) the individual investor choosing the fund, and (ii) the fund choosing the corporation.

Here, reputation plays a counterintuitive role. Given the two degrees of separation between the individual investor and the corporation, the investor will generally base his selection purely on returns expected from the fund. Thus, it is to the fund's reputational advantage to extract the highest possible return from the corporation, regardless of the means through which this goal is reached. This pattern of behavior erects a screen between the individual investor and the corporation.

As a result of this screen, it is unlikely that the individual investor would be aware of a fund's exploitative (i.e., psychopathic) policy vis-à-vis the corporation to which the individual investor might otherwise object. On the other hand, individual investors judge fund managers "according to whether the value of the fund portfolio went up or down yesterday."[634]

For two reasons, this scenario incentivizes the fund to exploit a corporation. First, the separation between the investor and the corporation shields the behavior of the fund vis-à-vis the corporation from investor scrutiny. Moreover, some investors may even approve of exploitation by the fund without regard for the overall effects beyond share price.[635]

Second, prolonged use of this investment strategy allows the fund to cheaply expand its shareholding. This is because exploitative behavior inevitably decreases share price by scaring shareholders into selling their stake before the market price reflects the decreased firm value.

[634] STOUT, *supra* note 29, at 90.

[635] *Id.* at 90-92.("[M]utual funds and hedge funds are supposed to act as fiduciaries for their individual beneficiaries. This concept might be read broadly enough to include protecting beneficiaries' interests not only as investors in the fund's portfolio, but also as customers, employees, homeowners, and biological organisms dependent on their environment." She also acknowledges that "fund managers have little to lose and much to gain from supporting corporate strategies that raise the stock prices of firms they hold in their portfolios, even when those same strategies harm their beneficiaries' outside interests. We should not be surprised to see a pension fund manager invest in corporations that cut costs by outsourcing jobs to China and India—even if many of the jobs that are outsourced belong to the employees contributing to the pension fund.").

Such a run to sell shares allows the fund to increase its amount of shares in the corporation at a discounted price.

Furthermore, whether the "bad" professional shareholder is foolish or knavish is not an immaterial distinction. While the fool may mistakenly engage in value-decreasing behavior, the knave purposefully exploits the corporation to gain private benefits including potential governance advantages, through which he will continue to siphon value, creating a vicious cycle.

B. Assessing Shareholders Qualities

i. Shareholders' Power without Assessment of Their Qualities

While in the context of a private corporation, coventurers can select one another on the basis of their personal qualities, when a firm goes public, shareholders relinquish this power to assess and recruit one another because anyone can buy shares in the corporation. Indeed, current shareholders are unable to screen prospective shareholders and assess their trustworthiness,[636] intellectual skills, professional expertise, educational background, emotional stability, moral sensitivity,[637] or general acceptability.

Because shares carry a set of rights, including the right to elect directors, listing a corporation on an organized stock exchange has important corporate governance implications.[638] This importance rests in the fact that a shareholder can obtain a controlling or influential position by purchasing the corporation's shares on the market.

A shareholder can therefore regain *de facto* control rights over the assets of the firm on a "tertiary" level. The primary level of control lays in the control rights over the assets that the shareholders have before contributing them to the corporation by entrusting the board of directors with reorganized control over the firm. The secondary level is the fiduciary control that the board of directors exercises. Finally, the tertiary level is a shift of control from the board to a shareholder when the shareholder obtains a controlling position, which typically stems from the right to elect and fire directors.[639]

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[636] With regard to trust and trustworthiness in corporate law, *see generally* Lynn A. Stout & Margaret M. Blair, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001).

[637] For an insightful discussion on the role of conscience in the business world, *see generally* STOUT, *supra* note 32.

[638] *See* Robé, *supra* note 31, at 71 (explaining why shareholders, among other stakeholders, have the authority to hire and fire directors).

[639] *See* Stout, *supra* note 31.

When shareholders gain control, an influential position, or are in any way able to make the board accommodate their preferences—e.g. adopting certain corporate strategies—the selection of shareholders based on their personal qualities "might appear to be a hopeless undertaking,"[640] but seems to be the only effective mechanism to actively protect the interests of corporations and of all a corporation's constituencies.

ii. The Need for Quality Assessment

As Warren Buffet put it, the aim of the corporation is to attract investors who will "understand operations, attitudes and expectations . . . [a]nd, fully as important, dissuade those who won't."[641]

Indeed, corporations benefit from shareholders whose investment behaviors mesh with the vision and operational strategy of the enterprise and who support, and are passionate about, corporate projects and strategies.[642]

We may consider these shareholders as coventurers of the corporation.[643] As opposed to the dynamics of coventurer selection in the Ancient Roman fable, Warren Buffet refers to coventurers of the corporate entity instead of coventurers of shareholders.[644] Indeed, Buffet's statement implies the crucial effect of organizing a firm in the corporate form: the pivotal center of interest shifts from each single equity member to the legal entity. Moreover, although equity owners may have founded a corporation initially, a public corporation becomes a center of interests distinct from its equity members, which its own "personal" qualities then characterize. On one hand, certain factors, such as the personal qualities of management, the provisions set forth in the

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[640] Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to shareholders (Mar. 14, 1984), *available at* http://www.berkshirehathaway.com/letters/1983.html.

[641] *Id.*

[642] *See* Belinfanti, *supra* note 564, at 812.

[643] *Id.*

[644] Belinfanti, *supra* note 564, at 812.

by-laws, and the legal framework of the jurisdiction in which the corporation is chartered shape these "personal" qualities. On the other hand, these personal qualities also determine the traits of desirable coventurers.

The identification of shareholders whose qualities and priorities do not align with those of the enterprise is just as critical as attracting suitable shareholders. And while the qualities of less-than-ideal coventurers varies from firm to firm, corporations will generally disfavor several types of shareholders including empty-voters, arbitrageurs, and activist shareholders who seek to impose their business strategies on firm management.[645] Additionally, while the liquidity and visibility of a corporation's shares are beneficial, shareholders with short-term financial interests can put disruptive pressure on the corporation.[646]

From a different standpoint, the degree of influence that shareholders may exert over the board may vary from an *ex lege* controlling position to a *de facto* influential position.

While shareholders' qualities may implicate corporate undertakings tangentially at lower levels of equity ownership, shareholders' features become crucial when shareholders trigger higher equity ownership levels, especially if they gain a controlling or influential position.

In fact, a shift in equity ownership in a corporation from a broad, disseminated shareholder base to a controlling shareholder reorganizes the corporation's governance mechanics and the personal qualities of the controlling shareholder affect the personal qualities of the corporate entity.[647]

Moreover, such a shift changes the nature, geometries, and magnitude of agency costs.[648]

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[645] *Id.*

[646] *See id.*; *see also* Anabtawi & Stout, *supra* note 603, at 1280, 1297; *and* Fox & Lorsch, *supra* note 441; STOUT, *supra* note 29, at 63.

[647] *See* Stout, *supra* note 433.

[648] *Id.*

iii. Qualities of Controlling and Influential Shareholders

As during Managerialism, corporate boards are highly independent and are insulated from shareholder pressures when corporations have passive, broadly dispersed shareholders.[649] If a shareholder gains a controlling position, however, as remarked by Berle and Means, the board of directors can transform into a "dummy" board in the hands of the controlling shareholder.[650]

According to Gilson, "[p]ublic shareholders will prefer a controlling shareholder as long as the benefits from the reduction in managerial agency costs exceed the detriment of the controlling shareholder's extraction of private benefits."[651]

In fact, a controlling shareholder who seeks to manage a corporation in the best interest of the legal entity has the incentive of a large financial interest to monitor management and, assuming that the controlling shareholder will hold the shares for a long time (potentially intergenerationally), support long-term projects.[652] These attitudes can be of great benefit to non-controlling shareholders, as well as other stakeholders.[653]

As Rock remarks, however, a controlling shareholder that concentrates on receiving non-*pro rata* profits at the expense of non-controlling shareholders harms not only the non-controlling shareholders, but also the corporation itself.[654]

Indeed, controlling shareholders can receive benefits of two sorts. The first type of benefit is based on the corporation's productivity: a controlling shareholder will share this benefit *pro rata* with other shareholders of the corporation. The second type, conversely, is the ability to extract private benefits, which siphon value from the corporation and, in turn, from the other shareholders and stakeholders.

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649 See *supra* Chapter 3, Part IIIB
650 See *supra* Chapter 3, Part IIIA
651 Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. Rev. 1642, 1652 (2006).
652 *See* Stout, *supra* note 31.
653 Gilson, *supra* note 651, at 1652.
654 *See* Rock, *supra* note 118, at 866.

In simple words, the acquisition of control over corporation that was a broadly dispersed shareholder base previously held entails a variety of contingencies. The new controlling shareholder may be a better controller than the original board if this new controller monitors and constrains the agency costs associated with management and refrains from extracting corporate assets at the expense of creditors, employees, or minority shareholders.[655] Furthermore, a controlling shareholder whose qualities are synergistic with corporate projects and the nature of business in which the corporation operates may provide the firm with long-term governance stability and thereby support sustainable growth.[656]

Along this line, Gilson's insight implies that the personal qualities of a controlling shareholder are crucial in determining whether a corporation will benefit from such a shift in control.[657]

Gilson's standpoint, however, faces two issues. The first is that a system of checks on management, which may be lacking under a controlling shareholder, is more complete and provides a better framework for monitoring and constraining agency costs. Indeed, the mechanics of selecting and appointing board members, together with specifically tailored fiduciary duties, a manager market, and the effect of takeovers, proxy contests, and derivative suits, produces quite an effective system of manager accountability.[658]

The second issue that Gilson's view faces is at the very core of this work: whereas shareholders select directors, they do not select controlling or influential shareholders. Specifically, shareholders do not assess controlling or influential shareholders' personal qualities in order to evaluate whether they have the appropriate credentials—namely, trustworthiness, knowledge, professional skills, and care—to assume the role of controller. Furthermore, given the absence of

[655] Gilson, *supra* note 651, at 1652.
[656] Gilson, *supra* note 651, at 1657.
[657] *Id.*
[658] *See* Rock, *supra* note 292, at 1010.

a shareholder market, shareholders do not have an inherent incentive for virtuous behavior to the extent that shareholders may even behave in a manner that some would call psychopathic.[659]

In this context, assessing the personal qualities of a shareholder that acquires a controlling position is the ultimate warranty against the extraction of private benefits or, more broadly, poor managerial strategies on the part of the shareholders.[660]

iv. "Good" and "Bad" Shareholders

What is the "optimal" shareholder? There is no one kind of shareholder whose qualities fit all types of corporations. In fact, the size of the firm, the industry in which it operates,[661] and the strategic goals of the firm are all variables within the definition of an optimal shareholder.[662]

Nevertheless, Warren Buffett's assertion--that shareholders should exhibit coventurer characteristics, captures the most essential features of a good shareholder.[663]

According to the coventurer definition, a good shareholder should commit to the firm for a substantial amount of time,[664] be well informed, understand the firm's operations and expectations, and be able to assess the real value of the projects that the corporation carries out. In turn, these characteristics produce share prices that reflect firm value. In short, good shareholders

659 See *supra* Chapter 3, Part IIIAv

660 *See generally* Rock, *supra* note 555.

661 In particular, certain types of industries that would require the corporation to focus on long-term projects,such as military technology, high technology, and oil and gas,are in a position in which shareholders' strategies and preferences become crucial to avoid foregoing long-term opportunities in order to respond to market expectations. As Lynn Stout points out, such pojects can typically benefit both present and future generations. *See* Stout, *supra* note 31 ("History offers many examples. During the 1950s and 1960s, it was common for large public corporations such as IBM, AT&T, DuPont, Kodak and Xerox to operate research laboratories devoted to pure science. These laboratories produced a wealth of inventions and innovations whose benefits we still enjoy, including the transistor, the laser, the solar cell, the ATM, the copying machine and the digital camera. Today, Google is pursuing pure research in robotics. While I may never benefit from the services of a personal robot, my children surely will. The corporate form accordingly can serve, and historically has served, as a mechanism that allows present generations to preserve and invest resources to benefit future generations. To the extent that the people alive at any moment in time feel altruism toward the people they expect will follow them, the corporate form provides a vehicle to better express their generosity.").

662 *See* Belinfanti, *supra* note 564, at 818; *see also* Rock, *supra* note 118, at 857.

663 *See* WARREN E. BUFFETT, AN OWNER'S MANUAL 1 (1996), *available at* http://www.berkshirehathaway.com /ownman.pdf.

664 In the words of Warren Buffett, "life-long co-venturers." *Id.*

evaluate firms according to long-term projects, and thus to fundamental value, as opposed to short-term earnings, and protect the corporation from the harmful implications of second-market underpricing.[665]

In addition, a good shareholder should have personal and professional skills, such as managerial and financial expertise, as well as trustworthiness. Along this line, the personal and professional qualities of a good shareholder produce a vetting effect.[666]

Lastly, a good shareholder is one who will protect a corporation from threats of market undervaluation or attempts to extract private benefits, in sum, serving a monitoring role.[667]

Conversely, a fool or knave shareholder is a "bad" shareholder, which through the inaccurate evaluation of the firm's value (particularly when related to long-term projects), or by intentional actions, harms the corporation.

Undervaluation of the firm causes share price to deviate substantially from the fundamental value of the firm, thus hurting the corporation by increasing the cost of capital and incentivizing the disposal of assets or the interruption of long-term projects.[668]

And while this effect is merely one of undervaluation, a bad shareholder may undertake intentional actions, such as interested transactions that siphon private benefits at the corporation's expense.[669] Typical techniques to extract private benefits are pressuring a firm into paying dividends beyond free cash flow, adopting a malicious litigation attitude, or enacting "greenmail schemes."[670]

[665] *See* Rock, *supra* note 118 at 854–55 *see also* Stout, *supra* note 31.
[666] Rock, *supra* note 118, at 855; *see infra* Chapter 4, Part IIA
[667] *Id.* at 856.
[668] See *supra* Chapter 3, Part IIIA
[669] *See generally* Anabtawi & Stout, *supra* note 603.
[670] The concept of "greenmail" consists of a corporate repurchase, at a premium above market price, of a block of shares held by a minority investor who is in some manner opposing the company's management by, for example, threatening to create a proxy contest. *See e.g.*, Viacom Int'l, Inc. v. Icahn, 747 F. Supp. 205 (S.D.N.Y. 1990).

v. Assessing Shareholders' Personal Qualities and Defective Corporate Governance

While extensive scholarship focuses on the opportunity to expand shareholders' franchise, this work claims that, regardless of the extension of the shareholders' rights and powers, the lack of assessment of shareholders' qualities causes defective corporate governance mechanics. The ability of any investor to buy shares, vote, and exercise governance influence without any form of selection or upfront assessment of their personal qualities exposes corporations, equity holders, non-equity coventurers, other stakeholders, and society in general to significant risks.

Indeed, fool or knave shareholders can gain a controlling position or other ability to wield *de facto* influence over management with harmful effects on long-term projects and, more broadly, the value of the corporation itself.

In this context, assessing shareholders' personal qualities is the missing piece of the puzzle for well-functioning corporate governance. The following chapter of this work suggests policies to repair the flawed mechanics and to spark a discussion of the best remedies to complete the corporate governance puzzle.

CHAPTER 4. ASSESSING SHAREHOLDERS' PERSONAL QUALITIES: FROM CURE TO PREVENTION

Introduction

The free transferability of publicly traded shares permits anyone, even a fool or knave, to acquire a large stake in a corporation without any process of assessing the acquirers' personal qualities.[671] Moreover, aside from governance influence that shareholders may acquire by owning a large amount of equity stock, in some circumstances minority shareholders, typically activist investors, are able to determine corporate actions and strategies by taking advantage of management incentives to think as shareholders, ISS oriented voting and rational apathy of retail investors. In these cases, some shareholders regain the ability to exercise control rights over the firm notwithstanding the original relinquishment of control rights.[672] This phenomenon causes a defect in corporate governance mechanics that are designed to entrust decision-making a body, i.e. the board of directors, whose members are selected by shareholders and the corporation appoints, in order to carry out business on the corporation's behalf. Indeed, when shareholders select board members, such shareholders implicitly consider the board members' personal qualities satisfactory, and therefore grant the board free business judgment within the constraints of their fiduciary duties, thus permitting the board discretion in corporate action.

Therefore, when unselected parties obtain positions that allow control over a corporation, the corporation and its stakeholders become vulnerable because the control system no longer provides an upfront assessment of the controllers' personal qualities. Given this contingency, a corporate governance system should address the inability to assess and select influential shareholders.

This chapter sketches three types of solutions.

[671] *See supra* Chapter 3, Part IIIB
[672] *See* STOUT, *supra* note 29, at 92-93.

The first solution is heightening the standard of review that applies to corporate actions that unselected controllers determine on the ground that the business judgment rule finds its rationale in *ex ante* assessment and selection of a corporation's controllers.

The second solution involves multiple strategies to craft and cultivate a desired shareholder base, considering in particular time-weighted equity shares.

The third proposed solution would require permission from an independent authority, which would consider a shareholder's integrity, before voting shares over certain thresholds.

SECTION I. SHAREHOLDERS' LEGAL EXPOSURE: HEIGHTENING THE STANDARD OF REVIEW WHEN SHAREHOLDERS DO NOT SELECT THE CONTROLLERS

This section argues that the business judgment rule is a product of the fiduciary relationship between the corporation and its board of directors, which arises from the selection process wherein shareholders may assess directors' personal qualities as well as their ability to exercise prudent and independent business judgment.

Shareholders elect directors and the corporation entrusts them with the power to exercise independent discretion over the day-to-day affairs of the firm. In other words, the business judgment rule is premised on the fiduciary relationship between the corporate entity and the board of directors. This relationship requires loyalty (i.e. trustworthiness and good faith) and due care (i.e. business acumen, professional skills, knowledge, and dedication).[673] According to a principle of corporate law that most jurisdictions recognize,[674] shareholders, as equity members, have the power to select board members on behalf of the legal entity as a whole.

Effective management requires free business judgment, however, this entails a higher degree of vulnerability for all of the coventurers, both equity and non-equity, who have made specific investments in the firm[675].

This vulnerability requires solutions through which the corporation protects itself against a corporation's controllers and their potentially harmful decisions. As Rajan and Zingales remarked, appointing an independent body, which does not participate in the specific investments of any category of co-venturer, allocates the profit stream of the business and determines corporate actions in an unbiased manner.[676]

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[673] See Blair & Stout, *supra* note 12, at 298.

[674] It must be acknowledged that, in two-tier systems, the members of the board are selected by the members of the supervisory board.

[675] See Blair & Stout, *supra* note 12, at 298.

[676] *See* Rajan & Zingales, *supra* note 37, at 422.

The primary measure through which all the coventurers protect themselves is an upfront assessment of controllers' personal qualities.[677] Only this initial selection process justifies the business judgment rule.[678]

On this ground, if a controller that shareholders have not selected and assessed—such as a shareholder or other party who is able to influence corporate decision-making mechanics—exercises business judgment, the justification for applying the business judgment rule breaks down, even in the absence of actual self-dealing.

Under circumstances where an entity who shareholders have not selected and trusted is actively involved in corporate affairs and determines corporate decisions, the standard of review that the courts apply should not be the business judgment rule, but rather a heightened standard such as entire fairness or a compelling justification standard.

This heightened standard of review, however denominated, should objectively assess the corporate action that resulted from the tainted decision-making process to determine (i) whether the process by which the decision was made was sufficiently informed and based on a legitimate business purpose, (ii) whether decision foreclosed compelling alternatives, and (iii) whether the decision harmed the corporation and its shareholders.

From a different standpoint, liability under such standard of review is rooted in an undue fiduciary relationship that exists between the controlling entity and the "dummy" board. Indeed, this parallels the fiduciary relationship between the board and the corporation.

As a result, in order to overcome the limits of the application of fiduciary duties only to controlling shareholders, this work suggests that every time a shareholder makes himself able to determine corporate decisions by virtue of a personal fiduciary relationship with one or more

[677] *See supra* Chapter 1.

[678] *See supra* Chapter 1.

members of the board of directors—establishing *de facto* a fiduciary relationship parallel to and distinct from the fiduciary relationship between the directors and the corporation—such a shareholder must be held liable as principal for any damage caused by the (disloyal) director(s) who acted as the shareholder's fiduciary.

i. *The Business Judgment Rule*

Stated simply, the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[679] The business judgment rule establishes "a powerful presumption in favor of actions taken by the directors."[680]

If challenged by a shareholder, a decision by a "loyal and informed" board will generally stand "unless it cannot be 'attributed to any rational business purpose.'"[681] If, however, a shareholder can successfully rebut the presumption,[682] then the burden shifts to the board to prove the "entire fairness" of the challenged corporate action.[683]

[679] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) ("The presumption initially attaches to a director-approved transaction within a board's conferred or apparent authority in the absence of any evidence of fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment.") (quotation marks and citation omitted)); In re RJR Nabisco, Inc. S'holders Litig., Civ. A. No. 10389, 1989 WL 7036, at *1 (Del. Ch. 1989) ("The business judgment form of judicial review encompasses three elements: a threshold review of the objective financial interests of the board whose decision is under attach (*i.e.*, independence), a review of the board's subjective motivation (*i.e.*, good faith), and an objective review of the process by which it reached the decision under review (*i.e.*, due care).").

[680] Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993; *see also* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (In applying the business judgment rule, "[c]ourts do not measure, weigh or quantify directors' judgments. . . . Irrationality is the outer limit of the business judgment rule.").

[681] *Cede & Co.*, 634 A.2d, at 361 (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)). The plaintiff bears the burden of rebutting the presumption that the board acted loyally, in good faith and on an informed basis. *See Aronson*, 473 A.2d at 812.

[682] *See Citron*, 569 A.2d at 64 ("The burden falls upon the proponent of a claim to rebut the presumption by introducing evidence either of director self-interest, if not self-dealing, or that the directors either lacked good faith or failed to exercise due care."); *see also* S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 127 (1979) (stating that "[a] director may . . . lose the benefit of the business judgment rule if [the] plaintiff proves that the director's challenged decision was prompted by an improper motive, that the director was not truly independent from an interested party, or any other circumstance demonstrating a lack of good faith").

[683] *Cede & Co.*, 643 A.2d at 361 ("Under the entire fairness standard of judicial review, the defendant directors must establish to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price.").

The business judgment rule arises from "the fundamental principle of Delaware law that the business and affairs of a corporation are managed by or under the direction of its board of directors."[684] The business judgment rule, however, is also grounded in three policy rationales. First, the business judgment rule is a product of judicial concern that persons who are competent to serve as directors and whose management expertise would benefit shareholders would nonetheless choose not to take on the responsibility of management if the threat of liability for good-faith but ultimately imprudent actions or the degree of judicial scrutiny of boardroom decision-making were too high.[685]

Second, and less compellingly, courts have cited a lack of expertise on the part of factfinders and a desire not to "second-guess" presumably well-informed management decisions as another rationale for the rule.[686]

Third, as emphasized in this work, the controller selection process justifies the business judgment rule. More specifically, the business judgment rule reflects the delegation of discretionary power to the corporate directors by the corporation, which is premised on the shareholders' *ex ante* assessment of the directors, and a resulting expectation that the directors will exercise their business judgment in a manner consistent with their personal qualities.[687]

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[684] *Id.* at 360. This principle is codified at § 141(a) of the Delaware General Corporations Law.

[685] *Cf.* Arsht, *supra* note 686, at 97 ("The business judgment rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge."); *see also* Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 444–45 (1993) (stating that application of a more stringent standard of review could have "the perverse incentive effect of discouraging bold but desirable decisions" by corporate directors and thereby reduce value-maximizing risk-taking).

[686] *See, e.g.*, Solash v. Telex Corp., Civ. A. Nos. 9518, 9528, 9525, 1988 Del. Ch. LEXIS 7, at *21 (Del. Ch. Jan. 19, 1988) ("Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith."); Eisenberg, *supra* note 689, at 444 (stating that, "in the case of business decisions[,] it may often be difficult for factfinders to distinguish between bad decisions and proper decisions that turn out badly").

[687] *See, e.g.*, In re ALH Holdings LLC, 675 F.Supp. 2d 462, 477 (D. Del. 2009) (suggesting that, pursuant to the separation of corporate control and ownership, "shareholders . . . must depend upon the integrity and deliberate consideration of the directors who manage the corporation," and that "the business judgment rule is a corollary that flows from the authority and responsibility inherent in the director's role"). *But see* Zapata Corp. v. Maldonado, 430

ii. Heightened Scrutiny

Delaware courts generally apply a less-deferential standard of review if the integrity of the board's decision-making process has been called into question. For example, a heightened standard applies if a plaintiff overcomes the protections of the business judgment rule by rebutting the presumption that the board acted loyally, in good faith or on an informed basis, if a controlling shareholder stands on both sides of a corporate transaction;[688] or in the change-of-control context (including where a decision to defend against a change-in-control is challenged).[689]

The applicable standard of review depends in part on the applicable standard of conduct and the likelihood of conflicts of interest:

> Under Delaware law, the standard of review depends initially on whether the board members (i) were disinterested and independent (the business judgment rule), (ii) faced potential conflicts of interest because of the decisional dynamics present in particular recurring and recognizable situations (enhanced scrutiny), or (iii) confronted actual conflicts of interest such that the directors making the decision did not comprise a disinterested and independent board majority (entire fairness). [690]

The most stringent standard of review is entire fairness.[691] It requires that the defendant directors "demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."[692] The components of fairness are fair dealing and

A.2d 779, 782 (Del. 1981) ("Directors of Delaware corporations derive their managerial decision making power. . . from 8 Del. C. § 141(a). This statute is the font of directorial powers.").

688 *See* T. Rowe Price Recovery Fund L.P. v. Rubin, 700 A.2d 536, 552 (Del. Ch. 2000) ("The entire fairness standard applies in the [merger and] non-merger context to interested transactions involving controlling stockholders."); *see also* Weinberger v. Uop, 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

689 *See generally* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) *; see also* Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, (Del. Ch. 2011) (describing the *Unocal* and *Revlon* standards as "enhanced scrutiny," and stating that "enhanced scrutiny requires that directors who take defensive action against a hostile takeover show (i) that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and (ii) that the response selected was reasonable in relation to the threat posed") (quotation marks and citation omitted)). The application of enhanced scrutiny is not limited to the change-of-control context. *See Reis*, 28 A.3d at 457–59 (discussing proxy contests, management actions affecting the shareholder franchise and "final stage transactions").

690 In re Trados Inc. S'holder Litig., 73 A.3d 17, 36 (Del. Ch. 2013).

691 *Reis*, 28 A.3d at 459.

692 In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006).

fair price.[693] The directors' subjective belief that the challenged act or transaction was entirely fair will not excuse directors' conduct; the act or transaction must be "objectively fair, independent of the board's beliefs."[694]

iii. Directors' Partiality

Directors owe a duty of loyalty to the corporation.[695] Self-dealing and interested transactions, whether involving a director who stands on both sides of the transaction or a controlling shareholder, implicate the duty of loyalty. "[A] relationship with an interested party [that] may affect the independent judgment of the director," however, also implicates the duty of loyalty.[696] Thus, in order to faithfully discharge their obligations, directors must be independent *and* act independently.[697] Further, a plaintiff challenging a corporate action on the basis of a lack of independence (and thus a breach of a director's duty of loyalty) bears the burden of "putting the participating director's independence into question."[698] The determination of independence requires "a subjective inquiry into the allegiance of each director on a case by case basis."[699]

A director may lack independence if he or she "is *dominated* by [a third] party, whether through close personal or familial relationship or through force of will," or if the director is "*beholden*

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693 *See* Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993). Generally speaking, "fair dealing" looks to the procedural aspects of an act or transaction, such as timing, quality of negotiations, disclosure and deal structure, while "fair price" looks to the form and amount of consideration received. *See* T. Rowe Price Recovery Fund, L.P. v. Rubin, 770 A.2d 536, 553–56 (Del. Ch. 2000).

694 Gesoff v. IIC Industries, Inc., 902 A.2d 1130, 1145 (Del. Ch. 2006).

695 *See* Blair & Stout, *supra* note 12, at 298.

696 In re ALH Holdings LLC, 675 F.Supp. 2d 462, (D. Del. 2009) (citing Orman v. Cullman, 784 A.2d 5, 25–26 n.5 (Del. Ch. 2002)).

697 *See* Texlon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002) ("Directors must not only be independent, but must act independently."); *see also Cede & Co.*, 634 A.2d at 362 ("We have generally defined a director as being independent only when the director's decision is based on the corporate merits of the transaction and is not influenced by personal or extraneous considerations.").

698 *ALH Holdings*, 675 F. Supp. 2d at 462.

699 *Id; see also* Beam v. Stewart, 845 A.2d 1040, 1049–50 (Del. 2004) ("Independence is a fact-specific determination made in the context of a particular case. The court must make that determination by answering the inquiries: independent from whom and independent for what purpose?").

to the allegedly controlling [party].'"[700] The fact that a shareholder or other controlling person nominated, designated or elected a director (directly or otherwise) is not sufficient to put that director's independence into doubt.[701] "The shorthand shibboleth of 'dominated and controlled directors'" is also not sufficient.[702] At least one federal court, applying Delaware law, has rejected the argument that a "special relationship. . . of trust and confidence" creates a presumption of controlling influence.[703]

The burden on the plaintiff to demonstrate the necessity of a more stringent judicial review based on a lack of director independence is substantial.[704] However, application of a heightened standard of review, where appropriate, may ultimately "help[] uncover situations where facially independent and disinterested directors have failed to act loyally. . . [on behalf of the corporation and shareholders generally] and instead have given in to or favored the interests of [a controlling

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700 *Orman*, 784 A.2d at 25–26 n.5. A director might be beholden to (and thus controlled by) another person if, for example, that person "has the unilateral power (whether direct or indirect . . .) to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or [which] is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively." *Id.*; *see also* Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984) (stating that, to prove lack of independence, "[t]here must be coupled with the allegation of control such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person"). *But see Beam*, 845 A.2d at 1050 ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence.").

701 *See Aronson*, 473 A.2d at 816.

702 *Id.* (quoting Kaplan v. Centex Corp., 284 A.2d 119, 122 (Del. Ch. 1971)).

703 *See* In re PMTS Liquidating Corp., Civ. No. 12-1020-SLR, 2014 WL 3737937, *5 n.5 (D. Del. July 28, 2014) ("Plaintiff also argues that GA LLC owed a fiduciary duty to ProxyMed because it was in a position of trust and confidence. Under Delaware law, this is not a valid basis to establish [a] fiduciary duty between a shareholder and the company in which it invests."). The plaintiff in *PMTS Liquidation Corp.* alleged that GA LLC interfered with the company's decision-making because the board's chairman and the company CEO were GA LLC's designees, the CEO provided periodic updates to GA LLC about the company's business plans and other confidential information, and GA LLC was intimately involved in approving various management decisions. The court rejected the plaintiff's arguments, stating that "GA LLC's involvement in ProxyMed's CEO selection process and managerial duties, as well as the request for company updates from the CEO, reflect the fact that a substantial minority investor has an incentive to be involved in company affairs and know how the company is performing in order to keep an eye on its investment." *Id.* at *5.

704 *See, e.g.*, Quadrant Structured Prods. Corp. v. Vertin, Civil A. No. 6990-VCL, 2014 Del. Ch. LEXIS 193, *65–66 (Del. Ch. Oct. 1, 2014) ("It is not enough . . . for a plaintiff simply to argue in the abstract that a particular director has a conflict of interest or is acting in bad faith because she is affiliated with a particular type of institution that may be pursuing a particular business strategy or have a particular business interest. There must be specific allegations and later, actual evidence sufficient to permit a finding that the director faced a conflict or acted with an improper purpose on the facts of the case.").

person].”[705] Further, the *Aronson* court’s articulation of the connection between the business judgment rule and the requirement of independence strongly suggests that if independence has been compromised, reliance on the business judgment rule is not appropriate:

> The requirement of director independence inheres in the conception and rationale of the business judgment rule. The presumption of propriety that flows from an exercise of business judgment is based in part on this unyielding precept. Independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influence. While directors may confer, debate, and resolve their differences through compromise, or by reasonably reliance [on experts], the end result, nonetheless, must be that each director has brought his or her own informed business judgment to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act. [706]

iv. Aiding and Abetting a Breach of Fiduciary Duty

“[I]t is well established that one who knowingly participates with a fiduciary in a breach of trust renders himself liable to the injured beneficiary.”[707] Particularly in situations where a plaintiff-shareholder is unable to prove the lack of independence of a majority of the board of directors—and thus cannot overcome the protections of the business judgment rule[708]—liability for causing a director to make a decision based not on “the corporate merits of the subject before the board”[709] but rather on the private interests of a controlling person could hypothetically be extended under an aiding-and-abetting theory.

Under Delaware law, a third party may be liable for aiding and abetting a breach of a corporate fiduciary’s duty to shareholders if the third party “knowingly participates” in the

[705] *Id.* at *81 (discussing application of the entire fairness standard particularly to controlling shareholder transactions).

[706] Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).

[707] Solash v. Telex Corp., Civ. A. Nos. 9518, 9528, 9525, 1988 Del. Ch. LEXIS 7, *33 (Del. Ch. Jan. 19, 1988).

[708] *See* Cede & Co. v. Technicolor, 634 A.2d 345, 363 (Del. 1993) (“This court has never held that one director’s colorable interest in a challenged transaction is sufficient, without more, to deprive a *board* of the protection of the business judgment rule presumption of loyalty.”).

[709] *Solash*, 1988 Del. Ch. LEXIS 7, at *33.

breach.[710] A plaintiff advocating a claim of aiding-and-abetting must successfully plead (i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in that breach by the defendant(s), and (iv) damages proximately caused by the breach.[711] Knowing participation in a fiduciary's breach requires "that the third party act with the knowledge that the conduct advocated or assisted constitutes such a breach."[712]

v. The Issue of Damages

The calculation of damages is particularly important. As explained in the previous chapter of this work, share price does not always reflect the value of a firm.[713] In particular, some business decisions, such as selling assets of the firm locked into long-term projects, might have the odd effect of raising share price but decreasing the value of the firm.[714] Thus, some actions that are harmful to the fundamental value of the firm may not be reflected in share price. Therefore, assessing whether a corporate decision caused damages to the corporation becomes particularly hard to prove, especially if damages cannot be linked directly to a subsequent drop in share price.[715] In other words, even if a board clearly lacks independence because of a controlling shareholder, a Delaware court might nonetheless insulate a decision, which arguably damages longer-term enterprise value but bestows a short-term cash benefit on all shareholders.[716]

710 Malpiede v. Townson, 780 A.2d 1075, 1096 (Del. 2001).
711 *Id.* (quotation marks and citation omitted).
712 *Id.*, at 1097.
713 *See supra* Chapter 3 Part II.
714 *See supra* Chapter 3 Part II.
715 *See supra* Chapter 3 Part II.
716 *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721–22 (Del. 1971) (applying the business judgment rule to the decision of a dominated board to issue a cash dividend rather than invest in the longer-term development of the corporation, on the grounds that "a proportionate share of [the declared dividend payments were] received by the minority shareholders" of the corporation, and because the dominating shareholder "received nothing from [the corporation] to the exclusion of its minority shareholders"); *see also* Quadrant Structured Prods. Corp. v. Vertin, Civil A. No. 6990-VCL, 2014 Del. Ch. LEXIS 193, *61–62 (Del. Ch. Oct. 1, 2014) ("[W]hen directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others."). *But see* In re PMTS Liquidating Corp., Civ. No. 12-1020-SLR, 2014 WL 3737937, *7 (D. Del. July 28, 2014) (finding that a third party's aiding and abetting of a director's fiduciary obligations to the corporation caused a cognizable loss of enterprise value).

In this context, although monetizing that harm might prove difficult,[717] using an approach based in contract theory, one could potentially characterize the harm to shareholders caused by the interference of a non-selected controller as the loss of a "benefit of the bargain" that separates ownership from control.[718]

vi. Why the Business Judgment Rule Should Not Be Applied to Decisions Made by Unselected Controllers

As explained above—besides the justification for the business judgment rule based on incentives for (*i.e.*, motivating qualified persons to manage the affairs of corporations), or expertise of (*i.e.*, deference to the business acumen of directors), the members of the board of directors—the application of the business judgment rule relies on the delegation of control by the corporation and an *ex ante* assessment by shareholders of the qualities of the controllers, who are thereafter given significant latitude to exercise their independent business judgment.[719]

To some extent, courts refrain from interposing themselves in conflicts between shareholders and directors that arise from directors' legitimate exercise of business judgment. This reflects a tacit admonition by the judiciary that, having selected the corporation's controllers, shareholders cannot thereafter complain when those controllers behave as expected. This rationale ultimately finds ground in the Phaedrus' principle that if someone entrusts the "Lion" with the power to harm her, only she is to blame.[720]

This scenario is different, however, if shareholders have not selected a controller, such as an influential shareholder, but the latter is in a position to determine corporate decisions and actions *de facto*. Such position undermines the integrity of the selection process, as well as its inherent value

[717] In theory, an effective method for penalizing non-selected controllers might be regulatory-type sanctions, which do not require a concise calculation of damages but rather serve to deter future infractions.

[718] *Cf.* Leo E. Strine, Jr., et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 647 (2010) (suggesting a comparison between the duty of good faith in the corporate context and the implied duty of good faith and fair dealing in contracts).

[719] *See supra* in this Chapter, Part Ii.

[720] See *supra* Phaedrus' Fable.

to shareholders and other stakeholders. In turn, corporations and their shareholders are not receiving "the benefit of the bargain" that they struck between themselves and management in accordance with the business organization's governance pattern.

In addition, if a decision originates with a non-selected controller, the decision-making process is inherently non-transparent to present shareholders, other stakeholders, and the capital market in general.

This opacity lends further justification to circumventing the protections of the business judgment rule and instead requiring heightened scrutiny, whether in the form of entire fairness review or another standard.[721] As to damages, a theory advocating stricter review of decisions originating with non-selected controllers could conceptualize the harm that results from such this decision-making phenomenon, by using an approach grounded in the law of contracts and the law of agency.

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[721] This heightened scrutiny could be articulated as a "compelling justification" standard, requiring directors to show that the challenged actions "were reasonable in relation to their legitimate objective" (with a subsidiary element being a legitimate or rational business purpose). *See* Mercier v. Inter-Tel (Delaware), Inc., 929 A.2d 786, 810 (Del. Ch. 2007). Novel or alternative standards of review might be more accurate, and the final goal of this policy is to raise awareness of the tainted decision, with the additional end of soliciting the proposal of specific standards of review.

SECTION II. SOFT-SELECTION OF SHAREHOLDERS

When a corporation goes public, its shareholder base embarks on a process comparable to the one that characterized the shift from the *societas consensu contracta* and its *fraternitas*-based organization, to the *societas publicanorum* and its third delegated control characteristic.

One of the risks of going public is that slacking, incompetent, or disloyal shareholders may replace original shareholders that were skilled and trustworthy.[722]

In fact, although equity investors in modern corporations relinquish their control rights, their personal qualities continue to affect the corporation.[723] Thus, a corporation should seek shareholders who exhibit "co-venturer" characteristics that fit well with the firm's vision, mission, and strategy.[724]

In order to enhance the discussion about corporate policies through mechanics for assessing shareholders personal qualities with the final intent to fix the corporate governance defect caused by the lack of judgment of (influential) shareholders inherent features, the first part of the present section briefly outlines some of the main techniques for selectively breeding shareholders.

The second part, instead, frameworks some of the main traits of time-weighted shares equity structures, with specific reference to the role that these securities have in determining the personal qualities of shareholders—namely re-aligning their investment perspectives with those of the corporation—and, above all, to the selective attraction they cause.

For a broader discussion of the aforementioned "shareholders breeding" techniques, it is recommended to refer to the essential articles of Belinfanti[725] and Rock[726].

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722 See *supra* Chapter 3, Parts II and III.

723 See *supra* Chapter 3, Parts II and III.

724 *See* BERKSHIRE HATHAWAY INC., AN OWNER'S MANUAL, 1 (1996), *available at* http://www.berkshirehathaway.com/ownman.pdf (explains that Berkshire Hathaway Inc. does not view its shareholders as "faceless members of an ever-shifting crowd," but life-long coventurers).

725 *See generally* Belinfanti, *supra* note 564.

726 *See generally* Rock, *supra* note 118.

From a different point, it must be acknowledge that anti-takeovers measures and shareholders' agreements represent two additional typical sets of tools to craft the (influential) shareholder base. For the specific discussion they require in order to be analyzed, however, this work does not cover them.

A. Crafting a Shareholder Base

i. Shareholders as Coventurers

Crafting a suitable shareholder base requires an upfront identification of the type of coventurers to target, which ultimately depends on how the corporation wishes to define itself.[727]

Shareholders that corporations seek as coventurers typically possess two characteristics: an investment behavior that meshes with the vision and operational strategy of the corporation, and an ability to understand and support the corporate missions and long-term strategies.[728]

Once corporations identify co-ventures to compose their shareholder base, they undertake "shareholder eugenics"[729] or "shareholder cultivation,"[730] in order to attract and cultivate "desired" shareholders and avoid or readdress "undesired" shareholders.

ii. Private-Placement

A typical mechanism to recruit shareholders is private placement of shares with desired coventurers—Goldman Sachs' sale of $5 billion in preferred stock[731] to Warren Buffett is a well-known example.[732] This sort of share placement is often referred to as "relational investing."[733] Warren Buffett has acted as a relational investor for decades. In the aforementioned example,

[727] *See* Belinfanti, *supra* note 564, at 810 (noting that "it is [] important for a firm to determine and identify those shareholders whose investment behavior and belief system tend to indicate non-co-venturer characteristics" such as "shareholder arbitrageurs, shareholders who engage in empty voting, and activist shareholders who seek to impose their personal business judgment on management"); *see also* Letter from Warren E. Buffett to the Shareholders of Berkshire Hathaway, Inc. (Mar. 14, 1984), *available at* http://www.berkshirehathaway.com/letters/1983.html ("Through our policies and communications . . . we try to attract investors who will understand our operations, attitudes and expectations. (And, fully as important, we try to dissuade those who won't)."); *see also id.*, at 818–821.

[728] *See* Belinfanti, *supra* note 564 at 812; *see also* Stout, *supra* note 31.

[729] *See generally* Rock, *supra* note 118; *see also* Chapter 1, Section III.

[730] *See generally* Belinfanti, *supra* note 564.

[731] *See* Goldman Sachs, Press Release to Redeem Preferred Stock Issued to Berkshire Hathaway (Mar. 18, 2011), *available at* http://www.goldmansachs.com/media-relations/press-releases/current/redeem-stock.html.

[732] *See* Rock, *supra* note 118, at 865.

[733] Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 1000-06 (1994).

Goldman's interest was securing Buffett's support at the lowest price possible, while Buffett sought a profitable investment. As this example shows, a good relational investor is beneficial to the corporation.[734]

However, at least two caveats should be considered with respect to private placing and relational investing. First, existing legal protections against corrupt relational investing are ineffective.[735] Second, private placement implicates the complete transfer of the equity-members power of one another selection as coventurers to the board of directors. In other words, shareholders delegate their ability to exercise their *intuitus personae* to the board.

These considerations raise at least three questions, although the answers to this are beyond this work's purposes. Can the equity-members effectively transfer their ability to exercise the *intuitus personae* in selecting coventurers? Is ability to exercise the *intuitus personae* inherently transferred to the board as an effect of shareholders' relinquishing control rights? Is the board of directors the appropriate body to select coventurers?

iii. Dividend Policies and Stock Price

A different tool to recruit shareholders is a dividend policy that serves the investing strategies of specific types of shareholders.

A variety of models have sought to explain dividend policy as an attempt to attract particular shareholders.[736]

While Modigliani and Miller's result is based on a "no taxes" assumption, in actual capital

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734 Rock, *supra* note 118, at 865.

735 *Id*., at 866.

736 *See* Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411, 411-15 (1961), Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958); *see also* Rock, *supra* note 118 at 875 ("Modigliani and Miller (M & M) showed that in perfect and complete capital markets, dividend policy will not affect firm value. But capital markets are neither perfect nor complete. In the wake of M & M, there has been a cottage industry engaged in trying to understand dividend policy within their framework.").

markets, taxes can play a relevant role in attracting specific types of shareholders.[737] Thus, Allen, Bernardo, and Welch observed that if minimizing taxes is the driving concern behind investment decisions, individuals prefer low-dividend stocks, corporations prefer high-dividend stocks, and investors who can avoid tax prefer medium-dividend stocks.[738]

From a different point of view, some evidence indicates that individual investors prefer dividend-paying stocks.[739] Thus, companies that seek individual investors as shareholders can increase their proportion in that particular shareholder base by paying dividends.

In addition, the time-horizon of corporate projects intrinsically affects dividend policies.[740] For instance, corporations engaged in long-term projects could not easily offer recurrent dividend payments, although the price of their stocks may reasonably reflect future returns and profits.[741]

Unsurprisingly, also stock price can potentially affect the composition of a shareholder

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[737] *See generally* Modigliani & Miller, *supra* note 742.

[738] *See* Franklin Allen, Antonio E. Bernardo & Ivo Welch, *A Theory of Dividends Based on Tax Clienteles* , 55 J. FIN. 2499, 2500-01 (2000).

[739] *See* Rock, *supra* note 118 at 865; *see also* Harry DeAngelo, Linda DeAngelo & Douglas J. Skinner, *Corporate Payout Policy*, 3 FOUND. & TRENDS FIN. 95, 207-10 (2008); Ravi Jain, *Institutional and Individual Investor Preferences for Dividends and Share Repurchases*, 59 J. ECON. & BUS.406, 426-27 (2007).

[740] *See* Belinfanti, *supra* note 564 at 818-819 ("[I]n terms of firm industry, different industries are thought to attract different types of investors. For example, slow- growth industries like utilities and manufacturing are generally thought to attract so-called 'income' investors who focus primarily on the stream of dividends a given stock is likely to generate. In contrast, high-growth industries, such as emerging technologies or green-building construction, tend to attract 'growth' investors, who focus primarily on the underlying quality of the business and the rate of expected growth, as opposed to immediate value and so-called 'GARP' ('growth at a reasonable price') investors, who combine the approaches of value investors and growth investors to identify companies with 'solid growth prospects and current share prices that do not reflect the intrinsic value of the business . . . .' Finally, in terms of the firm's value proposition, the story a firm tells about its business and its future will determine the types of investors the firm attracts. A story of future growth and no immediate payoff, for example, would detract income investors but attract growth and some GARP investors.").

[741] Stout, *supra* note 31 ("To understand this point, consider the perspective of a shareholder in a corporation that is pursuing some long-term project (say, mining the asteroid belt) unlikely to produce profits during the shareholder's remaining investing lifetime. If the shareholder cannot sell her shares, she will attach no value to corporate profits likely to be earned only after she has died or otherwise transferred shareownership. But in a reasonably liquid and fundamental-value efficient market, the shareholder can sell her shares to a younger shareholder who places a positive value on the future profits, because the younger shareholder expects to own the shares when the profits appear. Similarly, the younger shareholder might value future profits likely to be earned after he has transferred ownership, if he too anticipates he can sell his shares to an even younger investor who will own the shares when profits finally start rolling in. And so on, *ad infinitum*. Through the vehicle of a public corporation whose shares are traded at prices reflecting future returns, profits earned in the distant future can be transformed into wealth that can be enjoyed today. For example, if Google's decision to invest in self-driving cars increases today's price for Google stock, the present generation of Google shareholders can hope to profit from Google's investment even if they do not expect to own Google shares when the technology becomes commercially viable. This transformation of future expected returns into present-day wealth occurs to some extent even if equity markets are 'noisy' and prices do not perfectly capture expected future returns."); *see generally* Stout, *supra* note 520; Black, *supra* note 530; Gilson & Kraakman, *supra* note 506.

base[742]. A classic example is Berkshire Hathaway, whose original, high-voting, Class A shares have never been split[743]. Unlike unknown small or medium-sized public companies, however, Berkshire Hathaway is practically legendary, with a reputation that builds of its CEO's reputation, which gives Berkshire Hathaway the luxury of attracting the attention of the *right* sort of shareholders, rather than simply attracting the attention of *any* shareholders. [744]

As Tamara Belinfanti puts it, the use of dividends and stock splits are arguably somewhat weak as cultivation strategies because they do not involve targeting a particular group of shareholders based on demonstrated or potential stewardship behavior[745]. Thus, while dividends and stock splits theoretically signal a company's potential growth, the problem is that this signal is a "noisy" cultivation strategy. That is, the message's target recipients are not well defined or sorted to ensure that they are the type of shareholders that the company would want to cultivate. In the case of stock splits, however, this problem of untargeted recruiting goes away if the target recipient is a small investor.[746]

iv. Investor Relations and Communication

Another cultivation technique is developing communication between the company and its shareholders and other stakeholders.[747] For shareholders, the primary methods of communication include "the annual meeting; the company's website; quarterly earnings guidance; sell-side analyst calls; shareholder outreach; periodic reports; proxy statements; offering memoranda; press releases; and most recently, communications via social media."[748] Naturally, choosing a communication channel, a group of participants, and the substance of the communication, are all means by which

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742 *See* Belinfanti, *supra* note 564, at 812.
743 *See id.*
744 *See* Rock, *supra* note 118, at 878–80.
745 *See* Belinfanti, *supra* note 564, at 812.
746 *See id.*
747 *See e.g.*, BERKSHIRE HATHAWAY INC., *supra* note 730, at 1 ("[B]y our policies and communications, we can encourage informed, rational behavior by owners that, in turn, will tend to produce a stock price that is also rational.").
748 *See* Belinfanti, *supra* note 564, at 838.

management might reach, recruit, educate, and cultivate a targeted group of shareholders.[749] Such an approach is highly sophisticated because it is ultimately seeks to attract desired shareholders to join the venture and embrace its projects, and to dissuade investments by undesired shareholders.

v. Home Bias

Investors, including the most sophisticated investors, disproportionately invest in corporations listed in their own country.[750] Indeed, one of the explanations for cross listing a corporation on different stock exchanges is to broaden the corporation's investor base.[751] Given this "home bias," the choice of the jurisdiction for chartering, establishing corporate headquarters, and, in particular, listing the shares can greatly influence a shareholder base.

For example, if a corporation's products have a particular geographic focus, such as Europe, then the corporation may choose to list its shares on the London Stock Exchange because potential investors may well have heard of the firm's product from either product advertising, word of mouth, or press coverage—thus, product advertising in a given locale can affect shareholder base.[752] Such a strategic decision, in turn, affects the nationality of the corporation's shareholders.

Furthermore, analysts that value companies are biased because of their knowledge of the corporate law, listing rules, juridical system, and macro-economic factors they are most familiar with, thus they will focus the investments on corporations complaint with legal frameworks with which they are familiar.

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749 *See* Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L.REV. 821, 833-34 (2013).

750 Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 BEHAV. FIN. 222, 222 (1991).

751 *See generally* Joshua D. Coval & Tobias J. Moskowitz, *Home Bias at Home: Local Equity Preference in Domestic Portfolios*, 54 J. FIN. 2045 (1999).

752 *See* Gustavo Grullon, George Kanatas & James P. Weston , *Advertising, Breadth of Ownership, and Liquidity*, 17 REV. FIN. STUD. 439, 458 (2004).

vi. Avoiding Undesirable Shareholders

The counterpart of recruiting good shareholders is avoiding bad shareholders. There are several methods for doing so. One well-known but outdated[753] technique is targeted share repurchases, or greenmail, in which a board of directors approves the repurchase of shares owned by a disruptive investor at market price or a premium above market because the investor poses a threat to the company.[754]

As Rock points out, an extreme version of shareholder avoidance is "going private". Doing so, *all* public shareholders are indiscriminately bought out.[755] Usually this transaction is the result of an incessant pressure for quarterly results that is not compatible with the sustainable production of the firm.[756] In other words, the disadvantages of short-termism could lead a corporation to de-listing to save itself from public shareholders disruptive myopia[757].

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753 According to Rock, while greenmail is permissible under Delaware law, "in the control context [it] has largely or entirely disappeared. First, it was not particularly effective: although the bothersome shareholder could be eliminated, paying him off attracted other equally bothersome investors. Second, the poison pill was both more effective and cheaper and became the preferred defensive tactic. Third, greenmail became sufficiently distasteful that it attracted punitive tax treatment and made directors reluctant to succumb." (Internal citations omitted.) Rock, *supra* note 118, at 887.

754 *See* Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 13-14 (1985).

755 *See* Rock, *supra* note 118 at 887-88.

756 See Stout, *supra* note 31.

757 See *id.*

B. A Simple Outline of Time-Weighted Shares: Between Interest Re-Alignment and Selective Attraction

i. What Are Time-Weighted Shares?

Time-weighted shares are common stocks that offer additional rights to shareholders who hold them over a pre-determined amount of time, without creating different classes of shares from the outset.[758]

They are a tool both to selectively attract long-term investors and develop a long-term shareholding culture[759] that best serves corporate interests, especially if the object of the business requires long-term projects.[760]

Although related to control enhancing mechanisms (pyramid structures, non-voting shares, voting rights ceilings, ownership ceilings, supermajority provisions, cross-shareholding, shareholder agreements and multiple voting shares[761]), time-weighted shares equally provide to all shareholders[762] the same set of rights that reward loyalty—each stock having the potential to vest the benefits.[763] In fact, time-weighted shares alter the principle "one-share one-vote" in a similar manner as dual-class shares, though the allocation of rights is the result of the shareholder's "loyalty" to the corporation rather than being attached to the stock from the outset.[764]

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758 *See generally* Jane Ambachtsherr, Ryan Pollice & Ed Waitzer, Building a Long-Term Shareholder Base: Assessing the potential of loyalty-Driven Securities (2013), *available at* http://genfound.org/media/pdf-long-term-shareholder-base-17-12-13.pdf.

759 *See* Fox & Lorsch, *supra* note 441, at 52 ("[W]e do think that giving a favored role to long-term shareholders, and in the process fostering closer, more constructive relationships between shareholders, managers, and boards, should be a priority."); *see also* Belinfanti, *supra* note 564 at 818.

760 *See generally* Stout, *supra* note 31.

761 On the potential distortive effects of time-weighted shares see Luigi Zingales, *Quel voto plurimo così opaco*, available at http://www.ilsole24ore.com/art/commenti-e-idee/2014-08-01/quel-voto-plurimo-cosi-opaco--073028.shtml?uuid=ABywbMgB.

762 All shares provide the same set of actual and potential rights and are purchased at the same market price; and if a shareholder sells before satisfying the time period, there is no cost to the shareholder.

763 See Nicolas Chene, Le Droit de Vote Double en France 41-42 (2008) (unpublished memoire de recherché) (on file with école des Hautes Etudes Commerciales de Paris), *available at* http://www.vernimmen.net//ftp/NChene_Memoire_DDVdoubles.pdf.

764 *See* Patrick Bolton & Frédéric Samama, *L-Shares : Rewarding Long-term Investors* (ECGI Finance Working Paper, Paper No. 342, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2188661; Client Memorandum

ii. Loyalty Rewarding Rights

The time-weighted shares can allocate rights of different natures, aside from additional governance power, to "loyal" shareholders.

Thus, a corporation can decide what rights to attach to the time-weighted shares depending on its needs and goals. Although corporations enjoy free reign in framing the set of loyalty rights to attach to such shares,[765] three options are the most common: increased voting rights, increased dividends, and warrants.[766] These rights vest at the expiration of the pre-set period as long as the shareholder does not transfer her shares for consideration or free of charge (though potentially it is possible to provide an exception in case of transfer through succession following death or after a merger or spin-off of the shares[767]).

The first category grants the time-weighted shares with multiple[768] voting rights.[769] This system has already been applied in France, which has more than seventy corporations listed on the Société des Bourses Française 20 Index that have such provisions in their charters.[770] The Italian

from Davis Polk, *Les* L-Shares *primées par le forum pour l'investissement responsable* (Sep. 19, 2014), *available at* http://www.davispolk.com/sites/default/files/Les.LShares.prim%C3%A9es.par_.le_.forum_.pour_.l.investissement.responsable.pdf.

765 For insights on the possibilties for multiple voting time-weighted shares available under Italian Law, see Niccolo' Abriani, Azioni a Voto Plurimo e Maggiorazione del Voto: Prime Considerazioni, Rivista Mensile di Diritto e Pratica per la Gestione delle Imprese, at 16.

766 *See* Bolton & Samama, *supra* note 770, at 8.

767 See art. 127-*quinquies*, par. 3a, of the Italian Consolidated Law of Finance. See also N. Abriani, , Azioni a Voto Plurimo e Maggiorazione del Voto: Prime Considerazioni, Rivista Mensile di Diritto e Pratica per la Gestione delle Imprese, at 19.

768 Specific provisions cap time-weighted multiple voting rights in France and Italy. See art. L232-14 of the French Code de Commerce and art. 127-*quinquies* of the Italian Consolidated Law of Finance (Legislative Decree no. 58 of 24 February 1998).

769 "[A]lso known as tenured voting or time-phased voting, whereby a shareholder's voting power increases based on the length of time he or she has been a shareholder." Belinfanti, *supra* note 564, at 832.

770 See Ambachtsherr, Pollice & Waitzer, *supra* note 764, at 10.

Consolidated Law of Finance also contains favorable regulations for implementing time-weighted-multiple-voting,[771] thus incentivizing their use.[772]

The second category increases dividend rights. In France,[773] prominent corporations such as L'Oréal[774] and Air Liquide[775] have adopted such mechanisms. In Italy, the art. 127-*quarter* of the Italian Consolidated Law of Finance allows corporations to amend their by-laws to provide that each share held by the same shareholder for a continuous period of no less than one year or for a shorter period between two consecutive payments of annual dividends shall assign the right to an increase to a maximum of 10% of the dividends distributed to the other shares within certain limits.[776]

Finally, warrants grant a shareholder the right to purchase a predetermined number of shares at a pre-determined price. The French Corporation Michelin implemented such a scheme.[777]

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771 In short, art. 127-*quinquies* of the Italian Consolidated Law of Finance allows Italian listed corporations to amend their bylaws to increase voting rights (up to a maximum of two votes per common share) those shareholders who have continuously held their shares for at least two years. Proposed changes to the bylaws need the approval of votes representing the majority of the share capital present at a general meeting and a related resolution to amend the bylaws does not give rise to the withdrawal right as envisaged by art. 2437 of the Italian Civil Code. *See* 127-*quinquies* of Italian Consolidated Law of Finance, *available at* http://www.consob.it/mainen/documenti/english/laws/fr_decree58_1998.htm#Article_127-quater.

772 *See* Campari-Milano S.p.A. Explanatory Report by the Board of Directors to the Extraordinary Shareholder' Meeting on amendments to the Articles of Association dated December 19th, 2014.

773 *See* art. L232-14 of the French Code De Commerce *available at* http://www.legifrance.gouv.fr/affichCodeArticle.do?cidTexte=LEGITEXT00000563437.

774 *See* L'OREAL, http://www.loreal-finance.com/eng/registered-shares-loyalty-bonus (lastvisited Nov. 24, 2014)

775 *See* AIR LIQUIDE, http://www.airliquide.com/en/shareholders/the-air-liquide-share-1/the-loyalty-bonus-3.html (last visited Nov. 24, 2014)

776 *See also* art. 127-*quarter* of the Italian Consolidated Law of Finance (providing that "should the same party, during the maturation of the period indicated in subsection 1, have directly or indirectly through trustees, subsidiaries or third party, have held an investment in excess of 0.5 percent of the company capital, or lesser percentage specified by the Articles of Association, the majority may only be assigned for shares in total representing this maximum stake. The majority can not be assigned to shares held by those who, during said period, even temporarily exercised a dominant, individual or jointly with other shareholders by means of a shareholders' agreement as envisaged by article 122, or significant influence over the company. In any event, the increase may not be granted on shares which during the period indicated in subsection 1 were continuously or temporarily assigned to a shareholders' agreement as envisaged in Article 122 and in the same period, or part of that period, formed part of a total shareholding exceeding that indicated in Article 106, subsection 1 [30%].").

777 *See* Bolton & Samama, *supra* note 770, at 13.

iii. Crafting Time-Weighted Shares

Corporations may freely chose rights to attach to time-weighted shares.

The board of directors can decide to implement vote increases, dividend-increases, and warrants as time-weighted rights, depending on the incentives the corporation wants to provide.

Such flexibility is a major feature of time-weighted shares which can affect the investing and governance attitudes of the shareholders by aligning shareholders' investment perspective with the timeframe for industrial projects and by attracting and engaging synergistic shareholders to participate in governance.

Thus, a board can shape time-weighted shares around business projects' timeframes and the qualities of the shareholders they want to reward, incentivize, attract, and retain. Shareholders interested in a financial premium are not necessarily interested in a governance premium, and vice versa. It is certain, however that shareholders interested in shares that vest their premium rights by the long holding of shares have a tendency to commitment, which is functional to the support of long-term corporate undertakings.

In some jurisdictions, such as in Italy and France, time-weighted shares are specifically regulated.[778] In the United States, however, State corporate law grants broad discretion in crafting such securities.[779] Listing requirements distinguish between time-weighted voting and time-weighted dividends, however.

On one hand, time-weighted dividend shares are compatible with state law, federal law, and stock exchange listing rules.[780]

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[778] For a comparison with the French and Italian legal framework, see *supra* notes 767, 768, 771, and 776.

[779] Contractual freedom, which governs charters and by-laws, grants corporations discretion as to the choice of corporate governance and equity structure and introduce time-weighted vesting shares. Bus. Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990) (allowing General Motors to deviate from the one vote per share on common stock). This is a core decision left to the corporation's sole discretion and even the Securities and Exchange Commission is not empowered to intervene and ban such practices of "disenfranchisement."

[780] *See e.g.*, DEL. CODE ANN. tit. 8, § 170 (2011); Belinfanti, *supra* note 564, at 851 ("[T]he decision to adopt a time-weighted dividend policy would be protected by the business judgment rule and the existing immutable and default rules surrounding dividend payments and dividend policies would allow a board to implement a time-weighted dividend policy.").

On the other hand, time-phased voting shares seem permissible under state law, but not by the New York Stock Exchange ("NYSE") listing rules. Indeed, Delaware allows boards to award superior voting rights to long-term shareholders[781] and in Williams v. Geier, the Delaware Supreme Court held that a comparable equity scheme fell within the ambit of a reasonable business decision and reasonable corporate policy. The NYSE market rules, however, prohibit corporations from implementing time-phased voting once that corporation has already issued shares.[782]

Thus, the listing rules effectively restrict time-weighted voting to non-public companies and companies about to go public. However, the NYSE Para. 313.00 Interpretation No. 95-01 NYSE carves out from the prohibition some exceptions for corporate actions if the exchange finds that these actions have a "reasonable business justification."[783]

iv. Advantages of Time-Weighted Shares

Time-weighted shares put in place these incentives for long-term shareholders causing two main advantages.

First, they favor corporations in undertaking value-maximizing projects, including those that require an extended timeframe for the realization by rewarding "the committed shareholders (who are more prone to pursue sustainable growth and profitability with a long-term perspective)."[784]

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781 Under Delaware law, corporations are not constrained in how they depart from the default one-vote-per-share rule. *See* Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms,* 61 BUS. LAW 1011, 1059 (2006).

782 *See* New York Stock Exchange, *Listed Company Manual*, § 313.00(A) (Voting rights of existing shareholders of publicly traded common stock under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share exchange offer.").

783 Para. 313.00 Interpretation No. 95-01, N.Y. Stock Exch. (Jan. 10, 1995), http://nysemanual.nyse.com/LCM/pdf/votingrights.pdf.

784 *See* Campari-Milano, *supra* note 772 at 1.

Thus time-weighted shares, via the creation of patient and committed capital, incentivize investors to forgo the immediate return in anticipation of more substantial returns down the road.

This frees the board from short-term pressure, and provides the board with more independent and uninfluenced business judgment to pursue long-term projects[785].

In addition, due to the "engagement effect" time-weighted shares cause, shareholders have more incentive to monitor the board because shareholders are potentially missing quick quarterly profits for more substantial long-term profits. This makes more rational a stewardship approach based on the organization of the power of voice since time-weighted shares intrinsically discourage the "Wall Street Walk" (i.e. the quick and quiet selling of shares before others catch on).

Indeed, disfavored "exit" options incentivize—otherwise rationally apathetic—shareholders to engage in the stewardship of the corporation. The incentive structure of time-weighted shares at least partially compensates for monitoring costs (in the case of dividend increases) and incentivizes shareholders to exercise a "reinforced voice" (in the case of vote increases).

Thus, the re-orientation of shareholders' interest towards a long-term perspective produces advantageous and synergistic corporate governance, though it does not provide corporations with a system of shareholder selection. In other words, it cultivates "good" shareholders, but has nothing to do with actively assessing their inherent personal qualities.

The second beneficial trait of time-weighted shares is probably the most crucial for this work. Time-weighted shares selectively attract shareholders who likely possess a set of common qualities: loyalty to the corporation, patience in obtaining returns, and engagement in monitoring management.

785 Potential executives remuneration packages based on time-weighted shares would favor long-term projects.

Furthermore, maintaining shareholder consistency benefits a corporation that is pursuing long-term projects. Corporations such as Alibaba, Facebook, Google, and Groupon have made very clear statement of their dedication to stability before going public.[786] Corporations have already started issuing policy statements as to how its shareholders should be committed to a long-term investment.

In addition, giving long-term shareholders disproportionate voting rights, the governance power is concentrated in the hands of long-term-oriented investors.

On this ground, listing requirements that prohibit time-weighted voting may frustrate the advantages discussed above:

> As a cultivation tool, it rewards stewardship capital on one hand, and potentially discourages the aforementioned flippers and short-term gamblers. Moreover, with more attention being focused on the negative impacts caused by shareholder short-termism and some shareholder activists, the NYSE's ban on time-weighted voting may be ripe for reconsideration. In articulating its policy to ban "time phased voting plans" and their ilk, the NYSE does acknowledge in its listing manual that: "[t]he Exchange's interpretations under will be flexible, recognizing that both the capital markets and the circumstances and needs of listed companies change over time." With the growing presence and clout of shareholder- gamblers in corporate governance and corporate elections, there is a strong case to be made that for the NYSE to re-evaluate its voting policy, which treats all shareholders as equal, and "recogniz[e] that both the capital markets and the circumstances and needs of listed companies [have] change[d] over time."[787]

Time-weighted dividends, on the other hand, "provide an interesting cultivation strategy with relatively minimal legal constraints and a broad zone of play for a board to design such a policy."[788]

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[786] *See* Paul Hodgson, *Alibaba IPO: Shareholders can buy shares, not influence*, FORTUNE (Sep.18, 2014), http://fortune.com/tag/shareholder-rights/; *see also*, *Letter From the Founders*, THE WALLSTREET JOURNAL (April 29, 2004), http://online.wsj.com/articles/SB108326432110097510.

[787] Belinfanti, *supra* note 564 at 834.

[788] *Id.* at 852.

v. Structural Limits of Time-Weighted Shares

Two structural issues affect time-weighted shares. The first is a restriction on liquidity: time-based premium systems can suboptimally allocate investments in the financial markets. Both current and prospective shareholders could suffer from an efficient allocation of their resources.

Specifically, current shareholders may be detrimentally tied to defectively managed or unprofitable corporations because the cost of "exit" could determine their decision to hold shares despite the corporation's defects. Conversely, prospective shareholders may not want to wait the designated time before enjoying the same rights as older shareholders with the same amount of shares, despite paying the same price for shares.

This could cause a corporation's shares to become illiquid, which would partially defeat the purpose of taking the company public.[789]

The second issue is a difficulty to calculate the type and extent of premium rights relative to the objective they are to obtain. In other words, the consideration that a corporation will provide shareholders for committing to the corporation in order to fairly reward, incentivize, and attract shareholders without disturbing financial and governance balances.

vi. Closing Remarks on Shareholders' Soft-Selection

Corporations can reap many benefits by crafting its shareholder base, including increased capital, and enhanced cooperation between shareholders and managers.[790]

In particular, the selection of shareholders based on their personal qualities serves a mission-sustaining function in that it ensures that a firm has a shareholder base that supports and advocates for the corporation's mission and its industrial projects.

[789] *See generally* Bolton & Samama, *supra* note 770.
[790] *See* Belinfanti, *supra* note 564, at 811; *see also* Rock, *supra* note 118, at 854.

Once companies decide what sort of equity-coventurers suit their productive activity, they should think systematically about how to create a synergistic shareholder base.

Given the potential effect of shareholders' personal qualities on a firm's value and operations, crafting the optimal shareholder base is a strategic decision for a firm.

Put differently, organizing a business as an independent legal entity, shields the business from equity-members' fates and wills because of the shift from the *fraternitas*-based *societas consensu contracta* to the *societas publicanorum*.

Nevertheless, the modern corporation does not entail indifference toward shareholders' personal qualities. Building relationships around fundamental issues of corporate strategy and policy rather than quarterly earnings reports holds the potential for changing what might be an adversarial relationship between shareholders and management into synergistic relationship.

Shareholder cultivation converts share ownership from transient to stable, an effect that is increasingly beneficial as computers increasingly select stock rather than people. Moreover, this conversion parallels a broader social trend that emphasizes interconnectivity, community, and local specificity in the face of technology and globalization.

The choice of corporate domicile, stock exchange, public image, disclosure policy, stock price, and liquidity, and other factors that may affect what sorts of shareholders are attracted to a given company represent useful, but probably weak, strategies to effectively craft a shareholder base if considered disjointedly.

Similarly, the investor-relations function, is a constructive part of shaping a shareholder base, but does not permit a corporation to shift from a passive to an active position in the selection of coventurers, and therefore enhances only a form of "attractive persuasion" by itself.

Innovative forms of shareholder cultivation are substantially based on quality-based selective attraction techniques, and may revolve around rewarding only equity-coventurers that understand the scope, projects, and goals of a corporation.[791]

In this context, time-weighted shares offer flexibility in incentivizing investment that is relative to timeframes that are compatible with industrial projects and, even more relevant to the ends of this work, attract shareholders based on their inherent qualities.

These interest alignment and selective attraction mechanics represent novel approaches to address corporate governance flaws such as short-termism, shareholders' rational apathy toward governance and, above all, the failure to assess shareholders' personal qualities.

Potential negative effects on liquidity and difficulties calculating an algorithm for such rights do not seem to be absolute obstacles for successfully implementing these equity structures in the United States, as well as in Europe and other evolved legal-economic contexts.

Indeed, time-weighted shares may effectively fix corporate governance defects related to the lack of assessment of shareholder's personal qualities—especially if combined with an effective, positive investor-relations interaction. Nevertheless, because such methods only attract potentially desirable shareholders and align shareholders' interests with those of a corporation, but not permit an active assessment and selection of equity-coventurers, only partially address the lack of shareholders' personal qualities assessing.

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[791] *See* Belinfanti, *supra* note 564, at 845 ("[F]uture cultivation tools include: (1) nuanced financial products like 'MY Shares,' which offer superior voting rights and distribution rights to steward shareholders; (2) time-weighted dividends whose dividend stream is dependent on a shareholder's length of ownership; (3) mission-weighted dividends whose dividend stream depends on the quality of share ownership; (4) suspending the rights of shareholders who exhibit 'improper' behavior in violation of corporate law; (5) engaging regulatory agents such as stock exchanges and the SEC to develop best practices around integrated reporting; (6) implementing a transaction tax on shareholders who exhibit non-co-venturer behavior; and (7) shareholder 'rewards' point programs, which reward shareholder stewards with points that may be applied to additional shares or towards the purchase of the company's products or services.").

SECTION III. THIRD PARTY AUTHORIZATION ON INFLUENTIAL STOCK VOTING

As described in the previous chapter, in a public corporation, free transferability of equity shares entails the loss of *intuitus personae* among equity-coventurers. Although usually justified with centralized management, in actuality, the failure to assess (influential) shareholders' qualities gives rise governance defects because of the potential for shareholders to influence governance and lead management toward their idiosyncratic preferences.

This section suggests a policy to fix such a governance defect, within the limits of American corporate law. The proposed policy considers shareholders' relinquishment of control rights, the rational apathy of dispersed shareholders, and the conflicts of interest characteristic of public corporations.

In particular, the policy advances the hypothesis that if a shareholder triggers certain thresholds of beneficial equity ownership (e.g., 5%, 10%, or 15% of the share capital) an independent third party must authorize the acquiring shareholder to exercise voting rights of the shares in excess of the given threshold. I will refer to such excess shares as "influential" shares, given their presumed capability of effecting corporate management.

Hypothetically, the third party with such authority would be a federal regulatory agency, such as the Securities and Exchange Commission (the "Commission").

Such an authority should foreclose permission to vote "influential" shares if the acquiring shareholder has exhibited a tendency to engage in activities that undermine integrity and stability in the market, or has repeatedly harmed the firm (and its shareholders and other stakeholders) by exercising (potentially undue) influence on firm governance.

In order to put forth such a policy, this section provides regulatory and theoretical background and assesses the policy's feasibility.

A. Context: Securities Regulation and Current Policies

Although "Congress designed the Williams Act to be neutral and to leave decisions regarding a company's future and a company's management in the hands of shareholders,"[792] the Williams Act does not provide an adequate remedy for shareholders that have negatively assessed a potential acquiring shareholders' qualities with due regard for the company's best interest.[793] The *logos* is thus defective: shareholders cannot effectively select favored coventurers nor keep away disfavored coventurers. Shareholders can only sell their shares, but selling is not an ability to make decisions "regarding a company's future and a company's management."[794]

Therefore, in order for qualitative assessments of shareholders' qualities to provide sound protection for other shareholders and the firm, the law must create more effective mechanics for shareholders to undertake such assessments.

i. Current Disclosure Requirements and Germane Filing Rules

The Williams Act of 1968 amended the Securities Exchange Act of 1934 and added disclosure and filing requirements for non-issuer third parties. [795] Through the Williams Act, Congress hoped to provide the public "with adequate information on which to base intelligent investment decisions" and to put bidders and shareholders of target corporations on equal footing.[796]

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792 Allergan, Inc. v. Valeant Pharmaceuticals International, Inc., No. SACV 14–1214 DOC(ANx), 2014 WL 5604539, at *18 (C.D. Cal. Nov. 4, 2014).

793 *See e.g.*, *id.* (denying in part injunction of a tender offer on behalf of plaintiff shareholders despite the possibility that the acquiring shareholder would terminate the company's existence because such potential harm was not "certain or imminent") (citing Caribbean Marine Servs. Co. v. Baldridge, 844 F.2d 668, 674 (9th Cir. 1988)).

794 *Id.*

795 The Williams Act of 1968, Pub. L. 90-439, 82 Stat. 455 (July 29, 1968). When Congress passed the Williams Act, Congress was legislating against the background of a significant uptick in corporate takeovers involving cash tender offers. *See* Lucian A. Bebchuk & Robert J. Jackson Jr., *Toward a Constitutional Review of the Poison Pill*, 114 COLUMBIA L. REV. 1549, (2014); Andrew E. Nagel, Andrew N. Vollmer & Paul R.Q. Wolfson, *The Williams Act: A Truly "Modern" Assessment* 5 (2011), *available at* http://blogs.law.harvard.edu/corpgov/files/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf; Jonathan R. Macey & Jeffry M. Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U. L. Q. 131, 133 (1987).

796 The Williams Act's advocates were concerned that investors were not receiving sufficient information "to make prudent and profitable decisions." S. Rep. No. 550, 90th Cong., 1st Sess. 1 (1967); *see also* Rondeau v. Mosinee

The Williams Act mandates (1) public disclosure of share block acquisitions above a certain percentage threshold and (2) the delivery to issuers, the Commission and offerees of a tender offer information regarding the offeror and the purpose of the tender offer.

The Williams Act added section 13(d) to the Exchange Act.[797] As currently formulated, section 13(d) requires any person who becomes, directly or indirectly, the beneficial owner of more than 5% of the shares of a class of voting securities to file with the Commission, within 10 days of the acquisition which caused such person to exceed the 5% threshold, a statement containing the information required to be set forth in Schedule 13D or otherwise required by Commission rules and regulations.[798] Section 13(d) permits a more limited filing "if it appears to the Commission that such securities were acquired by such person in the ordinary course of his business and were not acquired or the purpose of. . . changing or influencing the control of the issuer."[799] 13(d) also exempts certain shareholders from these filing requirements in certain circumstances.[800]

The Williams Act also added section 14(d) to the Exchange Act.[801] Under section 14(d)(1)—the disclosure provision pertaining to tender offers—a person may not use the mail or instrumentalities of interstate commerce to make a tender offer for equity securities of an issuer that would result in that person becoming the beneficial owner of more than 5% of the class of securities subject to the offer unless, at the time that copies of the offer are first published or delivered to holders of the securities, the offeror has filed with the Commission a statement

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Paper Co., 422 U.S. 49, 58 (1975) ("The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information regarding the qualifications and intentions of the offering party."); GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971) (stating that the purpose of the Williams Act was to "alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of the technique employed, which might represent a potential shift in corporate control").

797 Codified at 15 U.S.C. § 78m(d).

798 15 U.S.C. § 78m(d)(1). The Williams Act originally required an acquirer to disclose its block acquisition to the SEC *and* to both the issuer of the securities and the exchange(s) on which the securities were traded; however,this requirement was abrogated in 2010.

799 15 U.S.C. § 78m(d)(5).

800 *See* 15 U.S.C. § 78m(d)(6)(A)-(D).

801 Codified at 15 U.S.C. § 78n(d). This section discusses only the disclosure provisions, although the Williams Act imposes additional requirements on persons making a tender offer.

containing the information specified in Schedule TO or otherwise required by Commission rules and regulations.[802] Additionally, the offeror must send to the issuer of the securities copies of all statements and materials furnished to security holders and the Commission no later than the date on which such statements and materials are published or delivered to any security holders.[803]

Commission Rule 13d-1 implements section 13(d) of the Exchange Act.[804] Under Rule 13d-1, a person who acquires more than 5% of the total shares in a registered class of voting securities must file with the Commission a statement containing the information specified in Schedule 13D within 10 days of the acquisition, which causes such person to exceed the 5% threshold (a "13D filing"). From the standpoint of the issuer and the issuer's shareholders, the most significant component of the 13D filing is presumably the Item 4 disclosure, which sets forth the purpose of the share block acquisition.[805] More specifically, Item 4 requires the filing person to disclose plans or proposals that "relate to or would result in" any of the following:

i. The acquisition (or disposition) by any person of additional securities of the issuer;

ii. An extraordinary corporate transaction (merger, acquisition, liquidation, etc.);

iii. A sale or transfer of a material amount of assets of the issuer or any of its subsidiaries;

iv. Any change in the composition of the board of directors or the management of the issuer;

v. Any material change in the present capitalization or dividend policy of the issuer;

vi. Any change in the issuer's charter or by-laws or other actions which might impede the acquisition of control of the issuer by any person; or

[802] 15 U.S.C. § 78n(d)(1).
[803] 15 U.S.C. § 78n(d)(1).
[804] 17 C.F.R. § 240.13d-1(a).
[805] *See* 17 C.F.R. § 240.13d-101, Item 4.

vii. Any action that would cause the issuer's securities to be delisted from a national securities exchange or not authorized to be quoted in an inter-dealer quotation system.[806]

A person filing a Schedule 13D must also "promptly" file an amendment with the Commission upon any material change in the facts as set forth in the Schedule 13D on file with the Commission, or upon a "material increase or decrease in the percentage of the class beneficially owned" by such person.[807] An increase (or decrease) of 1% or more (or less) is presumptively "material," while an acquisition or disposition of a lesser amount "may be material, depending upon the facts and circumstances."[808]

A person who would otherwise be required to file a Schedule 13D may file a short-form statement on Schedule 13G if the person has not acquired the securities "with any purpose, or with the effect, of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect."[809] This exemption from filing on Schedule 13D becomes unavailable, however, if the person acquires 20% or more of a class of voting securities. If a person reaches 20% beneficial ownership, the person must file with the Commission, within 10 days, a statement on Schedule 13D.[810]

In addition, a person who previously filed a Schedule 13G under section (c) of Rule 13d-1 (and who is currently the direct or indirect beneficial owner of more than 5% of a registered class of voting securities) must file a Schedule 13D within 10 days of acquiring or holding any securities of that class "with a purpose or effect of changing or influencing control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect."[811]

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806 *Id.*
807 17 C.F.R. § 240.13d-2(a).
808 *Id.*
809 17 C.F.R. § 240.13d-1(c).
810 *See* 17 C.F.R. § 240.13d-1(f)(1).
811 *See id.* § 240.13d-1(e)(1).

ii. The Cooling-off Period

Today, rule 13d-1 has two lock-up provisions which apply to any person who filed a Schedule 13G and, due to either crossing the 20% threshold, or acquiring or holding securities with an intent to change or influence control of the issuer, must subsequently file a statement on Schedule 13D.

First, under Rule 13d-1(f)(2), a person crossing the 20% threshold may not vote or direct the voting of any securities of the issuer held by such person from the time of crossing the threshold until after 10 days from the date of filing with the Commission a statement on Schedule 13D.[812] During that same period, the person may not acquire any additional beneficial ownership in any equity securities of the issuer or person controlling the issuer.[813] Second, under Rule 13d-1(e)(2), a person filing a Schedule 13D for the first time, in order to disclose an intent to change or influence control of the issuer, may not vote or direct the voting of securities of the issuer held by such person "[f]rom the time the person has acquired or holds the securities with a purpose or effect of changing or influencing control of the issuer" until after the tenth day from the date of filing a statement with the Commission on Schedule 13D.[814] Such person also may not acquire additional securities of the issuer or a person controlling the issuer.[815]

The Commission amended Rule 13d-1 in 1998 to grant passive investors the ability to file a Schedule 13G.[816] At the same time, the Commission adopted the above-described "cooling-off periods," because it would "prevent further acquisitions or the voting of subject securities until the market and investors have been given time to react to the information in the Schedule 13D

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812 17 C.F.R. § 240.13d-1(f)(2)(i).
813 *Id.* § 240.13d-1(f)(2)(ii).
814 17 C.F.R. § 240.13d-1(e)(2)(i).
815 *Id.* § 240.13d-1(e)(2)(ii).
816 *See* Amendments to Beneficial Ownership Reporting Requirements, 63 Fed. Reg. 2854-01 (Jan. 16, 1998). Rule 13d had a pre-existing carve-out for certain institutional investors acquiring securities in the ordinary course of business.

filing."[817] This suggests that the Commission believed that providing investors with additional protection beyond mere disclosure was necessary.

Commission Rule 14d-3 implements section 14(d) of the Exchange Act.[818] The rule requires that an offeror file with the Commission, on the date of commencement of a tender offer, a statement on Schedule TO summarizing the terms of the tender offer and other information required by the Commission.[819] The offeror must also deliver a copy of the filing to the issuer and any other bidder for the same class of securities who has also filed a statement on Schedule TO and whose offer is pending.[820] The information required to be set forth in the offeror's Schedule TO includes information relating to the identity of the offeror and to the purpose of the offering; the offeror must also disclose any plans or proposals that would result in material transactions or events such as a merger or acquisition or any change to the composition of the board.[821]

This set of provisions enhances the ability of the market to evaluate the combination between the qualities of the filing shareholder and her intentions vis-à-vis the corporation, ultimately with two effects.

The first effect is informing current and potential investors of the proposed acquisition. This allows such investors to decide whether to sell or buy shares of the company in consideration of the modified shareholding base and potentially consequential changes in the firm's management.

The second effect is a more informed, and thus accurate, formation of the price of the shares traded on the financial markets.

Although crucial for the fair, informed, and efficient trading of the firm's shares, mere disclosure requirements ultimately leave current shareholders, as well as the market and the firm,

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817 *Id.* at 2856. Rule 13d-1 included a similar cooling-off period provision when it was initially finalized by the SEC in 1978, but the provision applied only to qualified institutional buyers. *See* Filing and Disclosure Requirements Relating to Beneficial Ownership, 43 Fed. Reg. 18484, 18496 (Apr. 28, 1978).

818 17 C.F.R § 240.14d-3.

819 *See id.* § 240.14d-3(a).

820 *See id.*

821 *See* 17 C.F.R. § 229.1006(c) (Regulation M-A, Item 1006).

in a completely passive position towards fool or knave shareholders. They are left only with the decision whether to liquidate their holdings or to refrain from investing in a corporation as a response to the acquisition of influence by a "bad" shareholder.

Furthermore, broad liquidation can potentially advantage a "bad" shareholder who can consequently expand his holdings at a discounted price because of the decrease in the price of the shares caused by the sale by the other shareholders fearful of the "bad" shareholder's exploitative inclinations.

Additionally, this may potentially harm the corporation by increasing the cost of equity capital (due to the depreciation of its shares) and damaging the corporation's reputation vis-à-vis the financial markets.

In other words, disclosure requirements do not actually disadvantage "bad" shareholders if a complementary set of active defenses are not available. To the contrary, they could provide him with benefits and allot further disadvantages (beside the "bad" governance influence of the disfavored shareholder) over the firm.

iii. Assessing Shareholders' Personal Qualities in Takeover Contexts

As explained above, in order to effectively protect investors, mechanisms effectively defend against "bad" shareholders must complement the regulatory framework.

In other words, only a shift from a passive assessment of the qualities of the filing shareholder to an assessment followed by active countermeasures can shield firms as well as other shareholders and stakeholders from exploitation and harmful influence by disfavored shareholders.

Active countermeasures mean that corporation or its shareholders must be provided with the power to screen disfavored shareholders. The allocation of such power among the members of the corporate entity, however, is problematic because of shareholders' rational apathy and potential conflicts of interests, on one hand, and even stronger conflicts of interests with respect to the board of directors, on the other hand.

Accordingly, this section discusses two current methods of assessment: state antitakeover statutes and judicial remedies.

After passage of the Williams Act, several states enacted anti-takeover statutes.[822] Currently, states have enacted a scattered assortment of antitakeover laws, which give shareholders the power to sterilize the votes of a shareholder that either shareholders or management disfavors.

In *Edgar v. MITE Corp.*, the Supreme Court held that the Williams Act preempted, thus rendering unconstitutional, an Illinois antitakeover statute which, *inter alia*, permitted the Illinois Secretary of State to pass on the merits of a proposed tender offer and prevent shareholders located in other states from tendering their shares to the offeror.[823] The *Edgar* case was the death knell for many so-called "first generation" state anti-takeover laws.[824]

In the years after *MITE*, many states (none of which was Delaware[825]) enacted "second-generation" antitakeover statutes that deterred acquisitions by granting shareholders (rather than a governmental authority) the power to approve or deny an acquisition and voting of shares over a certain threshold (often defined as "control shares") by potentially disfavored investors.[826]

The most prominent of these statutes is the Indiana Control Share Acquisition Statute, which was upheld by the Supreme Court in 1987 in *CTS Corp. v. Dynamics Corp. of America*.[827] The Indiana statute prevents a person from voting shares acquired in a "control share acquisition," as

822 States could enact these statutes because, in general, the federal securities laws do not completely preempt state regulation of securities. *See* 15 U.S.C. § 78bb(a). "The courts' analysis of whether the Williams Act preempts state antitakeover law has focused exclusively on whether the state law at issue is an obstacle to the achievement of the purpose of federal law, and in particular on the possibility that the state law is an obstacle to the accomplishment of Congress's objectives when enacting the Williams Act." Bebchuk & Jackson, *supra* note 795, at 8.

823 457 US. 624, 639–40 (1982).

824 *See* Bebchuk & Jackson, *supra* note 795, at 11.

825 The State in which the largest number of major corporations are chartered in the United States.

826 *See, e.g.*, IND. CODE ANN. § 23-1-42-1 et seq. (Indiana); MD CODE ANN., CORPS. & ASS'NS § 3-701 et seq. (Maryland); OKLA. STAT. ANN. tit. 18, § 1145 et seq. (Oklahoma).

827 481 U.S. 69, 80 (1987).

defined, unless and until a majority of non-interested shareholders approve the exercise of voting rights by such person by shareholder resolution at a special meeting called by management.[828] The statute applies only to corporations incorporated in Indiana and provides that corporations may opt-out of the statute via charter or by-law amendment.[829] If shareholders do not approve the exercise of voting rights, then the corporation *may*, at its option and only if authorized by the charter or by-laws, redeem the shares at a "fair value."[830]

The Supreme Court in *CTS Corp.* upheld the statute in part because it "d[id] not alter the balance between management and the offeror in any significant way" and "allow[ed] *shareholders* to evaluate the fairness of [a tender] offer collectively."[831]

iv. Securities Regulation Filing Violations and Shareholder Disenfranchisement

In addition to possible statutory remedies such as antitakeover laws, issuer corporations have an implied right of action for equitable relief under section 13(d).[832] In order to obtain an injunction, a corporation must demonstrate a violation of section 13(d)—for example, a false, misleading or inadequate filing or a filing after the statutory 10-day period—and that irreparable harm to the corporation or its shareholders would result in the absence of an injunction.[833]

828 *See* IND. CODE ANN. §§ 23-1-42-5 & -9.

829 *See id.* §§ 23-1-42-4 & -5.

830 *Id.* § 23-1-42-10.

831 *CTS Corp.*, 481 U.S. at 82 n.7 and 84. The Court further concluded that the Indiana statute "grant[ed] shareholders the power to deliberate collectively about the merits of tender offers. This result is fully in accord with the purposes of the Williams Act." *Id.* at 82 n.7.

832 *See* Indiana Nat'l Corp. v. Rich, 712 F.2d 1180, 1184 (7th Cir. 1983); GAF Corp. v. Milstein, 453 F.2d 709, 719–20 (2d Cir. 1971); *see also* Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 59 n.9 (1975) (assuming "the availability of injunctive relief to remedy a section 13(d) violation following compliance with the reporting requirements," but not reaching the issue of whether "a corporation could obtain a decree enjoining a shareholder who is currently in violation of section 13(d) from . . . exercising voting rights[] . . . pending compliance with the reporting requirements").

833 *See Rondeau*, 422 U.S. at 65; *see also* Medical Imaging Ctrs. of Am., Inc. v. Lichtenstein, No. 96-0039-B(AJB), 1996 U.S. Dist. LEXIS 22362, *6–9 (S.D. Cal. Feb. 29, 1996) (stating that an issuer must demonstrate a likelihood of success on the merits and irreparable harm, and finding probable success on the merits with respect to plaintiff-issuer's claim that the defendants violated section 13(d) by failing to adequately disclose the identities of all persons associate with the defendants with a direct or indirect ownership interest in the plaintiff-issuer's stock).

Accordingly, corporations have sought to enjoin disfavored investors from voting any shares obtained during a period when either a Schedule 13D was not, but should have been, filed, or when there was a false or misleading Schedule 13D on file with the Commission that was not properly amended or corrected.[834] In some cases, a plaintiff-corporation has gone so far as to request that the court force a disfavored investor to divest itself of all stock holdings in the plaintiff-corporation.[835]

Although generally disfavored,[836] disenfranchisement (or sterilization of shares) may nonetheless be available if a corporation can show that irreparable harm would result from the disfavored investor voting its shares (and there is case law which suggests that management can potentially obtain the disenfranchisement of a shareholder if it can convince a court that the shareholder has committed some error in a section 13(d) filing and that the corporation is threatened by some irreparable–typically, a change in control-related–harm).[837]

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[834] *See, e.g.*, *Rondeau*, 422 U.S. at 55; General Aircraft Corp. v. Lampert, 556 F.2d 90, 93 (1st Cir. 1977); *Medical Imaging Ctrs. of Am.*, 1996 U.S. Dist. LEXIS 22362, at *14; Graphic Sciences, Inc. v. Int'l Mogul Mines, Ltd., 397 F. Supp. 112, 115–16 (D. D.C. 1974).

[835] *See* Liberty Nat'l Ins. Holding Co. v. Charter Co., 734 F.2d 545, 547 (11th Cir. 1984); *Indiana Nat'l Corp.*, 712 F.2d at 1181.

[836] *See Liberty Nat'l Ins. Holding Co.*, 734 F.2d at 565–66 ("[W]e conclude from the statutory language, the contextual setting, the Supreme Court's interpretation of subsidiary questions, and the relationship between the alleged wrong and the relief requested in this case that there was no clear legislative intent to imply an issuer right of action to obtain the ouster of a shareholder who has made a false schedule 13D filing.").

[837] *See, e.g.*, *Medical Imaging Ctrs. of Am.*, 1996 U.S. Dist. LEXIS 22362, at 14–16. The *Medical Imaging* court granted the plaintiff-issuer's motion to enjoin disfavored shareholders from voting their shares (allegedly obtained during an ongoing schedule 13(d) violation) at an upcoming shareholders meeting. Although the plaintiff sought total disenfranchisement, the court was willing to order only "proportional voting" of the defendants' shares, on the grounds that it was "reluctant to order total disenfranchisement" and "wishe[d] to award the most minimal equitable relief that is consistent with the culpable conduct and the irreparable injury to be prevented." Accordingly, the court permitted the defendants to vote their shares according to a formula that included votes that the defendant did not hold, "divided by the total number of corporate shares of the same class outstanding to determine the 'proportion multiplier,'" which would then apply "to the Tainted Shares [the shares held by or on behalf of the defendants], which will be voted under defendants' control in that proportion.". Some courts, however, have refused to disenfranchise a shareholder on the grounds that "the Williams Act was not intended to be used by management to draw the federal courts into factional intracorporate disputes" and because "[i]nvestors are entitled to the legitimate fruits of their investment." General Aircraft Corp. v. Lampert, 556 F.2d 90, 95, 97 (1st Cir. 1977); *see also* Graphic Sciences, Inc. v. Int'l Mogul Mines, Ltd., 397 F. Supp. 112, (D. D.C. 1974) (granting motion to enjoin defendants from acquiring additional shares of the plaintiff-corporation and from seeking or soliciting proxies or making any tender offer, but permitting defendants to vote their shares and thus "enjoy the legitimate fruits of their investment").

Furthermore, although the intended beneficiaries of the Williams Act are shareholders, not management, corporations are able to bring claims under section 13(d) to the extent that they do so on behalf of shareholders, who "have neither the knowledge nor the capacity to ensure that section 13(d) is enforced."[838]

But while it appears well settled that a corporation may, in theory, obtain *some* form of equitable relief against an investor who has either outright, or perhaps only arguably, violated section 13(d), the appropriateness of remedies such as divestiture and disenfranchisement is less settled.

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[838] *Indiana Nat'l Corp.*, 712 F.2d at 1185.

B. Why an Independent Third Party Authorization on Influential Stock Voting?

i. Allocation of the Intuitus Personae *to an Independent Third Party*

The limits of the current approach toward regulating influential shareholders are twofold.

First, they introduce a great deal of uncertainty into the securities markets, because interested parties could react multiple ways depending on the circumstances. The members of the firms can be proactive when they fear to lose their jobs, but apathetic if they do not feel threatened. Similarly, current shareholders' reactions are biased by collective actions issues and idiosyncratic interest. Moreover, the judicial assessment takes place *ex post*: too late both for filing shareholders (which investing decision would become more burdensome) and for the suing corporation.

Second, although equity holders that are attempting to select fellow coventurers face collective organization issues in public corporations, directors doing so would suffer from an inherent conflict of interest.[839]

In fact, the members of the boards of directors could be biased in assessing influential shareholders because of a fear of losing their position as directors.[840] Moreover, when management implements defensive measures (e.g., poison pills) or attempts to enjoin the investor from voting, the corporation suffers high costs.[841]

ii. Heightening Investors Protection

From an operative point of view, such protective activities against investors which management views as a threat take managements' attention away from focusing on industrial business and by making incumbent management more difficult to uproot.[842] In addition, they could

[839] Three questions should be considered. First: do shareholders of public corporation relinquish their intuitu personae selective power? Is it part of the set of relinquished power with which the board of directors is entrusted? Is it appropriate to grant the board of directors with such an instrinsically conflicted power?

[840] *See* Lucian A. Bebchuk, *Don't Make Poison Pills More Deadly*, DEALBOOK (Feb. 7, 2013), http://dealbook.nytimes.com/2013/02/07/dont-make-poison-pills-more-deadly/.

[841] *Id.*

[842] *Id.*

discretionally impose costs on shareholders by potentially denying shareholders the opportunity to sell their shares to the disfavored investor at a price favorable to the selling shareholders.[843]

Mandatory third party authorization of influential voting could remedy these problems. Specifically, shifting decisionmaking authority from several disparate actors, each with their own interests and defective prerogatives, to a third party arbiter – potentially the Commission –, the proposed scheme would resolve the uncertainty and cure the likely conflict of interest created by empowering the board of directors to seek disenfranchisement of shareholders.[844]

From a different standpoint, Congress has decided that securities transactions that take place on the national exchanges are "effected with a national public interest," necessitating regulation and control.[845] Indeed, the purpose of the Exchange Act (and the Securities Act of 1933) is to protect interstate commerce and the interests of investors.

Congress has also charged the Commission with considering "whether [rulemaking or reviewing rules of self-regulatory organizations] will promote efficiency, competition, and capital formation."[846] This would likely justify a scheme under section 13(d) involving the authorization of share voting.

The proposed authorization scheme could forestall the inefficient use of corporate resources which management-protective activities might entail by providing management adequate assurance that an investor who truly poses a threat to the corporation will be hindered, at the threshold and by a third party, in any take-over attempt or attempt to influence the governance of the corporation.

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843 *See* Bebchuk, *supra* note 840.

844 *See General Aircraft Corp.*, 556 F.2d at 95 ("[T]he Williams Act was not intended to be used by management to draw the federal courts into factional intracorporate disputes, so long as the interests of all investors are adequately protected.").

845 Section 2 of the Exchange Act, codified at 15 U.S.C. § 78b.

846 15 U.S.C. § 78c(f).

This might also relieve management from the burden of having to defend against claims by shareholders that any defensive measures that might have otherwise been implemented by management were too draconian in light of the perceived threat.[847]

Although the proposed scheme could seem, *prima facie*, hardly compatible with the Commission's duty to promote efficiency, competition and capital formation (somebody could rise the fact that implementation of such a scheme may result in less-active securities market—for example, by providing the benefits to management described above),[848] a careful consideration of section 2 of the Exchange Act – which lays out the purpose for regulation of the national securities markets – evidences a concern of Congress about the effect the securities markets have on the economy more generally[849], thus justifying the intervention.

Furthermore, without a system for assessing shareholders personal qualities, fool or knave shareholders can harm or exploit firms without a check on their relational attitude vis-a-vis the corporation. Nor can repeated games give rise to disincentives, since even through the long repetition of exploitative dynamics, the professional shareholder might reach the counterintuitive beneficial effect increasing "personal" returns and potentially expanding their shareholding for a cheap price.

Shareholders do not suffer reputational damages by exploiting corporations in which they have invested because the investment decision is unilateral, i.e., a shareholder selects a corporation, not vice versa.[850] An aggressive approach vis-à-vis the corporation could lead to a positive

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[847] *See* Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[848] *Cf.* Nagel, Vollmer & Wolfson, *supra* note 801, at 20–22 (arguing that strengthening 13(d) disclosure requirements would deter "engaged shareholders" from participating in the capital markets and "decrease overall shareholder value"); Macey & Netter, *supra* note 867, at 144–45 (arguing that mandated disclosure under section 13(d) "deters socially beneficial investments in research and beneficial takeovers").

[849] *See* 15 U.S.C. § 78(b)(1), (3) & (4); Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 736 (2013) ("The stock market bubble of the 1920s, the crash in 1929, and the Great Depression revealed a strong relationship between the health of the capital markets and the national economy. It was this relationship that led Congress, in the early 1930s, to adopt the federal securities laws.").

[850] *See supra* Part 1.C.

reputation vis-à-vis its current and potential investors if the returns so achieved are larger than those of competitors.[851]

Therefore, shareholders never suffer a reputational disadvantage by extracting private benefits that harm the corporations in which they invest.

Second, professional shareholder might experience a reputational advantage by exploiting a corporation: one vis-a-vis final investors and another vis-a-vis the corporation. Through the long repetition of these dynamics, a professional shareholder might benefit by expanding its interest in a corporation for a cheap price. Indeed, if a bad shareholder acquires stock in a corporation, fear of extracting private benefits may decrease the corporation's value provoking other shareholders to liquidate in in advance of the market perceiving such decreased value and creating a significant drop in the price of shares, thus providing "bad" professional shareholders with discounted shares.[852]

On this ground, independent third party authorization for influential voting, by preventing or making more costly such detrimental activities, would further Congress's purposes of preserving healthy growth of the economy and the stability of firms and interstate commerce as well as the investors' protection[853].

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851 The intermediate position of professional shareholders might hide the means for reaching larger from final investors. Indeed, final investors might only have partial information about the ethics of the professional shareholders, unless the professional shareholder accurately documents and explains their methods to investors.

852 *See generally* Macey & Netter, *supra* note 802.

853 *See id.*, at 143. Macey and Netter argue that disclosure under section 13(d) could make it easier for a corporate raider to gain control of a company and loot it by converting assets to his own personal use, because shareholders privy to the disclosure and aware of the character or intent of the disclosing person may be "strongly inclined to sell out at the firm's current market price in order to avoid the danger of other shareholders selling out and being left with a minority position in a firm controlled by looters." *Id.* This would make it less costly for the raider to obtain control of the company. *Id.* Arguably, the proposed authorization scheme would solve this dilemma and convince shareholders to maintain their holdings because the raider would be ill-equipped, in the absence of voting power, to carry out its intention to loot the company.

iii. The Trend of Disadvantaging Bad Actors

The Commission's recent amendment to Rule 506 of Regulation D ("Reg D") illustrates an approach to "bad actors" that is in harmony, to some extent, with the proposed authorization scheme.[854]

In section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress required the Commission to amend its rules to disqualify certain issuers from eligibility for the Rule 506 exemption.[855] Rule 506 provides issuers an exemption from registration for certain offerings of securities.

In general, offerings of securities in the United States must be either registered or exempt.

Section 4(2) of the Securities Act of 1933 provides an exemption from registration for "transactions by an issuer not involving any public offering."[856] The Commission promulgated Reg D in order to implement the section 4(2) exemption. Rule 506 of Reg D permits an issuer to raise an unlimited amount of money from the issuance of securities, provided that it satisfies one of two sets of conditions.

Under the first set of conditions, an issuer may raise an unlimited amount of capital but must limit its sale of securities to no more than 35 non-accredited investors.[857] In addition, the purchasers who are not accredited investors must be "sophisticated" investors.[858] Finally, the issuer may not advertise the offering or make a general solicitation for the purchase of securities.[859]

Under the second set of conditions, the issuer may raise an unlimited amount of capital and may publicly advertise the offering and make a broad solicitation.[860] However, the issuer must take

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[854] *See* Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings, 78 Fed. Reg. 44729 (July 24, 2013).

[855] A Commission rule disqualifies felons and other persons from eligibility for the Regulation A exemption for offerings not exceeding $5 million during any 12-month period. *See* 17 C.F.R. § 230.262.

~~15 U.S.C. § 77d(a)(2).~~

[857] 17 C.F.R. § 230.506(b)(2)(i).

[858] *Id.* § 230.506(b)(2)(ii). Sophistication requires "knowledge and experience in financial and business matters" such that the person can adequately assess the merits and risks associated with an investment. *Id.*

[859] *See id.* § 230.506(b)(1).

[860] *See id.* § 230.506(c)(1).

reasonable steps to ensure that all purchasers are accredited investors, and all purchasers must in fact be accredited investors.[861] Sale to non-accredited investors is not permitted, even if they are "sophisticated."

In other words, it provides a benefit to issuers in the form of relief from the rather onerous registration requirements that typically accompany a public offering of securities.

iv. Amendment of Rule 506

The Commission finalized its amendment to Rule 506 in 2013, adding new paragraphs (d) and (e) to the preexisting rule. These provisions have two primary effects.

First, paragraph (d) disqualifies issuers from the Rule 506 exemption if the issuer or certain affiliates have committed any "bad acts" after September 23, 2013 and within certain specified periods prior to the offering.[862]

Second, paragraph (e) requires that issuers who have not been disqualified under paragraph (d) nonetheless disclose to purchasers of securities in a Rule 506 offering certain "bad acts" which occurred *prior* to September 23, 2013 but within certain specified periods prior to the offering.[863] Both paragraphs impose on the issuer a duty to use reasonable care in investigating prior "bad acts."

The Commission's amendment to Rule 506 revokes the rule's benefit (i.e., requiring issuers to register) if the issuer or persons affiliated with the issuer, including controlling shareholders, engage in certain criminal or civil acts in violation of the securities and other laws or in connection with the conduct of business as an underwriter, broker, dealer, investment advisor, et cetera. As such, the rule puts "bad actors" at a disadvantage to other issuers who are free to take advantage of the Rule 506 exemption.

[861] *Id.* § 230.506(c)(2).
[862] 17 C.F.R. § 230.506(d).
[863] *Id.* § 230.506(e).

A covered "bad actor" may be the issuer, any director, executive officer or other officer participating in the offering, any general partner or managing member, any shareholder who holds 20% or more of the issuer's outstanding "voting equity" securities, any promoter connected with the issuer at the time of the offering, any investment manager if the issuer is a pooled investment fund, and certain other persons.[864] Such persons are qualified as "bad actors" if they have, *inter alia*, been recently (i) convicted of a felony or misdemeanor in connection with the purchase or sale of a security, after making a false filing with the Commission or arising from the conduct of business as an underwriter, broker, dealer, investment advisor, et cetera; (ii) subject to any order, judgment or decree of a court of competent jurisdiction that restrained or enjoined such person from engaging in securities purchase or sale transactions or in the business of underwriting, brokerage, dealing or advising; or (iii) subject to certain enforcement or disciplinary actions by the Commission.[865]

Thus, the "bad actor" provisions of Rule 506 illustrate a regulatory approach based on disadvantaging financial markets players on the basis of prior offensive behavior.

In particular, it discourage "bad acts" by foreclosing benefit and causing a competitive disadvantage vis-à-vis other issuers, who can more easily access the capital markets through the Rule 506 exemption. In turn, it incentivizes management to disaffiliate from players (officers, directors, influential stockholders and other insiders) who have committed "bad acts" under the securities laws or in connection with the purchase or sale of securities.

In short, the "bad actor" provisions of Rule 506 strive to protect investors by providing specific disadvantages based on the assessment the qualities of financial market players.

[864] *Id.* § 230.506(d)(1).
[865] *Id.* § 230.506(d)(1)(i)-(viii).

C. Feasibility

i. Proposed Criteria for Authorization

In general, a restriction on voting could be "local" or "universal."

A universal restriction would prohibit a disfavored investor from voting the securities of *any issuer* that represent the beneficial ownership of more than (say) 5% of a class of voting securities.

Alternatively, a local restriction would prohibit a disfavored investor from voting only those securities that are the subject of a section 13(d) filing. A local restriction is likely less objectionable than a universal restriction. A universal restriction resembles a ban on an activity—specifically, acquiring large holdings in public companies—and therefore appears punitive and would require substantial justification.

Conversely, a local restriction is justifiable as an appropriate regulatory action to protect a firm and its shareholders against irreparable injury that might result from allowing a "bad" shareholder to acquire and vote a large block of securities. This is essentially what the courts are already empowered to do through injunctive relief.

The voting restriction should also be temporally limited—how long should a shareholder be prohibited from voting its shares? Although persons affected by an adverse decision under the proposed authorization scheme might immediately dispose of their shares, others might retain their ownership position if the restriction were only temporary and if they viewed the long-term benefits of retaining ownership to be greater than the short-term costs of owning shares with no voting rights. Similar to the universal/local distinction, a permanent restriction on voting would likely be difficult to support, at least in part because the Commission would have to justify its basis for imposing the restriction continually.

One fairly reasonable solution to this problem would be impose on all persons who initially file a Schedule 13D the same 10-day cooling-off period that currently applies to persons who must switch from filing a Schedule 13G to a Schedule 13D. Congress could then authorize the Commission to lengthen that period (*e.g.*, by 10 or 30-day increments) if it finds that doing so is in the best interests of a firm and its shareholders (on the basis of necessity for further information). A shareholder could then seek reconsideration of an order to extend the cooling-off period and ultimately judicial review upon denial of reconsideration.

Furthermore, the Commission could apply a "bad actor" disqualification to persons disclosing under section 13(d) that would track the "bad actor" disqualification found in Rule 506 of Regulation D. Under such criteria, any person who has recently violated the securities laws, banking laws or other laws which cover or relate to the financial sector or who has been disqualified from registration or membership in any exchange or commodities trading association would be prohibited from voting any securities of an issuer that represent the beneficial ownership of more than 5% (or higher thresholds) of a class of the issuer's securities.

The rationale would be that any such person has exhibited a tendency to engage in activities that undermine the integrity and stability of the markets.

As mentioned above, however, such a framework would fail to catch knave or fool shareholders, which, though not strictly qualifiable as "bad actors" under 17 C.F.R. 230.506(d), still threaten other shareholders, the firm, and its stakeholders.

This problem requires a higher bar: the mere fact of escaping the definition of "bad actor" set forth under 17 C.F.R. 230.506(d) with respect of criminal law does not make shareholders ethical, nor sufficiently skilled to presume that their influence over the firm activity will not result in disruptive effects on the productive activity. Therefore, besides such statutorily defined "bad actors", shareholders not complying with given ethical standards also should not have authorization to vote.

Given that the application of "governance duties" to shareholders outside the realm of closely held corporations is undeveloped (and would provide only an ex post remedy),[866] assessing the personal qualities of influential shareholders seems to represent both a necessary remedy and the proper policy to fix the defects in corporate governance created by the lack of selection of coventurers with equity ownership rights.

The Commission would therefore have to look to supplemental sources or principles in order to derive a set of ethical criteria that it might use to determine whether to prevent a shareholder from voting common stock, other than those that frame the definition of "bad actors."

The rules governing other players in the financial markets, such as securities brokers, could provide a basis for such standards.

For example, in implementing the proposed authorization scheme, the Commission could potentially utilize criteria modeled after the FINRA rules. Specifically, Section 2010 of the FINRA Manual mandates that each "member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[867]

Although individuals that the Commission has sanctioned for unethical conduct have challenged this rule on vagueness grounds, courts have upheld it.[868] One court, for example, found that the rule and SEC opinions interpreting the rule gave sufficient notice to the defendant that "commercial honor" was required in his dealings with customers and with his employer.[869]

The FINRA rule sweeps broadly beyond the relationship between a broker and his customer and imposes a more general ethical requirement that securities brokers behave honestly and observe general principles of fair dealing.

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[866] *See* Anabtawi & Stout, *supra* note 603, at 1293.

[867] FINRA Manual § 2010, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.

[868] *See, e.g.*, Ialeggio v. SEC, 185 F.3d 867, 867 (9th Cir. 1999) (unpublished opinion); Vail v. SEC, 101 F.3d 37, 39 (5th Cir. 1996); Sorrell v. SEC, 679 F.2d 1323, 1326 (9th Cir. 1982); *see also* In re Benjamin Werner d/b/a Benjamin Werner & Co., 44 S.E.C. 622 (1971).

[869] *Ialeggio*, 185 F.3d at 867.

Thus, under the proposed authorization scheme, shareholders that violate "ethical shareholding standards" would be prohibited from voting their shares exceeding the threshold.

In addition, a shareholder that has repeatedly exploited or harmed corporations in which it has invested should not be authorized to vote. This second evaluation should consider prior cases in which a shareholder has used its influence to extract private benefits, thus destroying corporate value.

In simple words, the authorization should be denied each time a shareholder showed lack of integrity in exercising its influential role in prior corporate governance experiences.[870]

From a different standpoint, given the difficulty in judging the causality between shareholder influence and the destruction of corporate value, the authorization scheme, in order to be effective and enforceable, should provide certain presumptions.

Thus, acknowledging that a system based on presumptions intrinsically discounts a degree of fallibility in effectively casting the causality, it seems proper to foreclose the authorization to vote the shares exceeding the relevant thresholds only when the harmful or exploitative behavior in financial transaction is repetitive: in other words, when the exploitative or harmful behavior vis-à-vis corporations has occurred more than once.

Lastly, the proposed authorization scheme should only consider ethical violations or exploitative or harmful behavior within a limited timeframe.

Such a timeframe should be long enough to catch a significant piece of recent business activity history, but also contained in order to provide financial player with a certain degree of forgiveness.

[870] The exact formulation of the criteria should be subject of a specific and detailed investigation and should take into consideration the positions of all the players in the financial markets.

D. Potential Objections and Counterarguments

i. The Internal Affairs Doctrine

According to the internal affairs doctrine, in disputes over the conduct of a corporation's internal affairs or that implicate the internal relationship between the corporation, management, and shareholders, courts should apply the law of the state of incorporation.[871]

The rationale for the doctrine is that applying the laws of the state of incorporation "facilitates planning and enhances predictability," because managers can more easily predict the scope of their rights and obligations.[872] The Delaware Supreme Court has concluded that the doctrine "[has] important federal constitutional underpinnings," namely the Due Process Clause, the Commerce Clause and the Privilege and Immunities Clause of the United States Constitution.[873]

The doctrine is related to and depends upon the principle that corporations are governed by state law, not only with respect to the actual act of incorporation but also with respect to matters of corporate governance that may arise years afterwards.[874] This presents a potential obstacle to the proposed authorization scheme because, under the doctrine, the prerogative to determine the substance of shareholder voting rights belongs, in the first instance, to the state.[875] Therefore, any

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871 The Harvard Law Review Association, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy*, 115 HARVARD L. REV. 1480, 1480 (2002); Restatement Second, Conflict of Laws § 304 (1971).

872 P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE. L.J. 1, 98 (1985); *see also* VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1112–13 (Del. 2005) ("By providing certainty and predictability, the internal affairs doctrine protects the justified expectations of the parties with interests in the corporation.").

873 McDermott Inc. v. Lewis, 531 A.2d 206, 209, 216 (Del. 1987).

874 *See* CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 90 (1987) ("[The] free market system depends at its core upon the fact that a corporation—except in the rarest of circumstances—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporation law of the State of incorporation."); Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 479 (1977) ("Corporations are creatures of state law, and . . . state law will govern the internal affairs of the corporation.") (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)); Restatement Second, Conflict of Laws § 304 (1971) ("The local law of the state of incorporation will be applied to determine the right of a shareholder to participate in the administration of the affairs of the corporation . . . .").

875 *See CTS Corp.*, 481 U.S. at 89 ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, *including the authority to define the voting rights of shareholders*.") (emphasis added); Business Roundtable v. SEC, 905 F.2d 406, 413 (D.C. Cir. 1990) (stating that the SEC's assertion of authority to implement Rule 19c-4 [governing the issuance of weighted shares] "directly invades the 'firmly established' state jurisdiction over corporate governance and shareholder voting rights") (quoting *CTS Corp.*, 481 U.S. at 89); *see also* Restatement Second, Conflict of Laws § 304, comment *a* (1971) ("The law selected by application of [the internal affairs doctrine] will be applied to determine a shareholder's right to vote and receive dividends. Thus, this law will be

attempt by the Commission to intervene in corporate governance by preventing disfavored shareholders from voting their common stock—when, under state law, such shares enjoy full voting power—may run afoul of the doctrine. In fact, in a significant and often-cited opinion, the D.C. Circuit rebuffed a controversial attempt by the Commission to dictate the relative voting power of common stock, largely because voting rights are a matter of state law.[876]

Courts view the notion of a federal corporate law with suspicion. In *Santa Fe Industries, Inc. v. Green*, for example, the United States Supreme Court stated its reluctance, in the absence of "a clear indication of congressional intent," "to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established policies of corporate regulation would be overridden."[877]

More recently, a former chief justice of the Delaware Supreme Court, speaking about federal "incursions into the internal corporate affairs traditionally governed by state corporate law," highlighted the consensus among the courts that "federal courts and agencies, as well as the SEC, are not at liberty to fashion a kind of federal common law of corporations," although he conceded that "Congress has the power to intrude into state internal corporate affairs" if it so chooses.[878]

Nonetheless, federal intrusion into the internal affairs of corporates is increasingly commonplace, even with respect to shareholder voting. One prominent example is the Sarbanes-Oxley Act of 2002, which was enacted following the Enron accounting scandal.[879]

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applied to determine whether the holder of preferred shares, or other classes of shares, *may vote* and the manner in which he may vote, such as by cumulative voting or by proxy . . . .") (emphasis added).

[876] *See Business Roundtable*, 905 F.2d at 407 (concluding that Commission Rule 19c-4, which prevented the national exchanges from listing stock of a corporation which took any action "with the effect of nullifying, restricting or disparately reducing the per share voting rights" of shareholders, was invalid and outside the authority of the Commission because it "directly control[led] the substantive allocation of powers among classes of shareholders," a prerogative reserved to the states); *see also* Fisch, *supra* note 849, at 758 (citing to the *Business Roundtable* case for the proposition that "federal law does not purport to address shareholders' substantive voting rights").

[877] 430 U.S. 462, 479 (1977).

[878] E. Norman Veasey, *What Would Madison Think? The Irony of the Twists and Turns of Federalism*, 34 DEL. J. CORP. L. 35, 35, 42, 54 (2009); *see also* Fisch, *supra* note 849, at 733 ("Today it is clear that Congress can federalize corporate law entirely. . . . [However,] Congress has, for the most part, steered clear of efforts to regulate corporate governance.").

[879] Pub. L. 107-204, 116 Stat. 745 (July 30, 2002). Sarbanes-Oxley is focused primarily on "accounting regulation and the auditing process." Fisch, *supra* note 849, at 733.

Another, more relevant example is the Commission's "Say-on-Pay" rule.[880]

In Section 951 of Dodd-Frank, Congress amended the Exchange Act by adding a requirement that issuers include in their proxy statements "[n]ot less frequently than once every 3 years" a resolution subject to shareholder vote "to approve the compensation of executives."[881] In addition, at least once every 6 years, the issuer must include in its proxy statement a resolution subject to shareholder vote "to determine whether votes on the resolutions [for approval of executive compensation] will occur every 1, 2, or 3 years."[882]

The "Say-on-Pay" rule is a significant precedent of federal intrusion into internal affairs.[883] According to Jill Fisch, while, prior to Dodd-Frank, "federal law ha[d] not attempted to reallocate substantive governance rights," the "Say-on-Pay" rule represents an unprecedented attempt by Congress to "increase shareholder power relative to management."[884] "Say-on-Pay" not only requires that management make certain disclosures to shareholders regarding executive compensation—which, under state law, the board of directors often has exclusive authority to determine[885]—it also mandates a shareholder vote either approving or dissenting from management's exercise of its business judgment at least once every three years. Moreover, although the vote is non-binding on management, the "Say-on-Pay" rule requires that management disclose the results of the vote and explain how it has incorporated the shareholders' approval or disapproval into its decisions with respect to executive compensation.[886] This power shift between management and shareholders is typically affected under state, not federal, law.

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880 17 C.F.R. § 240.14a-21.

881 *See* 15 U.S.C. § 78n-1(a)(1).

882 *See id.* § 78n-1(a)(2).

883 *See* Fisch, *supra* note 849, at 734 (noting that, with the Dodd-Frank amendments to the Exchange Act, "Congress intruded [for the first time] into the allocation of decision-making authority within the corporate entity").

884 *Id.* at 739.

885 *See id.* at 746 (noting, that "Delaware case law offers shareholders no practical mechanism for challenging such board determinations, affording compensation decisions the full protection of the business judgment rule").

886 *See* 17 C.F.R. § 229.402(b)(1)(vii); Fisch, *supra* note 849, at 752–53.

ii. Conflict with State Law Shareholder Remedy

As discussed above, the corporate laws of some states (not those of Delaware) empower shareholders to prevent disfavored investors from voting control blocks of shares, thereby changing or influencing the control of corporations subject to those laws. In theory, these state laws give shareholders ample protection against investors whose interest collide with those of the co-owners of the corporation.

In addition, they stand for the proposition that shareholders, not management or the government, should decide the nature and identity of their associates.[887]

Therefore, one potential counterargument to the proposed authorization scheme is that it improperly removes decision-making power from the hands of shareholders and gives it to a governmental authority, thereby conflicting with both the purpose of the federal securities laws and current state-law mechanisms for shareholder authorization.[888]

Admittedly, a federal authorization scheme would likely preempt state antitakeover laws outright to the extent that they imposed conflicting demands on an investor—"You may vote" *and* "you may not vote," for example.[889] Shareholders could also utilize the scheme, however, to provide a protective backstop to state law if shareholders either are not fully capable of anticipating the risks posed by a disfavored investor, or if there is a strong federal interest in blocking the franchise of an investor who might otherwise receive approval from shareholders. Shareholders and the Commission do not necessarily share the same interests and priorities; as such, a federal scheme might beneficially supplement a state-law scheme.

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[887] The purpose of the Williams Act and the Exchange Act more generally is also to preserve the integrity of the shareholder franchise and empower shareholders to make their own, informed decisions about management and control of the firm. *See infra* notes 93, 109 and 110 and accompanying text.

[888] *Cf.* Edgar v. MITE Corp., 457 U.S. 624, 639 (1982) (striking down an Illinois antitakeover statute permitting the Illinois Secretary of State to pass on the fairness of a proposed tender offer and to block the offer if it "[was] inequitable or would work or tend to work a fraud or deceit upon the offerees"; the Court concluded that, in passing the Williams Act, Congress "intended for investors to be free to make their own decisions").

[889] *See MITE Corp.*, 457 U.S. at 631.

iii. Due Process and Judicial Review of Agency Determinations

According to the Fifth Amendment of the United States Constitution, "[n]o person shall be. . . deprived of life, liberty, or property, without due process of law."[890] Consequently, the federal government (including the Commission) cannot deprive a person of property or rights in property without due process, which generally entails notice and an opportunity to be heard.

According to the interpretation that the right to vote common stock is a right in property,[891] a potential regulatory scheme that deprives a person who has purchased common stock the right to vote such stock in the same manner as persons who, for example, have not crossed the 5% threshold requiring 13(d) disclosure, would likely raise due process concerns (and possibly Equal Protection concerns, which this work does not address).

Assuming such a restriction would implicate the Due Process Clause, may the Commission make a determination to disenfranchise a shareholder prior to notifying the shareholder of its intent to make such a determination?

If the government deprives a person of a property interest in which the person has a legitimate expectation, the baseline rule is that the government must give the affected person at least some opportunity to object to the deprivation of property before the government's deprivation.[892] The Supreme Court laid out the test for determining what sort of process is required in *Mathews v. Eldridge*.[893] Under this test, a court analyzes three factors:

> First, the private interest that will be affected . . . ; second, the risk of erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and finally, the Government's

[890] U.S. CONST. AMEND V.

[891] *See* J. I. Case Co. v. Borak, 377 U.S. 426, 431 (1964) (noting that when Congress passed the Exchange Act, it did so with the belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange") (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934)). The position that equity ownership entails only the rights granted with the securities, however, presents a challenge to the qualification of the right to vote in common stock as a property right. Thus, in general, such property right could be reconsidered and, moreover, securities could carry conditional voting, subject to the proposed authorization.

[892] *See* Goldberg v. Kelly, 397 U.S. 254 (1970) (deprivation of welfare benefits requires notice and an opportunity to be heard prior to deprivation).

[893] 424 U.S. 319 (1976).

interest in using its chosen procedure [and the burdens that would be imposed by further or alternative procedural safeguards]. [894]

Applying this test, the Court has typically found that "the Constitution requires some kind of hearing *before* the State deprives a person of liberty or property."[895] There are, however, exceptions; for example, if expediency is important or providing for predeprivation process is impractical.[896]

What about a deprivation of voting rights?

Absent any Commission practice or procedure available for examination, a *Mathews v. Eldridge* analysis is circumscribed. On the other hand, *some* predeprivation process is due to a person making a 13(d) disclosure, and that would largely be sufficient for mapping out the rough contours of the Commission's powers under the proposed authorization scheme. In other words, start with the assumption that the Commission would have to provide notice of its intention to deprive a person of share voting rights and some opportunity for the person to object prior to its rights being revoked.[897] The next step would be to consider remedies in the event that such person's objection is overruled.

Administrative law does not always demand uniform process for all agency determinations. In general, if a statute says that an adjudication must be made "on the record after notice and opportunity for hearing," then the agency implementing that statute must provide sufficient procedural protections in accordance with the Administrative Procedure Act.[898] Nevertheless, if

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[894] *Id.* at 335.

[895] Zinermon v. Burch, 494 U.S. 113, 127 (1990).

[896] *See, e.g.*, Gilbert v. Homar, 520 U.S. 924, 930 (1997) ("This Court has recognized, on many occasions, that where a State must act quickly, or where it would be impractical to provide predeprivation process, postdeprivation process satisfies the requirements of the Due Process Clause."); FDIC v. Mallen, 486 U.S. 230, 240 (1988) ("An important government interest, accompanied by a substantial assurance that the deprivation is not baseless or unwarranted, may in limited cases demanding prompt action justify postponing the opportunity to be heard until after the initial deprivation.").

[897] *Cf.* Am. Sumatra Tobacco Corp. v. SEC, 93 F.2d 236, 239 (D.C. Cir. 1937) ("In [a case where a person alleges irreparable injury as a result of the Commission's actions] it is fundamental that the property rights of the citizen may not be put in jeopardy or destroyed in any proceeding before an administrative board without notice, hearing, and judicial review.").

[898] The Administrative Procedure Act is codified at 5 U.S.C. §§ 551–559. "Adjudication" is defined in the Administrative Procedure Act as "agency process for the formulation of an order." An "order" is "the whole or a part

the statute is silent, then the agency may craft its own rules of practice, sometimes in light of a congressionally established baseline.[899] Under the securities laws, for every adjudication not required to be on the record with notice and an opportunity to be heard, the Commission must prescribe rules which, at a minimum, "provide that prompt notice shall be given of any adverse action or final disposition and that such notice and the entry of any order shall be accompanied by a statement of written reasons."[900] Therefore, the securities laws potentially contemplate Commission determinations without notice and opportunity for a pre-determination hearing.

From a different standpoint: what sorts of remedies, if any, would be available to a person disenfranchised by the Commission, either with notice and opportunity to be heard or without?

The Commission's determination under the proposed authorization scheme would likely be an "order" of the Commission.[901]

Further, a Commission order that disenfranchised a shareholder would involve denying that person a right to which it is otherwise entitled under state law; as such, the order would likely be reviewable by a federal appellate court pursuant to section 78y. Prior to filing a petition with a court, however, the affected person would have to raise its objection to the order with the Commission.

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of a final disposition, whether affirmative, negative, injunctive, or declaratory in form, of an agency in a matter other than rule making but including licensing."

[900] 15 U.S.C. § 78w(d); *see also* 17 C.F.R. § 201.191 (rules of practice for informal adjudications).

[901] A federal appellate court may potentially review orders pursuant to 15 U.S.C. § 78y. Section 78y provides that any person aggrieved by a "final order of the Commission" may seek review by a United States Court of Appeals, provided that such person has first sought reconsideration of the order by the Commission. 15 U.S.C. § 78y(a)(1) & (c)(1). Not all Commission actions are "final orders," though, only those which "impose an obligation, deny a right or fix some legal relationship as a consummation of the administrative process." Amalgamated Clothing and Textile Workers Union v. SEC, 15 F.3d 254, 257 (2d Cir. 1994) (quoting Chicago & S. Airlines, Inc. v. Waterman S. S. Corp., 333 U.S. 103, 113 (1948)). One example of a final, reviewable order is a decision by the Commission to deny an application to preserve the confidentiality of certain information required to be disclosed in public filings. *See* Am. Sumatra Tobacco Corp. v. SEC, 93 F.2d 236 (D.C. Cir. 1937). The fact that the Commission's actions are discretionary and not required to be made after notice and an opportunity for a hearing does not prevent an order from being "final" for purposes of section 78y.

In the interest of certainty for filing shareholders as well as the firm, its current shareholders and stakeholders and given the due process concerns outlined above, any criteria utilized by the Commission in making a determination to authorize or block the voting of securities would have to be clear, objective and substantiated so as to provide sufficient notice to investors of the qualities or acts that might subject them to agency action. In addition, clear, objective, and substantiated criteria would help insulate Commission decisions from judicial scrutiny and charges of arbitrary or capricious deprivations of rights in property.

In this context, the proposed authorization scheme will protect firms and investors as long as the criteria to provide or foreclose the authorization to vote shares exceeding the thresholds are fair, clear and make the authorization reasonably predictable.

FINAL REMARKS

While inevitably falling short of being truly comprehensive, this work intends to draw attention to the role of shareholders' personal qualities in the mechanics of sound corporate governance.

When considering the steps necessary to provide public corporations with the most effective governance, logic dictates that the discussion on the importance of shareholders' personal qualities precede the debate on the extensiveness of shareholders' empowerment and engagement in the governance.

The arguments raised in this work strive to demonstrate that the current debate on sound corporate governance fundamentally neglects the implications of shareholder's personal qualities.

Accordingly, the policies presented in this thesis act as a proposal to address the current system's dearth of assessment of shareholders' personal qualities. The first policy calls for amplified shareholder legal exposure by applying a heightened level of scrutiny—such as stricter standards of review—because shareholders are not chosen through a selection process like board members. The second policy suggests developing corporate strategies to attract shareholders with qualities most compatible with the corporation's venture or to incentivize shareholders to modify their behaviors to become more synergistic with the corporation's venture. Finally, the third policy proposes that shareholders with specific levels of equity ownership only be allowed full voting rights when an independent third party has determined that they meet a threshold of integrity.

Although one might find some of the aforementioned policies to be radical, they would truly heighten awareness of the issue and perhaps inspire discussion amongst policymakers and scholars when forming new regulations.

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