The Evolution of Corporate Law

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I. Introduction

It was not so long ago that Bayless Manning remarked that “Corporation law, as a field of intellectual effort, is dead in the United States. . . . We have nothing left but towering skyscrapers of rusted girders, internally welded together and containing nothing but wind.” Corporate law scholarship has steadily advanced past this desolate image. Thanks in large part to an interdisciplinary focus on corporate law using tools of historical, comparative, and quantitative analysis, the field has been rejuvenated.

Even with the new analytical tools, however, significant gaps remain. Consider historical and comparative analysis. While the history of the large industrial enterprises in various systems has been the subject of extensive analysis, the evolution of corporate law has been largely neglected. This paper attempts to fill this gap by tracing the evolution of the corporate law in several jurisdictions since the beginning of the nineteenth century, using statutory law as a source to analyze the timing and locus of legal change. The research is designed to be explorative in nature. We use an open-ended list of legal indicators to identify patterns of legal change and pay tribute to the idiosyncrasies of legal evolution in different countries. The data allow us to review the theories about legal evolution and convergence of corporate governance systems that is

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1 (Manning 1962) at p. 245.
3 An important exception is (Horn 1979). While there are numerous publications that compare corporate law of two countries (US and Germany, US and UK, France and Germany etc.), or which focus on particular aspects of the corporate law, there are few multinational comparisons.
currently underway. We also use them to draw some normative conclusions about the possible impact of legal reform in the area of corporate law.

We focus on the law on the books, but drawn on case law, where this seems to be warranted. Change in the formal law is not necessarily identical with changes in the organization and administration of the firm. But the statutory law establishes the framework that stakeholders of the firm may use to structure their relations. It also reflects policymakers’ perceptions of the role of the corporation and its stakeholders, and documents their response to changes in the business environment.

Now consider quantitative corporate law studies. Recent scholarship analyzes the relation between a set of shareholder indicators and the development of capital markets or the ownership structure of firms. These studies suggest that there is a statistically significant difference between the level of minority shareholder protection in common law and civil law countries, with the former scoring higher on average. Common law countries also have lower ownership concentration and better developed capital markets.

These quantitative studies have puzzled comparative legal scholars who had previously concluded legal systems are distinguishable not so much by the content of legal rules, but by systemic characteristics such as the process of lawmaking and law enforcement. This study contributes to this debate by filling in a second gap: the origins of the legal indicators that have been used in the empirical studies. We find that only a few of the shareholder indicators that have been attributed to the superiority of the common law actually existed in common law jurisdictions at the time those jurisdictions first enacted corporate statutes. The most pronounced difference between common law and civil law jurisdictions at that time was the availability of judicial recourse to disgruntled shareholders, and by implication the role of courts in developing the principles of corporate law.

In addition to an examination of these initial starting conditions, we focus on the subsequent evolutionary changes that followed. Doing so yields a simple observation: legal systems had largely similar laws on the books at the outset, but subsequently follow different paths. Drawing on previous comparative legal literature and the patterns of legal change we can observe in the ten countries studied, this study attempts to offer some plausible explanations for differing evolutionary paths.

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4 (La Porta, Lopez-de-Silanes, Shleifer, and Vishny 1998) (La Porta, Lopez-de-Silanes, Shleifer, and Vishny 1997) and numerous follow up studies. See also (Levine 1997) (Levine 1999) and (Johnson, Boone, Breach, and Friedman 1998).
In explaining these evolutionary developments, this paper suggests a refocus of the corporate law and governance debate. Most studies of corporate governance today emphasize shareholder rights. Similarly, policymakers urge countries around the world to incorporate legal rules that protect minority shareholders. This policy stance reflects a preoccupation of the comparative corporate governance literature with the principal-agent problem. According to this view, shareholders as the principals of the corporation require legal protection to control management as their agents. Without this legal protection, managers might be inclined to maximize their personal rather than shareholder value.

Our analysis of the evolution of corporate law suggests that the function of corporate law is much more complex, involving a tradeoff between agency problems and flexibility. Early corporate laws had relatively effective solutions for the agency problem, including *ultra vires* doctrine, unanimous shareholder vote provisions, and creditors’ rights to petition for the liquidation of the firm if minimum capital requirements were not met. Such legal provisions limit agency problems, but at the same time greatly restrict the ability of corporations to respond to a quickly changing environment. But a corporate law that allows greater flexibility implies more misuse, and thus higher agency costs. The historical challenge of the corporate law has been to balance these two conflicting interests and develop legal control mechanisms that afforded corporations (i.e. its management) with substantial flexibility without creating a control vacuum. We call provisions that serve this function indirect, or complementary control mechanisms.

To capture the evolution of control mechanisms, we identify the allocation of key decision making rights among stakeholders of the firm, including rights relating to the existence of the corporation as an independent entity, its governance structure, and issues of corporate finance. These decision rights may be vested with the state/legislature, or may be allocated to stakeholders, including shareholders, managers, creditors, and labor. The allocation of rights may be final (mandatory) or may allow the relevant stakeholders to delegate their rights to another group (default). Countries that afford stakeholders greater flexibility to structure their relationships and opt out of the statutory law should have a higher incidence of complementary control mechanisms.

Our findings suggest two central claims. The first concerns the process of evolution: the most important differences among the ten jurisdictions analyzed in this study are their relative positions on the flexibility-rigidity continuum and whether they have been able to develop complementary control devices to compensate for the legal void that results from greater flexibility. At least four factors seem to account for relative success and failure in these tasks.

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5 Perhaps the best example is the OECD Principles for Corporate Governance (OECD 1999).
First, differences among legal families matters. Common law systems had a head start over civil law systems in developing complementary control mechanisms. Prior to the enactment of corporate statutes, courts had already developed principles for the corporation based on trust law and courts continued to adapt these principles and develop new ones even after statutory law had been enacted.

Second, competition affects the pace and extent of legal reform. Regulatory competition was largely confined to the United States. It contributed to the development of Delaware as the jurisdiction with the most flexible law within a period of only a few decades. Economic competition has affected lawmaking more generally and has forced lawmakers to be responsive to market developments. Many important legal changes cluster around periods of substantial economic competition. Yet, they don’t all point in the same direction as the initial conditions in a given country define the need for as well as the limits of law reform.

Third, initial conditions, including the quality of legal institutions and the legal profession plays a role. Countries that transplanted law have been substantially less innovative and lag behind the origin countries in adopting new complementary mechanisms of control.

Finally, the development of financial markets matters, especially during the formatting stages of corporate law. Financial market crises, particularly in the early stages of legal evolution, led to a “backlash” by legislatures who sought to avoid future crises by imposing a rigid corporate law with long term implications for the further development of corporate law.

Our second claim concerns the starting point of evolution. We find that irrespective of legal family, transplant countries reveal different patterns of legal development than origin countries. Some countries show extreme volatility in legal change after the enactment of the first corporate statute. This can be interpreted as a response to the economic effect that resulted from the enactment of the law, or as a rejection of certain aspects of a law that had been more or less imposed on a country. In other countries, the law on the books did not change for decades despite a remarkable economic takeoff, a phenomenon that also may be interpreted as a rejection of the transplant.

We conclude from this analysis that the acceptance of law in a transplant country takes time. Users as well as lawmakers need to recognize the relevance of the law for economic undertakings and learn how to adjust law based on their own experience. Moreover, they need to develop appropriate complementary institutions, which frequently are less developed in transplant countries than in origin countries from which the law is borrowed. Some transplant countries have sought to make up for the lacunae of legal institutions by strengthening state monitoring and allowing only little flexibility in their laws. The problem with this approach is that while it avoids
some of the pitfalls of a flexible law, it restricts the capacity for innovation and change. It also retards the development of complementary institutions, which are necessary when a country moves from a rigid to a more flexible regime.

These findings have implications for the debate about convergence or divergence of legal systems. It has become fashionable – or at least commonplace – to hail the advent of shareholder value doctrines around the world. We suggest that this conclusion begs the central question of what shareholders value. It is widely assumed that shareholders value the effective protection of their rights. But shareholders may rationally forego some protection if doing so gives corporations more flexibility to respond to changes in the business environment; provided, of course, that shareholders participate in the gains that arise from these opportunities. We suggest that the solution for this complex task differs from country to country and is influenced by factors exogenous to corporate law, including the availability of complementary control mechanisms, the effectiveness of legal institutions, and the market response to greater legal flexibility, which will be influenced by the first two factors.

The paper proceeds as follows. Section II sets forth the scope of the analysis. It presents the selection of countries and the definition of corporate law we use for our investigation. Section III discusses the usefulness of analyzing the law on the books and the legal indicators we use to identify patterns of legal change. Section IV traces the evolution of corporate law in the four origin countries included in the sample using a common taxonomy of shareholder rights. Section V analyzes the tradeoff between rigid and flexible laws, responses to the legal void that often results from greater flexibility, and the emergence of complementary control devices. Section VI traces the evolution of law in the six transplant countries in the sample. Section VII analyzes complementary controls in transplant countries and seeks explanations for the fact that they seem to be less developed than in most origin countries. Section VIII discusses the factors that determine the evolution of corporate law. Section IX summarizes our main findings.

II. Scope of Analysis

a. Selection of Countries

6 Most explicit are (Hansmann and Kraakman 2000).
7 As will be further discussed below, where one comes out in the divergence/convergence debate depends crucially on the level of analysis. Since most countries in the world have a corporate law today, there is some level of convergence. Moreover, the issues a corporate law could possibly address are not indefinite. Our claim that we see persistent divergence rests on a highly detailed analysis of the law.
Our analysis begins with the first enactment of general corporate statutes and traces the development of corporate law until the end of the 20th century. The beginning of the period is marked by the enactment of the *code de commerce* in France in 1807. This code along with other Napoleonic codes was subsequently enacted in many parts of Europe and thereafter was transplanted to Latin America and parts of Africa. In the United States, New York was the first state to enact a corporate statute in 1811, which was limited in application to manufacturing companies, followed by New Jersey in 1816. Delaware’s corporation law, which has come to dominate in the United States, was enacted in 1883. In England, codification of corporate law began in 1844. The revised and first comprehensive companies act of 1862 became part of a package of codified common law that was later transplanted to British colonies. In Germany, the political development delayed codification for much of the 19th century. Prussia enacted a corporate law in 1845. In 1860, the General Commercial Code for all of Germany – including Austria – was enacted, which devoted a section to joint stock companies. A later revision (1884) of this law for unified Germany served as a model for Japan.

The four countries that were first to enact general corporate statutes have spearheaded the development of corporate law. An analysis of the evolution of corporate law in these countries and the extent to which they have followed similar or perhaps different paths may shed light on the evolution of an institution, which has been called one of the key inventions for the development of capitalism. It may also help understand variations in the development of different legal systems, in particular the common law and in civil law systems. England and the United States represent the core countries of the common law family, Germany and France those of the German and French civil law families respectively.

Another question this paper seeks to address is whether similar patterns of legal evolution that can be found in countries that developed the formal corporate law internally also characterize...
the evolution of law in countries that received the models for the formal law externally. In Europe, the evolution of the corporation can be traced to commercial societies of the Middle Ages on the one hand and state chartered, though mostly privately financed corporations, on the other. The majority of countries around the globe copied or received the foundations of their corporate law from the core Western European countries (France, England and Germany) as a result of colonization, legal imposition after a lost war or as a result of (semi-) voluntary subjugation to foreign pressure in an attempt to retain or regain their sovereignty.

The fact that the transplantation of similar if not identical laws within decades after their enactment in the Western origin countries did not produce similar results questions the importance of formal law on the books for economic development. However, there may be more to effective law making than getting the rules on the books right. Without a demand for law, which could be spurred by socioeconomic development, the law will live a book-life, but will be ignored in practice.

The paper seeks to address these questions by including several countries that received their formal corporate law externally rather than developing it internally. We selected at least one country for each of the main legal families. For the common law we include Israel and Malaysia. For the French civil law family Spain and two Latin American countries, Chile and Colombia.
Finally, for the German legal family, we include Japan.\footnote{The classification of Japan into one of the legal families poses difficulties in particular in the area of corporate law. At the end of the nineteenth century Japan enacted codes in key areas of civil and commercial law that are primarily influenced by German law. But after World War II, the United States ensured the revision of the corporate law based largely on Illinois law. See (West 2000a).} Table 1 lists the countries included in the study and classifies them according to legal family and origin.

<table>
<thead>
<tr>
<th>Origin Transplant</th>
<th>Origin Transplant</th>
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<tbody>
<tr>
<td>French civil law</td>
<td>France Spain, Chile, Colombia</td>
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<tr>
<td>German civil law</td>
<td>Germany Japan until 1950;</td>
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<tr>
<td>Common law</td>
<td>USA (Delaware) Japan since 1950</td>
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<td></td>
<td>UK Israel, Malaysia,</td>
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</table>

Note: *Technically, the US is a transplant, because its legal system is derived from English common law. But the development of corporate law since the early 19th century has been sufficiently idiosyncratic to warrant a classification as an origin country.

b. The scope of corporate law

Defining the scope of corporate law can be problematic. “Corporate law” may be defined by the contents of the formal legal acts labeled corporate law, companies act, or the like. Alternatively, it may be defined functionally as all legal rules that seek to influence the organization of the corporation or the rights and obligations of its various stakeholders irrespective of the title of a specific legislative enactment that may contain such provisions. Shareholder protection, for example, can be found not only in corporate statutes, but also in securities market regulation. Similarly, creditor protection may be included in the corporate law as well as in bankruptcy law or the civil code. Moreover, the effectiveness of legal protection afforded by substantive legal provisions depends on the accessibility and effectiveness of procedural rules. Thus, at least indirectly, such factors as civil procedure law and judicial institutional structure are important elements of the legal framework for corporations.

While we acknowledge the importance of related areas of the law, this paper begins with an in-depth analysis of the law found in relevant corporate statutes. Doing so helps define the scope of analysis for a larger number of jurisdictions. While we extend the analysis to securities market regulation (without matching the detail of the corporate law analysis), we do not include bankruptcy or other areas of the law at this point in order to keep the analysis sufficiently focused.

III. Methodology
A “law on the books” approach faces two major challenges. First, one recent line of thought holds that the end of history for corporate law is near. To make such a claim, investigation of past practice would seem to be required. Yet we know remarkably little about the evolution of law in general or about specific areas of the law, such as the corporate law, in particular. Apart from several analyses of the early development of corporate law during the period of industrial revolution, long-term analyses of legal evolution across countries are unavailable. Without a deeper understanding of the trajectories of legal development in the past, we can hardly make predictions about the future.

Moreover, the proclamation of the end of history for corporate law rests on the premise that the integration of financial markets has made shareholder value the overarching objective of corporate performance around the world. Although legal change may not quite have caught up with this development yet, it is bound to do so eventually. This argument assumes that shareholders primarily value strong legal protection of their rights. This claim squares oddly with an earlier debate that hailed the advantages of an optional corporate law without that would include few, if any, mandatory provisions on protection shareholder rights. It also contradicts the empirical observation that corporations incorporated in Delaware, a jurisdiction that has systematically dismantled mandatory shareholder rights protection in corporate law over time, are traded at higher value than corporations registered elsewhere in the United States. Second, some scholars claim that law on the books is trivial. In comparison with governance mechanisms such as capital markets, product markets, and managerial labor markets, the importance of corporate law is at best of secondary nature. The triviality proposition did not declare all law pertaining to the corporation and/or investors to be trivial; securities legislation in particular was excluded from the claim even then. We suggest that we need to study the evolution of corporate law more closely to substantiate claims of triviality as well as convergence.

14 (Hansmann and Kraakman 2000).
15 See especially (Horn 1979); (Coing 1986).
16 This is certainly the conclusion drawn in (La Porta et al. 1998); (La Porta et al. 1997).
17 See only (Gordon 1989); (Romano 1989); (Coffee 1989); (Easterbrook and Fischel 1991) especially chapter 1. For a sketched out history of the trend from mandatory to enabling corporate law see also (Black and Kraakman 1996).
18 (Daines 2000). As will be further discussed below, the development of complementary control devices, including relatively strong courts and effective federal securities regulation may have taken the place of corporate law in protecting shareholder rights.
19 (Black 1990).
b. Legal Indicators

The choice of legal indicators for a functional analysis of corporate law is determined by the theory of the firm. The fundamental principal-agent problem in the corporation is that between shareholders and managers. Corporate law plays an important role in ameliorating the agency costs by offering legal mechanisms of control. The better these control rights, the fewer inefficiencies arise. Based on this theory of the firm, the first large empirical study on law and finance, not surprisingly, codes a list of indicators said to be crucial for the protection of minority shareholder rights vis-à-vis management.

From a property rights perspective, by contrast, the function of the corporate law would be allocated residual control rights over key decisions and leave the reallocation of control rights to the parties themselves. We define key control rights as the right to make decisions that affect the existence of the corporation as an independent entity, its governance structure, and its financial structure. Table 2 below lists the indicators used to identify these control rights.

<table>
<thead>
<tr>
<th>Taxonomy of Legal Indicators</th>
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<tr>
<td>Existence</td>
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<td>Formation</td>
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<td>Liquidation</td>
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<td>Term</td>
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<td>Merger</td>
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20 (Black 2000)
21 (Jensen 1976) who develop the economic theory. For the legal literature, compare only (Easterbrook and Fischel 1991; Romano 1989) and (Hart 1989). Oliver Hart distinguishes between the principal-agent theory on the one hand, and the nexus of contract theory on the other. While the principal-agent theory attempts to explain why certain transactions are internalized rather than carried out on the market, the nexus of contract theory views the firm itself as nexus of contract. Thus, for both theories the principal-agent relationship is important, but only one sees the firm as a solution to it.
22 (La Porta et al. 1998). The function of some of the indicators used in this study is, however, ambiguous.
23 (Grossman and Hart 1986; Hart and Moore 1990)
24 A similar definition underlies the OECD Principles of Corporate Governance (1999). Under rights of shareholders, the OECD defines “fundamental corporate changes” as “1) amendments to the statues, or articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions that in effect result in the sale of the company.”
For each country, we create a matrix indicating the allocation of control rights over these matters to different stakeholders. Various allocation possibilities exist; control rights may be allocated exclusively to one stakeholder, or different stakeholders may share control rights. Sharing control rights can also take different forms; stakeholders may be required to act together (joint control rights), or binding decisions may require a motion by the board of directors as well as shareholder approval.

The allocation of control rights can be mandatory or optional. Where it is mandatory, the allocation of control rights is made by law and cannot be changed, even by shareholders. For example, the law may stipulate that decisions concerning the formation of a corporation and changes in its articles of incorporation (charter)\(^\text{25}\) can be made only by shareholders. Thus, shareholders could neither delegate these rights to management, nor could creditors include provisions in their contract that would allow them to participate in these decisions. Where the allocation of control rights is optional, it may vary for different corporations and may change over the lifetime of the corporation. The crucial question then becomes not who holds the control rights on a specific issue, but who controls charter changes in midstream, which may result in a reallocation of control rights.\(^\text{26}\) Lastly, the law itself can prescribe certain substantive issues, rather than only allocating control rights over them. Minimum capital requirements, or mandatory provisions on the board structure (one-tier or two-tier structure) are examples for such provisions, which are removed from the stakeholders’ control.

IV. Origin Countries

Using the above-described indicators, we recorded the contents of the relevant provisions found in the law. We did not convert the indicators into binary variables that could be used for statistical analysis. While the quantitative analysis of law has sparked much interest in legal issues and has produced interesting results, such analyses have at least three limitations. First, coding legal provisions as binary variables while giving each indicator equal weight assumes that counting the number of indicators indicates better legal protection. Yet, it is conceivable that some indicators have more bite than others. Thus, adding more indicators may distort the picture rather than help assess differences in the quality of law. Second, depending on when the list is

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\(^{25}\) The legal terminology for the various corporate documents differs from country to country. We use the term ‘charter’ across all jurisdictions to denote the founding document or constitution of the corporation. This term should not be confused with the state “chartering” a company, i.e. authorizing a specific undertaking and endowing it with certain privileges.

\(^{26}\) For discussion of charter changes in midstream, see (Bebchuk 1989).
closed, the results may bias against some jurisdictions, despite the fact that a few well-placed legal constraints may have the same effect as a larger number of rules. Finally, a closer analysis of the indicators that have been used in previous studies reveals that their function may be more ambiguous than has been assumed.  

Our analysis starts from the simple premise that an important function of corporate law is the allocation of control rights among different stakeholders. We suggest that the allocation of control rights has implications for the flexibility of the corporation to respond to a changing environment. It also influences the long-term evolution of corporate law, because the initial allocation of rights may trigger legal responses to problems that occur because of the way in which rights were allocated in the first place. Where the initial allocation of control rights has not changed over time, i.e. because the law mandates a certain allocation without allowing for flexibility, the corporate law today should still resemble largely the original corporate law, and include only few legal innovations. Where the allocation was optional rather than mandatory or where it has become more flexible over time, we should observe legal responses that filled the void in areas where control rights have been shifted. Additional governance devices may have emerged outside the narrow corporate law as substitutes or complements to more rigid control allocations in earlier laws.

Understanding the interaction between the allocation of key control rights and the emergence of complementary mechanisms of checks and balance is crucial for the comparative analysis of law, as well as for legal reform. Indicators that have shown to be significantly correlated with market development, such as the indicators used by LLSV, may reflect the response of a legal system to a certain allocation of key control rights. Their relevance may therefore be contingent on this particular allocation of rights. Perhaps, the governance structure these indicators captures is overall superior to alternative governance structures in terms of economic efficiency. But the insertion of only these indicators into another country’s law will not change the overall governance structure, and is therefore unlikely to be very effective as long as the underlying allocation of control rights remains unchanged. In other words, legal indicators

27 For example, LLSV use preemptive rights, i.e. the right of existing shareholders of first refusal when the corporation increases its capital and issues new stock, as one of the six indicators in their anti-director index, which purports to measure the level of minority shareholder protection. Preemptive rights may, however, benefit existing block-holders, not minority shareholders because they force the company to return to existing financiers rather than reach out to new investors, thus creating a more dispersed ownership structure over time (Wymeersch 1998). While our methodology may unfortunately result in a more lengthy analysis than a statistical study, we believe that by sacrificing brevity, we achieve significant gains in accuracy.

28 This premise is influenced by the property rights theory of the firm. See (Grossman and Hart 1986), (Hart and Moore 1990).
cannot be adequately assessed in isolation, but must be viewed in context.

We begin our analysis by examining two early evolutionary factors: entry conditions and limited liability. We then turn to the allocation of control rights.

1. Early Evolution

*Entry Conditions*

Until well into the nineteenth century, the allocation of control rights among the stakeholders of the corporation, was secondary to the reservation of control rights by the state. The state’s veto power over incorporation can be traced to the incorporation of state chartered companies in the Middle Ages. For companies to be recognized as independent legal entities and for them to freely sell their shares, they required a state charter (or concession). However, promoters of commercial undertakings frequently found ways around these restrictions. In particular in England during the economic boom following the 1688 Revolution it had become common to buy charters from moribund companies and use them for different purposes. This practice was stopped with the enactment of the Bubble Act in 1719, which sought to reestablish the prerogative of the Parliament to grant charters of incorporation. In France, free registration of all private companies was proclaimed in 1791 in the aftermath of the revolution. After all, this was the revolution of the bourgeoisie, not of the proletariat. The boom in startups and the following bust led to a complete reversal in 1793. However, in 1796 the principle of free incorporation had been re-established, only to be replaced once more in 1807 with the concession system by the restaurative Napoleonic *code de commerce*. This system was retained until 1867. In the UK, the Bubble Act was repealed in 1825. The ensuing railway mania with its many successful companies, but also widespread fraud and pyramid schemes led in 1844 to the enactment of the Companies Clauses Consolidation Act. It established the principle of free incorporation subject only to registration, but did not recognize limited liability.

The shift from the concession to the free registration system in France in 1867 was induced by the expansion of activities of English companies on the continent. Once France had allowed companies that were incorporated in England without special approval by the parliament to operate as corporations in France, it faced pressure from domestic companies to drop the

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29 Under the act “the acting or presuming to act as a co Corporate Body or Bodies, the raising or pretending to raise transferable Stock or Stocks (…) without legal Authority (…) shall for ever be deemed to be illegal and void, and shall not be practiced or in any wise put in execution.” Anno 6° GeorgII, c. 18 (A.D. 1719) pp. 323. See (Davies 1997) pp. 24 on the history of the South Sea Bubble and the enactment of the Bubble Act.
concession requirement at home. In addition, it had become ever more apparent that promoters circumvented the concession requirement by establishing a *société en commandite*, i.e. a corporation with at least one unlimited partner, and all others limited, rather than a joint stock company. Thus, domestic and foreign competition played an important role in the shift of control rights over incorporation from the state to private parties. Germany soon followed suit with an amendment of the general commercial code for all of Germany in 1870. The code was originally enacted in 1861. It uses the *société en commandite (Kommanditgesellschaft)* as the model for joint stock companies. As in France, this was the most common form used by large enterprises at the time, most likely because its formation was not subject to state concession.\(^\text{31}\)

The development of the principle of free incorporation without special state approval was slightly different in the United States. By the end of the eighteenth century, most corporations operating in the United States had been chartered in England. New York was the first state to enact a corporate statute in 1811, followed by New Jersey in 1816. It allows the free incorporation of companies in manufacturing business. However, the term of these companies was limited to 20 years and their capital could not exceed US$100,000.\(^\text{32}\) Most companies were incorporated by a special bill adopted by parliament until in the 1830s most states began to adopt general corporate laws and allowed companies to incorporate under these laws. Still, many companies preferred to incorporate by special bill, because they often bargained with the legislature for special privileges, including monopoly rights in public work projects.\(^\text{33}\) Delaware enacted its first general corporate law in 1883, after a constitutional amendment in 1875 had established the right of parliament to enact such a law. Incorporation by special bill remained possible until 1897, when another amendment of the Constitution stipulated that from now on, incorporation as well as renewal of existing incorporations could be achieved under the general law only. The reason was that special bills had led to much controversy and corruption allegation.

\(^{30}\) (Horn)
\(^{31}\) At that time another form of company dominated, the *Kommanditgesellschaft (KG)*, which has at least one unlimited member, for all others liability is limited to their contribution. The provisions on the corporation use this form as the model and add provisions only where deviations are necessary. The predominance of the KG (*société en commandite* in France) in Europe in the first part of the 19th century can be largely explained with the fact that unlike the corporation with full limited liability, a special concession was not required for setting up this company. (Horn 1979); Hommelhoff in (Schubert and Hommelhoff 1985); (Horn ). This form of company was not known in England. Some commentators suggest that this may have been the result of England lagging behind the Continent in bookkeeping techniques in early modern times. See (Davies 1997) p. 19.
\(^{32}\) See Sections II and V of the *Act relative to Incorporation of Manufacturing Purposes*, March 22 1811, New York Laws, Chapter LXVII (1811).
\(^{33}\) (Hovenkamp 1991) and (Larcom 1937).
Limited Liability

As the above discussion suggests, shareholder liability or rather the privilege of limited liability for shareholders played an important role in the choice of legal form for corporations and the willingness of legislatures to forego concession requirements. Not all jurisdictions recognized limited shareholder liability in their original statutes. England was the first country to move towards free registration in 1844, but did not recognize limited liability of shareholders at that time. Only after several court decisions, which recognized contractually granted limited liability did the legislature follow suit. In the United States, different states pursued different strategies with respect to limited liability. In California, limited liability was recognized only in 1931. In Delaware, prior to 1967 the law left it to the certificate of incorporation to determine “whether the private property of the stockholders (...) shall be subject to the payment of corporate debts, and if so, to what extent.” Only the 1967 code established limited liability as a default rule. For the French legislator, by contrast, limited liability was an essential feature of the corporation, recognizing it right away with the first codification in 1807. Germany followed in 1861.

Table 3: Legal Recognition of Shareholders’ Limited Liability

<table>
<thead>
<tr>
<th>First Corporate Statute</th>
<th>Free Incorporation</th>
<th>Limited Liability Recognized by Law</th>
</tr>
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<tbody>
<tr>
<td>France</td>
<td>1807</td>
<td>1867</td>
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<tr>
<td>Germany</td>
<td>1861</td>
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<td>United States</td>
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<td>California</td>
<td>1849</td>
<td>1849</td>
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<tr>
<td>Delaware</td>
<td>1883</td>
<td>1883</td>
</tr>
</tbody>
</table>

Note: Date in parenthesis refers to date when limited liability is recognized as a default rule.

Shifting the right to incorporate from the state to shareholders also meant that the state gave up control rights over future changes in the articles of incorporation. State approval for such changes was no longer necessary. To be sure, special rules existed for some commercial undertakings, including banking and insurance, but for general commercial activities the state had

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34 Act for limiting the Liability of Members of certain Joint Stock Companies, 14th August 1855, Cap. 133 (1855).
35 Shareholder liability was not joint and severally, but pro rata, see (Blumberg 1993). There is no evidence that the lack of full limited liability prevented firms from incorporating in Delaware.
36 Section 7.10 of the 1899 Delaware Law on Corporations. Laws of Delaware (1899), 445.
37 According to Section 102 (6) of the 1967 law, to certificate of incorporation may include “a provision imposing personal liability for the debts of the corporation on its stockholders or members to a specified extent and upon specified conditions; otherwise, the stockholders or members of a corporation shall be personally liable (...).” Emphasis added.
38 Art. 33 Code de Commerce (1807).
largely relinquished ex ante control, i.e. control over entry into the market. With the principle of free incorporation having been established, the state’s attention shifted to other areas. One was ex post control. The Delaware code of 1899 for example, stipulates that the legislature may dissolve any corporation “at leisure” created under its act, or alter or amend its charter of incorporation.

There is, however, little evidence that this provision has been much used. More important was the attempt by legislatures to establish a viable legal framework that could replace the ex ante control function it had exercised hitherto. The move to a system of free registration was accompanied in all countries by the enactment of a much more elaborate corporate law. This is not surprising. As long as the state – be it the legislature or bureaucracy – could verify the content of the charter of any corporation that wished to enter the market, there was little need to design a general governance structure. The focus of legislatures shifted to the conditions for incorporation. The new corporate laws stipulated entry requirements that applied to all corporations and had to be met before a company could commence operation as a legally founded joint stock company.

Table 4 below lists the entry requirements for the four origin countries at the time free registration was introduced.

<table>
<thead>
<tr>
<th>Registration</th>
<th>France 1867</th>
<th>Germany 1870</th>
<th>UK 1844</th>
<th>US/Del 1883</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charter filed with clerk of commercial court</td>
<td>Commercial court where company is located</td>
<td>Provisional registration followed by final registration with newly established Registrar of Companies</td>
<td>Judge where corporation is located; judge checks lawfulness and public interest concern</td>
<td></td>
</tr>
<tr>
<td>Publication</td>
<td>Summary of bylaws published in press</td>
<td>Announcement in official gazette and notarial certification of charter</td>
<td>Registrar collects information on incorporation, constitution, annual returns</td>
<td>Notice of intention to incorporate must be published daily in 2 newspapers of country for at least 10 consecutive days</td>
</tr>
<tr>
<td>Founders</td>
<td>7</td>
<td>0 (1870)</td>
<td>25</td>
<td>3 Founders*</td>
</tr>
<tr>
<td>Minimum nominal share value</td>
<td>100 FF</td>
<td>50 VT for registered 100 VT for bearer shares</td>
<td>20 Pounds</td>
<td>Stipulated in charter</td>
</tr>
<tr>
<td>Paid in Capital</td>
<td>1/4 of capital must be paid in</td>
<td>1/10 per share must be paid in</td>
<td>3/4 of nominal capital</td>
<td>1/10 of capital must be fully paid in</td>
</tr>
</tbody>
</table>

Note: VT stands for Vereinsthaler, or the common currency unit in use in the German Confederation. It was replaced with the Reichsmark (RM) after German unification in 1871.

*Denotes provisions that existed already in earlier laws.

Source: Compilation by authors. For list of legal documents consulted, see Appendix.

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39 Section 14 of the *Act Concerning Private Corporations*, Chapter 147 Laws of Delaware pp. 212, Title Tenth of Corporations.
The new liberalized entry requirements were soon put to a test. Most countries experienced a founders’ boom after the liberalization of corporate law, which in some cases was followed by a major bust. In England, the ongoing railway mania led to several corrections in the corporate law after 1844, including the statutory recognition of shareholder limited liability.\textsuperscript{40} The strongest case for a boom and bust in the market followed by a legislative backlash, however, is Germany.\textsuperscript{41} While the causality between the liberalization of the law in 1870 and the founders’ boom and bust that followed is still subject to dispute,\textsuperscript{42} the close timing suggested to contemporary lawmakers a close relation between the two events. The results were two major legal enactments: The revised corporate law of 1884, which cemented the principles of a mandatory corporate law that was highly protective of shareholders and creditors; and the Stock Exchange Act of 1896, which introduced publication requirements and liability for wrongful information in the prospectus.\textsuperscript{43} The 1884 corporate law included provisions on the minimum number of founders (5), required full payment of contribution by holders of bearer shares,\textsuperscript{44} and increased the minimum nominal value of shares to RM 1,000. This was a large sum at the time, which was designed to exclude the poor and inexperienced from investing in the corporate sector.\textsuperscript{45} In addition, the law included stiff liability provisions for promoters, founding shareholders and company management for wrongful formation of the corporation. Thus, in addition to competition, backlash has played an important role in the formatting phase of corporate law.

2. Allocation of Control Rights

The state’s relinquishing of its right to approve each new corporate entry did not end state involvement in corporate affairs. Instead, new avenues were sought to ensure that others would take over the monitoring function that hitherto had been assumed by the state. This was accomplished by exceedingly elaborate corporate statutes that allocated key control rights to stakeholders of the corporation. The following sections document the allocation of key control

\textsuperscript{40} For a detailed account of this development see (Kostal 1994).
\textsuperscript{41} For a discussion on the backlash effect on legal development see (Roe 1998).
\textsuperscript{42} (Horn 1979)
\textsuperscript{43} Enforcement of the act, however, proved to be problematic. Only shareholders still in possession of the relevant shares could file a claim.
\textsuperscript{44} The 1870 law had contained a major gap. It required only 1/10 of capital per share to be paid in, but granted shareholders full limited liability, including for the unpaid part. See Hommelhoff in (Schubert and Hommelhoff 1985). In comparison, the Delaware law stipulated that the shareholder remained fully liable for the part that had not been paid in.
rights, which we have defined as the existence of the corporation as an independent entity, its governance structure, and corporate finance.46

Existence of the Corporation as and Independent Entity

By the end of the nineteenth century, the founding shareholders had acquired control rights over the creation of a corporation subject to the mandatory provisions of the law. Another question is whether shareholders also hold the control rights over the continuing existence of the corporation as an independent entity, in particular over liquidation and mergers. With respect to liquidation, shareholders in all countries share control rights with creditors and in most also with the state. Since incorporation was – and still is - regarded as a special legal privilege the state retained the right to take this privilege away either “at leisure” or in case the company violated the law. Table 5 summarizes the main trends that will be discussed below.

Table 5: Existence of Corporation as Independent Entity

<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>Germany</th>
<th>England</th>
<th>Delaware</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formation</td>
<td>1807 State</td>
<td>1861 State</td>
<td>1844 Shareholders</td>
<td>1883 Shareholders and/or state 1897 Shareholders</td>
</tr>
<tr>
<td></td>
<td>1867 Shareholders</td>
<td>1870 Shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidation</td>
<td>1807 Unanimous</td>
<td>1861 1/2 Vote</td>
<td>1862 3/4 Vote</td>
<td>1883 2/3 Vote 1899 Written consent sufficient</td>
</tr>
<tr>
<td></td>
<td>1867 3/4 Vote</td>
<td>1884 3/4 Vote</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Term</td>
<td>1807 Shareholders</td>
<td>1861 Shareholders</td>
<td>1844 Shareholders</td>
<td>1883 Law: 20 years 1899 Shareholders</td>
</tr>
<tr>
<td>Merger</td>
<td>1867 Unanimous</td>
<td>1861 1/2 Vote</td>
<td>1909 3/4 Vote</td>
<td>1883 State approval for acquiring shared in other corporations 1899 Shares may be acquired; 2/3 Vote 1929 1/2 Vote for asset merger</td>
</tr>
<tr>
<td></td>
<td>1913 3/4 Vote</td>
<td>1937 3/4 Vote</td>
<td>1959 Free transfer to bidder</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1966 2/3 Vote</td>
<td>1994 No Vote if minority stake affected</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Compilation by authors

All jurisdictions establish supermajority requirements (3/4 or 2/3) for the voluntary dissolution of the corporation. Some jurisdictions, most notably Delaware, include extensive notification requirements for the shareholder meeting that were to decide on the dissolution of the company. The purpose of both, majority and notification requirements, is to ensure that these decisions cannot be captured by a small group of shareholders. Yet, it is also worth noting that earlier provisions that required a unanimous vote for liquidation were abandoned. The strong

45 Reich argues that these provisions contributed to the concentration of ownership in Germany, because only large corporations could afford acquiring shares in other corporations at that price. (Reich 1976).
46 See Table 2 above and accompanying text.
control rights these rules gave to minority shareholders were offset by the holdup problems they created.

Creditors and labor are most at risk in case of dissolution. Labor concerns are not addressed in most corporate codes, but they are often addressed in bankruptcy codes, where wage claims are given priority over unsecured claims and in some cases even over other claims. Still, Delaware included a provision in 1883, which gave labor a lien over up to one month of wage payment (two months since 1899) with priority over other creditors in the case of liquidation. In Germany, the 1861 law required that creditors were notified about the pending dissolution and were given 12 months to file claims. Prior to that date, assets could not be liquidated.

In a merger, reorganization or other form of corporate reconstruction, frequently one of the companies ceases to exist as an independent entity. Unlike liquidation, the assets post-merger are still used as a going concern, but are now part of a different legal entity. This result has implications for the position of the stakeholders of the formerly independent entity, which is why they are frequently given control rights over such transactions.

Most of the early statutes did not address mergers explicitly. Technically, a merger could be consummated by dissolving the target company according to the general rules on dissolution. In France, a unanimous shareholder vote was required until the law was revised in 1913. In Germany simple majority sufficed under the 1861 law, but government approval was required. In England and the United States, the ultra vires doctrine stood in the way of merger transactions. Until 1898 when New Jersey changed its law, corporations in the US could not acquire shares in other corporations, as this was deemed to be beyond the purpose of a typical manufacturing or trading corporation. After the enactment of the Sherman Act in 1890, companies sought shelter in corporate law to structure transactions with suppliers, customers, as well as with competitors that would withstand the scrutiny of anti trust enforcers. As price cartels were deemed not only null and void, but could trigger civil and criminal sanctions, market control by way of holding structures and trusts became an attractive alternative. But this required that corporations could hold stock in other corporations within their state of incorporation as well as outside of it. In 1899, Delaware followed the example New Jersey had set in 1898 and stipulated that corporations could acquire stock in other corporations registered in Delaware or elsewhere and exercise all rights shares confer to their owners. Delaware thus became a home for nationwide trusts and holding companies. Soon, they came under scrutiny of anti-trust agencies, driving

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47 Similar provisions may be found in bankruptcy codes in other countries, but we did not include them into our analysis.
48 (Hovenkamp 1991).
49 For a detailed analysis of early court decisions on the Sherman Act, see (Thorelli 1954).
many firms into full vertical integration. Delaware facilitated this development by lowering the threshold for asset mergers. Until 1929, all merger transactions required a qualified majority vote by shareholders. Since then, a simple majority has been deemed sufficient for asset mergers, i.e. for the sale, lease, or other form of disposal of any or all of the corporation’s assets. In other words, control rights over corporate reconstructions were shifted away from minority shareholders – who could veto these transactions as long as supermajority requirements applied. While asset mergers still needed shareholder approval, management gained substantial discretion, especially in companies with dispersed shareholder.

In France and Germany, the ability of corporations to acquire shares in other corporations was never questioned. The French code stated as early as 1807 that other companies could become shareholders of a joint stock company. Neither was there an antitrust policy in the two countries until after World War II. This may explain why we observe much more diverse strategies by companies in structuring market controls through contractual arrangements and only partial integration.

German legislatures responded to the proliferation of company groups in 1937 by including several provisions on groups in the 1937 law and by developing a full-blown law on company groups in 1965. The major objective of group law is to protect minority shareholders and creditors of companies that are members of groups within the framework of corporate law. There has been much debate about the efficacy of this law and its ability to protect minority shareholders. For the purpose of this analysis, the important point is that the evolution of merger provisions in the Delaware law and groups law in Germany can be best understood as responses to problems that occurred as the corporate sector developed. Several factors shaped this development, one of them being the legal framework. The approach each country took to deal with these problems had further implications for the path of legal evolution. For example, in an attempt to limit cross shareholdings, the German legislature included a provision in the 1937 law that prohibits subsidiaries from acquiring shares in parent companies. As a result of this provision, triangular mergers using a subsidiary to consummate the merger are not possible under

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50 This asset loophole was closed only by the Celler-Kefauver Act adopted in 1950. On the interpretation of antitrust law and their application to mergers, see (Thorelli 1954).
51 Malepeyre & Jourdain (1833) 222.
52 Dunlavy (1998) attributes this greater diversity to differences in voting rules. As will be further discussed below, voting rules tended to favor per capita voting in throughout the nineteenth century. However, in the United States, this rule was exceedingly replaced by the one-share-one-vote rule. This facilitated control transactions. By contrast, Germany and France, but also England held on to less ‘plurcratic’ and more ‘democratic’ voting rules much longer.
German law. While it is possible to circumvent these restrictions, this entails additional transaction costs.

The only other stakeholders, who at least in some jurisdictions, have control rights over the existence of the corporation as an independent entity, are creditors. France introduced consent requirements for merger transactions in 1935 and this feature has been adopted in other countries belonging to the French legal family. Germany required notification, but not consent in the corporate law. This does not mean that under English or American law, creditors could not contract for veto rights in bond covenants or credit contracts. The difference is that some countries mandate creditor consent, while others leave it to the bargaining power of the parties.

Corporate Governance

The earlier corporate statutes did not pay much attention to the governance structure of firms. All laws initially stipulated that the company would be managed by directors or by trustees who were shareholders of the firm. At the time these codes were drafted, this reflected existing business practice. Increasingly management was professionalized and delegated to outsiders, resulting eventually in the famous separation of ownership and control. England dropped the requirement that directors had to be shareholders of the firm already in 1844, Delaware in 1935. This is somewhat surprising, as in the United States the emergence of professionally managed firms occurred much earlier than in England. One would therefore have expected that Delaware preceded England in dropping this provision. The fact that this was not the case suggests that for such changes to take place, legal change may not be needed as a trigger, at least not if formal requirements can be easily circumvented.

The four jurisdictions differ considerably in the role the legislature assumes in prescribing the governance structure of the firm. Table 6 documents the major statutory provisions and their evolution.

Table 6: Governance Structure

<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>Germany</th>
<th>England</th>
<th>Delaware</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board structure</td>
<td>1807 no provision; Administrators need not be SH 1966 2-tier structure optional</td>
<td>1861 1-tier board structure 1884 2-tier board structure</td>
<td>1844 Directors; need not be SH</td>
<td>1883 3 Directors must be SH 1935 Directors need not be SH</td>
</tr>
</tbody>
</table>

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53 (Baums 1999).
54 (Berle and Means 1932).
56 Obviously, it is easy to ensure that a candidate for the board acquires some shares just to ensure that he qualifies for elections.
<table>
<thead>
<tr>
<th>Board function</th>
<th>1807 Shareholders</th>
<th>1870 Charter</th>
<th>1844 SHM</th>
<th>1883 SHM or board as stipulated in charter; 1883 narrow purpose; ultra vires transactions are void; 1889 any legal purpose; directors may change scope within stipulated purpose; 1889 Bylaws may be changed by directors 1899 Changes in charter and bylaws; corporate capital; liquidation, mergers. 1899 Bylaws may be changed by directors 1899 Changes in charter and capital 2/3 Vote 1901 1/2 Vote for charter changes 1927 1/2 Vote for changes in capital and asset mergers 1883 3 SH 1927 SH representing 10% 1935 single SH may petition court 1967 SH representing 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966 committees cannot take binding decisions</td>
<td>1870 Charter</td>
<td>1844 directors agents of SHM (= supreme organ) 1862 Board may delegate management functions to committees (binding effect)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MB: management, consultation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SB: supervision, consultation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1844 directors agents of SHM (= supreme organ)</td>
<td>1862 Board may delegate management functions to committees (binding effect)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1862 Board may delegate management functions to committees (binding effect)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1862 before end of term, if stipulated in charter 1909 1/2 Vote sufficient</td>
<td>1862 Board resolution</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1862 ultra vires acts are void; changes of purpose require court approval 1948 no court approval required 1972 ultra vires has no third party effect</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1844 SHM supreme organ with universal decision making rights unless restricted by charter</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1861 purpose of corporation as approved by state 1867 Charter</td>
<td>1861 purpose of corporation as approved by state 1867 Charter; ultra vires has no third party effect</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1861 Charter 1884 Changes in charter, capital, scope of business, mergers</td>
<td>1844 SHM or SB 1937 SB only for cause</td>
<td>1862 ultra vires acts are void; changes of purpose require court approval 1948 no court approval required 1972 ultra vires has no third party effect</td>
<td>1883 SHM or board as stipulated in charter 1883 narrow purpose; ultra vires transactions are void 1889 any legal purpose; directors may change scope within stipulated purpose 1889 Bylaws may be changed by directors 1899 Changes in charter and bylaws; corporate capital; liquidation, mergers. 1899 Bylaws may be changed by directors 1899 Changes in charter and capital 2/3 Vote 1901 1/2 Vote for charter changes 1927 1/2 Vote for changes in capital and asset mergers 1883 3 SH 1927 SH representing 10% 1935 single SH may petition court 1967 SH representing 10%</td>
<td></td>
</tr>
<tr>
<td>1807 Board</td>
<td>1884 SHM or SB 1937 SB only for cause</td>
<td>1862 ultra vires acts are void; changes of purpose require court approval 1948 no court approval required 1972 ultra vires has no third party effect</td>
<td>1883 SHM or board as stipulated in charter 1883 narrow purpose; ultra vires transactions are void 1889 any legal purpose; directors may change scope within stipulated purpose 1889 Bylaws may be changed by directors 1899 Changes in charter and bylaws; corporate capital; liquidation, mergers. 1899 Bylaws may be changed by directors 1899 Changes in charter and capital 2/3 Vote 1901 1/2 Vote for charter changes 1927 1/2 Vote for changes in capital and asset mergers 1883 3 SH 1927 SH representing 10% 1935 single SH may petition court 1967 SH representing 10%</td>
<td></td>
</tr>
<tr>
<td>1807 purpose of corporation as approved by state 1867 Charter</td>
<td>1861 purpose of corporation as approved by state 1867 Charter; ultra vires has no third party effect</td>
<td>1862 ultra vires acts are void; changes of purpose require court approval 1948 no court approval required 1972 ultra vires has no third party effect</td>
<td>1883 SHM or board as stipulated in charter 1883 narrow purpose; ultra vires transactions are void 1889 any legal purpose; directors may change scope within stipulated purpose 1889 Bylaws may be changed by directors 1899 Changes in charter and bylaws; corporate capital; liquidation, mergers. 1899 Bylaws may be changed by directors 1899 Changes in charter and capital 2/3 Vote 1901 1/2 Vote for charter changes 1927 1/2 Vote for changes in capital and asset mergers 1883 3 SH 1927 SH representing 10% 1935 single SH may petition court 1967 SH representing 10%</td>
<td></td>
</tr>
<tr>
<td>1807 Liquidation, changes in charter and corporate capital</td>
<td>1861 Charter 1884 Changes in charter, capital, scope of business, mergers</td>
<td>1844 SHM supreme organ with universal decision making rights unless restricted by charter</td>
<td>1883 Changes in charter and bylaws; corporate capital; liquidation, mergers. 1899 Bylaws may be changed by directors 1899 Changes in charter and capital 2/3 Vote 1901 1/2 Vote for charter changes 1927 1/2 Vote for changes in capital and asset mergers 1883 3 SH 1927 SH representing 10% 1935 single SH may petition court 1967 SH representing 10%</td>
<td></td>
</tr>
<tr>
<td>1807 Unanimous vote for above decisions 1867 1/2 Vote for changes in charter, corporate capital</td>
<td>1884 3/4 Vote for above decisions; all others simple majority</td>
<td>1862 3/4 Vote for extraordinary resolutions (liquidation; corporate capital, changes in charter)</td>
<td>1883 Changes in charter and bylaws; corporate capital; liquidation, mergers. 1899 Bylaws may be changed by directors 1899 Changes in charter and capital 2/3 Vote 1901 1/2 Vote for charter changes 1927 1/2 Vote for changes in capital and asset mergers 1883 3 SH 1927 SH representing 10% 1935 single SH may petition court 1967 SH representing 10%</td>
<td></td>
</tr>
<tr>
<td>1807 Annual meeting; charter stipulates conditions for calling co meeting 1867 Single SH may petition court to call</td>
<td>1861 SH representing 10% or more of total stock</td>
<td>1862 SH representing 20% 1909 SH representing 10% 1948 SH representing 5%</td>
<td>1883 Changes in charter and bylaws; corporate capital; liquidation, mergers. 1899 Bylaws may be changed by directors 1899 Changes in charter and capital 2/3 Vote 1901 1/2 Vote for charter changes 1927 1/2 Vote for changes in capital and asset mergers 1883 3 SH 1927 SH representing 10% 1935 single SH may petition court 1967 SH representing 10%</td>
<td></td>
</tr>
</tbody>
</table>
Voting Rules

<table>
<thead>
<tr>
<th>Year</th>
<th>Rule Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1807</td>
<td>No provision;</td>
</tr>
<tr>
<td>1861</td>
<td>1 sh-1V for 1st 10 shares; one additional vote for every 5 shares up to 100; one additional vote for every 10 shares above 100</td>
</tr>
<tr>
<td>1897</td>
<td>Shares with different voting rights permissible</td>
</tr>
<tr>
<td>1937</td>
<td>Multiple voting rights prohibited</td>
</tr>
<tr>
<td>1998</td>
<td>No voting ceiling in listed companies</td>
</tr>
</tbody>
</table>

Note: SHM = shareholder meeting; eo = extraordinary; sh = share; SH = shareholder; V = Vote; SB = supervisory board; MB = management board.

*This applies only to companies with more than 2,000 employees.

Source: Compilation by authors

The two extreme cases in the four-country sample are Delaware and Germany. Delaware law has left the design of the governance structure primarily to the founding shareholders or promoters of the corporation. Moreover, it relaxed the general assumption that only shareholders could decide the governance structure. The board of directors was empowered to set up board committees and to delegate management tasks to them. Moreover, the law recognized that decisions taken by the committees had binding effect on the corporation. England introduced similar changes in 1862, but neither France nor Germany allowed as much flexibility in their corporate laws. In fact, France clarified in the 1966 law that board committees had purely advisory functions, but could not take binding decisions for the corporation.

The 1899 Delaware law went even further and indicated that shareholders could delegate the right to change the bylaws (not the corporate charter) of the corporation to the board. While shareholders could choose not to insert such a provision in the charter, the change in the law gave directors the bargaining power to negotiate a shift in control rights in their favor. Shareholders initially retained indirect control rights by controlling the composition of the board and by having the right to fire board members prior to the expiration of their term. In 1927, however, a provision was introduced that allowed the board to fill vacancies among its members. Shareholders could challenge this by demanding an extraordinary shareholder meeting, but the primary control right had shifted to the board itself. The 1967 law reemphasized this shift in control rights by allowing the directors who had been appointed by the board to serve not only until the next annual meeting, but in case of staggered boards as long as the class of directors they belonged to.

57 Staggered boards were allowed in 1883 with 3 classes of directors being elected at subsequent shareholder meeting. Directors could thus serve for up to three years.
Moreover, directors intending to resign in the future could participate in naming their successors. These provisions made it possible for management to perpetuate its control over the corporation without much shareholder control.

In Germany, by contrast, the legislature mandated a governance structure with exceedingly rigid provisions. The 1861 law established a simple one-tier board structure. By 1870 a two-tier structure was optional, by 1884 it had become mandatory. The justification for this more elaborate governance structure was that the supervisory board was to replace the state as monitor of the corporation. Its task is not to manage, but to supervise management. To underline this function, the law specified that members of the supervisory board could not concurrently serve on the management board. The members of the supervisory board were elected by the shareholder meeting.

Before 1937, members of the management board could be elected either by the meeting, or appointed by the supervisory board. The latter became mandatory in 1937, creating a clear representative model akin to parliamentary democracy. Whereas in Delaware board members serve only for one year, in Germany members of both boards serve for up to five years. Members of the supervisory board can be recalled at any time by the shareholder meeting with a supermajority vote. However, since 1937 members of the management board can be removed only for cause. Formally, this makes it more difficult to remove directors. In practice, however, the turnover of directors in Germany has shown to be not lower on average than in the US.

German law also regulates the number of members serving on the supervisory board. In 1937, when this was first done, the number was linked to the amount of statutory capital of the firm. Legislation on codetermination introduced in 1976 in addition regulated the composition of board, and linked the number of board members to the number of employees of the company. Companies with more than 2,000 employees were mandated to have fifty percent employee representatives on the supervisory board. The chairman of the board, who is elected by the shareholder representatives, has two votes in case of a tie. Under this law, companies with more than 20,000 employees must have a supervisory board with twenty members. The large board size has been the target of much criticism, but plans to change these provisions along with other amendments introduced in 1998 were dropped as the government faced opposition from the labor unions. This is an example for path dependent legal evolution in the face of apparent

58 See Hommelhoff in (Schubert and Hommelhoff 1985); (Hopt 1979).
59 For a comparison of corporate governance with models of representative or direct democracy see (Black and Kraakman 1996).
60 (Kaplan 1994)
61 For details on codetermination and its historical evolution in Germany, see (Pistor 1999).
Codetermination shows how the legislature sought to address new policy concerns (the alignment of interests of workers with those of capital) by using the by now well-established approach of mandatory legal rules. In 1884, their primary purpose was to protect shareholders and creditors. In 1976, the same approach was used to protect worker interests.

England and France fall somewhere between Delaware and Germany. In England, directors are regarded as trustees of the corporation who are elected by shareholders. Since 1862, the board may delegate tasks to committees, which may make binding decisions on behalf of the company. Legal requirements for the dismissal of board members have been relaxed over time. Whereas the 1862 law stipulated that directors could be dismissed prior to the end of the term only, if provision for this had been made in the charter, an amendment of 1909 established that shareholders could dismiss directors at any time with an ordinary resolution, i.e. by simple majority vote. Unlike Delaware, however, the law made no attempt to strengthen the position of other board members in replacing vacancies. Control rights over these issues were left with shareholders.

France did not regulate the board structure in detail in 1807, but left this to the articles of incorporation. In practice, they typically provided for the appointment of an executive officer in charge of day-to-day management. This feature was recognized in the 1867 code. The board is also responsible for dismissing the head of the administration. In 1966, the law was amended to include an option for a two-tier management structure along the lines of the German model. Similarly, in 1986, employee board representation became optional. Neither change has had a significant impact on the governance structure of French firms, as most companies have chosen to stick to the one-tier board structure and employee representation remains a rare event.

The two main organs of the corporation are the board (the management board in the German case) and the shareholder meeting. The four countries address their respective rights and responsibilities quite differently. In England and the US, the delineation of responsibilities has been left largely to the corporate charter (articles of incorporation). Directors overstepping the established boundaries were acting ultra vires. Transactions ultra vires were null and void and directors could be held personally responsible. The success of the ultra vires doctrine as an instrument to control management has had mixed results. In Delaware, courts soon accepted

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62 On the concept of path dependency, see (North 1990) p. 4. For its application to legal evolution, compare (Roe 1996).
63 Malepeuye & Jourdain (1833), pp. 253-256 and 247-249; see also id at 476 discussing the deed of incorporation of the Railway Company between Paris and Orleans.
64 Employee representation on the board is, however, mandatory for state owned enterprises as well as formerly state owned enterprises that have now been privatized.
65 For a discussion about the costs and benefits of the ultra vires doctrine compare (Carpenter ).
very broad definitions of the corporation’s powers, which effectively undermined the doctrine’s
effect. In England, the ultra vires doctrine still applies in principle, although its effect has been
mitigated by provisions in the 1948 law that allow a much broader definition of the purpose of the
corporation, and under EU law introduced in 1972, which eliminated the third party effect
(voidance of any transactions) of the doctrine.

Under French and German law, a corporation is also required to state its purpose in the
charter. But overstepping these boundaries or any other restrictions shareholders may place on
directors has no effect vis-à-vis third parties. In both countries legal certainty was deemed more
important than sanctioning ultra vires transactions. Instead, the two continental European
countries mandated a governance structure with a clearly defined division of power between
shareholders and directors. Both countries’ laws include enumerated lists of exclusive rights of
the shareholder meeting, which cannot be delegate to or appropriated by the board. Powers not
included in this list are assumed to be within the realm of the board’s power. The flip side of the
assumption is that shareholders are explicitly denied the right to participate in management
decisions unless the board decides to seek shareholder approval on these issues.

Governance affects not only the relation between shareholders and management, but also
the relation between different shareholders. Shareholders are frequently treated as stakeholders
with similar interests. But they may have divergent interests, largely as a result of the size of the
stake they hold in the company. Small, dispersed shareholders are typically passive and have few
incentives to invest in monitoring or control. The most important control device for them is the
exit option. Large blockholders, by contrast, cannot easily exit the firm, or only at a substantial
discount. They tend to have longer-term interests in the corporation. They may use this interest to
monitor management, to direct management, but also to collude. If the block-holder is a parent
company, it may try to influence management strategies to benefit the parent or the interests of
the group of companies to which both subsidiary and parent belong. The stakeholders most
endangered by these strategies are minority shareholders, as well as creditors. They may be given
veto power over key decisions or be vested with the right to call an extraordinary shareholder
meeting.

In early corporate laws, decisions affecting the existence of the corporation as an
independent entity (liquidation, mergers) required unanimous shareholder vote. At the time, the
corporation was a relatively small entity run by a homogenous group of shareholders. This

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66 See (Pistor 2000b) for a discussion of antiblockholder devices in corporate law.
67 (Coffee 1991)
68 For a discussion on governance structures and homogeneity or heterogeneity of interests, see (Hansmann
  1990) and (Hansmann 1996).
requirement was subsequently replaced with supermajority requirements for key decisions with 3/4 or 2/3 used as a threshold. This reflected the growing number of shareholders and the greater diversity of interests they represented. For some decisions, the threshold was reduced further. In France, the 1867 law required unanimous vote for changes in the corporate charter. The threshold was reduced to a 2/3 majority in 1930. Delaware also moved from supermajority to simple majority for changes in corporate capital in 1927 and – as discussed above - for asset mergers in 1929.

Instead of using their veto power to hold up decisions that conflicted with their interest, minority shareholders can voice their concern by calling an extraordinary shareholder meeting. The original 1883 law in Delaware allowed any three shareholders to call a special meeting. By 1927, this threshold had been raised to 10 percent of common stock holders. Similar requirements existed in Germany since 1861 and in England since 1909. Germany and England lowered the level to five percent of common stock in 1884 and 1948 respectively. In France, until 1966 any single shareholder could file a motion with a court to call an extraordinary meeting. This low threshold was balanced with a rather cumbersome procedure to call such a meeting. In 1966, France introduced the 10 percent rule and eliminated the need to file a motion with the court.

The effectiveness of rights allocated to shareholders depends to a large extent on voting rules. The one-share-one-vote rule was a contentious issue in the nineteenth century. Per capita voting was common practice in many countries and was widely perceived to be more democratic. In fact, early French commentators found it necessary to justify that corporate practice using the one-share-one-vote rule did not violate public policy. The 1867 law stipulates the one-share-one-vote rule as a default rule, but at the same time established a voting ceiling of ten shares per person. Similar concerns led in England to the adoption of a regressive voting system. For the first 10 shares voting is one vote per share; an additional vote is given for each additional five shares thereafter up to one hundred shares, but only one vote for each ten shares for more than one hundred shares. To this day, voting by showing hands, i.e. voting per capita rather than per share is still recognized as common business practice, although a poll can be called in controversial matters. Of the four countries discussed, France was the only to allow corporate charters to exclude shareholders with only few shares from participating and

69 For the history of voting rights in the US and Europe in the nineteenth century, compare (Dunlavy 1998) For France see also Malepeyre & Jourdain (1833), 220-22.
70 Similar voting systems existed in France. The charter of the Société Anonyme Chemin de Fer d’Orléons founded prior to 1833 for example, provides that for 5 shares there is one vote, for ten two, for twenty three and for forty five. No shareholder has more than 5 votes even if his holdings exceed forty shares.
71 Compare (Davies 1997) p. 589 stating that “unless the company’s regulations otherwise provide, voting is in the first instance by show of hands, i.e. those present indicate their views by raising their hands”.

27
It also included provisions for multiple voting rights, although after 1930 double voting rights may be exercised only if the shares had been registered for at least two years. Germany allowed voting ceilings in the 1884 law and also recognized multiple voting rights until 1937, when the latter were declared void. As of 1998 voting ceilings are also prohibited for companies that are listed on the stock exchange. In the United States the movement towards the one-share-one-vote rule as a default rule occurred earlier than in other countries, but even there, this rule was never made mandatory in corporate law. \(^7^2\) Strong encouragement for the one-share-one-vote rule came, however, from the New York Stock Exchange after 1926.

Shares without voting rights\(^7^3\) were recognized relatively early. In England, the charter could include provisions on nonvoting stock since 1862, in Delaware nonvoting preferred stock were recognized in 1899, and in Germany shares with different voting rights, including shares without voting rights could be issued after 1884. The only jurisdiction to introduce cumulative voting rules among the four discussed here, was Delaware, where the rule became optional in 1917. \(^7^4\) At the face of it, cumulative voting increases the likelihood that small shareholders can elect their representatives to the board, because it allows them to bundle their votes and place all of them behind one candidate. Historically and practically, cumulative voting has been more ambivalent, as it allows current directors who are either shareholders themselves or hold proxy rights of smaller shareholders to ensure that their interests influence the outcome of board elections.

**Corporate Finance**

Corporate finance is the area of greatest divergence among the four jurisdictions and also the area where we observe substantial change over time. All countries initially left the key decisions over corporate capital, including changes in corporate capital, pricing and placement of shares in the hands of shareholders. Some decisions, in particular the repurchase of shares and - at least in some countries - the decrease in corporate capital were removed from shareholder control. They were either flatly prohibited or required state approval. In some jurisdictions, most notably

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\(^7^2\) Note, however, that companies listed on the New York Stock Exchange (NYSE) had to comply with this rule.

\(^7^3\) Sometimes known as preferred stock. Preferred or preferential stock may mean different things in different jurisdictions. France, for example, introduced preferred stock with *multiple* voting rights in 1903.

\(^7^4\) For the history of cumulative voting rules see (Gordon 1994). His detailed analysis of the introduction of cumulative voting in two waves (turn of the dentury, and again after WWII), and their reversal (in the mid 1950s many states that had made cumulative voting mandatory first, relaxed this to opt-in provisions), documents that legal change is often not a one-way road, but quite a dynamic process.
in Delaware, these restrictions gave way in the early twentieth century to a very flexible regime in which shareholders still hold key control rights but can delegate many rights to management. Germany, by contrast, has upheld most restrictions and has begun to relax some of them only over the last couple of years. Table 7 summarizes the major trends for the four origin countries.

### Table 7 Allocation of Control Rights over Corporate Finance:

<table>
<thead>
<tr>
<th>Allocation of Control Rights</th>
<th>France</th>
<th>Germany</th>
<th>England</th>
<th>Delaware</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital increase</strong></td>
<td>1807 Unanimous SH vote</td>
<td>1861 3/4 SH vote</td>
<td>1862 3/4 SH vote</td>
<td>1883 2/3 SH vote</td>
</tr>
<tr>
<td>1867 board resolution + 3/4 SH vote</td>
<td>1884 original contributions must be fully paid in</td>
<td></td>
<td>1929 1/2 SH vote</td>
<td>1935 Directors may increase capital by setting aside net assets</td>
</tr>
<tr>
<td><strong>Capital decrease</strong></td>
<td>1807 Unanimous SH vote</td>
<td>1861 State approval and 3/4 SH vote</td>
<td>1844 Court approval &amp; 3/4 SH vote</td>
<td>1899 2/3 SH vote</td>
</tr>
<tr>
<td>1867 board resolution + 3/4 SH vote</td>
<td>1884 3/4 SH vote</td>
<td>1867 Charter may provide for decrease &amp; 3/4 SH vote</td>
<td>1927 Directors decide to redeem stock</td>
<td></td>
</tr>
<tr>
<td>1935 Bondholders may redeem, if they object</td>
<td></td>
<td>1985 Court confirmation for capital decrease required</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Valuation of in kind contribution</strong></td>
<td>1867 court appointed appraiser</td>
<td>1870 Charter</td>
<td>1844 directors determine value</td>
<td>1899 Board valuation conclusive</td>
</tr>
<tr>
<td></td>
<td>1978 Independent appraiser</td>
<td></td>
<td>1980 Independent appraiser</td>
<td></td>
</tr>
<tr>
<td><strong>Timing, pricing, placement of securities</strong></td>
<td>1973 authorization of stock by SHM; timing and placement by board; price adjustment must be approved by SHM</td>
<td>1884 No issuance of shares below nominal value (1,000 RM)</td>
<td>[1862 authorized unissued stock]</td>
<td>1929 authorized unissued stock; directors determine timing, price and placement</td>
</tr>
<tr>
<td></td>
<td>1897 Preemptive rights mandatory</td>
<td>1937 Preemptive rights may be waived, if less than 10% of stock</td>
<td>1927 bylaws may restrict preemptive rights</td>
<td>1967 Bylaws must explicitly mention preemptive rights for them to apply</td>
</tr>
<tr>
<td></td>
<td>1937 SHM authorizes capital; MB may decide timing and placement within 5 years</td>
<td>1994 Preemptive rights can be waived, if less than 10% of stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1994 Preemptive rights can be waived, if less than 10% of stock</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Repurchase of shares</strong></td>
<td>1998 requires special prospectus &amp; clearance from Sec. Commission</td>
<td>1870 prohibited</td>
<td>1862 charter may determine conditions for repurchase of shares</td>
<td>1883 Directors may redeem unpaid stock</td>
</tr>
<tr>
<td></td>
<td>1884 exception only for formal decrease</td>
<td>1884 for repurchase of shares</td>
<td>1897 case law: repurchase prohibited</td>
<td>1927 Redeemable stock; directors may redeem stock at any time</td>
</tr>
<tr>
<td></td>
<td>1937 up to 10% may be repurchased</td>
<td>1929 redeemable stock may be issued</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1965 Exemptions extended to put options and employee stock options</td>
<td>1948 repurchase permissible under certain conditions</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1998 exemptions extended to management stock options</td>
<td>1980 repurchase permissible if charter conditions are met</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Note: sh = share; SH = shareholder; V = Vote;  
Source: Compilation by authors.
Corporate capital was (and often still is) regarded as a trust fund to protect creditors. In the United States, the trust fund theory was first formulated in *Wood v. Dummer* in 1824,75 in which corporate capital was depicted as the price shareholders have to pay for the privilege of obtaining limited liability.76 The doctrine was also reflected in statutory law. The 1899 Delaware law, for example, holds shareholders liable for the total amount of subscribed but unpaid capital.77 The doctrine worked in practice as long as contributions were in cash rather than in kind. Once in-kind contributions became acceptable, this opened the door for watering stock, as the actual value of these contributions could differ substantially from the value of stock given out in return.78 The key question was whether in case of insolvency the contribution made could be re-assessed and shareholders potentially held liable for additional contributions. Since shares were transferable this raised the question, whether the original or also subsequent shareholders could be held liable.

Two responses can be observed to this problem. One was to shield shareholders from the risk of reappraisal. Several states included provisions that assured shareholders that the valuation of their contributions was final and thus could not be challenged in future by creditors. This was accomplished by making the directors’ assessment conclusive, which was done in New Jersey in 1898 and in Delaware in 1899. Another response was to require a third party appraisal at the time the contribution was made. France required an independent appraisal of in kind contributions in 1867. Germany left the evaluation to shareholders, but required that the charter explicitly stated the number of shares issued in return for the contribution. In 1978 Germany followed the French model, which had become the EU model, and required independent appraisal for in kind contributions. In England explicit provisions on the valuation of in kind contributions did not exist before 1980, when independent appraisal became the norm following EU guidelines.

The next logical step in shifting control rights over issues of corporate finance from the state/legislature to shareholders and ultimately management was to drop the legal requirement that only shares with specified par value could be issued. Delaware was one of the first states in the United States to allow the issuance of non par value stock in 1917. Even before this change,

76 Justice Story in *Wood v. Dummer* ob cit at p. 436 stated that “…the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. (…) The individual shareholders are not liable for the debts of the banks in their private capacities. The charter relieves them from personal responsibility, and substitutes the capital stock in its stead.” (emphasis added). Note that although the case involved a bank, the doctrine applied to corporations more generally. For an account of similar views in German doctrine, see (Mestmäcker 1958) pp. 227.
77 Section 14 of the 1899 Delaware law.
the nominal value itself was established in the charter rather than being mandated by law. The only requirement that was mandatory was that at least US$1,000 of the capital had to be paid in before a company could commence operation. Germany, by contrast, mandated a minimum par value of RM 1,000 in 1884. This was a major increase after the 1870 law and demonstrates the legislature’s belief that it had to prevent small investors from investing in stock. In 1937 Germany introduced minimum capital requirements of RM 500,000 (US$…), and DM 100,000 in 1965. This reflected the basic concept that the legal form of the publicly traded joint stock company should be reserved for large corporate undertakings. For smaller companies, a special law on limited liability companies was introduced in 1892. Capital requirements are still only half of that required for the large corporation, but stakes in the limited liability company cannot be publicly traded. Recognizing the increasing importance of tradability of shares for small and medium size companies, an amendment to the law on joint stock companies introduced in 1994 relaxed some of the existing entry barriers. The minimum capital requirement, however, was left unchanged. Minimum capital requirements were introduced in France in 1966 and extended to the UK after it joined the European Union in 1980.

The contrast between the flexibility of the Delaware law and the rigidity imposed by most other corporate laws, especially by the German law is most pronounced in the allocation of control rights over decisions concerning the use of financial instruments for structuring control transactions, including authorized stock, preemptive rights, and the repurchase of shares. Authorized but unissued stock places the decision over timing of a stock placement in the hands of directors. Preemptive rights give current shareholders a priority right to acquire newly issued stock. Any relaxation of preemptive rights shifts the right over placing this stock with outside shareholders to the board of directors or management respectively. Similarly, the prohibition of share repurchase by the corporation limits the possibilities of the board to use repurchase as a defense strategy, but also prevents them from offering repurchase as a substitute for dividend payments.

As Table [7] documents, Delaware had shifted control rights over these issues from shareholders to directors by 1930. In Germany, they remain firmly vested in the hands of shareholders, reducing the ability of firms to flexibly respond to new business opportunities. Although it has become possible in Germany for shareholders to authorize unissued stock in 1937, a number of strings were attached. The board can dispose of the issued stock only for a

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78 See (Larcom 1937).
79 It is not clear that this does impose a major entry barrier. Its significance lies more in the fact that the legislature still regards this as an important device for protecting creditors and for regulating the market for publicly traded as opposed to closely held corporations.
period of five years. Stock has to be authorized at least at the minimum nominal value required by law and cannot be sold for less than par. Should a change become necessary, another decision by the shareholder meeting is required. Moreover, the law still guarantees shareholders a preemptive right (since 1897). Although this right can be waived with a ¾ majority vote, it proved to be difficult to combine the authorization of unissued stock with a waiver of preemptive rights. This resulted less from the wording of the law, but from case law. The German Supreme Court (BGH) ruled in 1978 that preemptive rights could be waived only, if shareholders were compensated for relinquishing these rights. This required that the transaction over the newly issued shares was sufficiently specified to assess its benefits and compare them with the benefits of preemptive rights which shareholders were asked to relinquish. After having confirmed these criteria in several decisions, first signs that the court would change its opinion appeared in 1994 in a case involving a major bank (Deutsche Bank). In this decision, the court held that the plan to place stock on a foreign stock exchange (Tokyo) was sufficiently specified to justify a waiver of preemptive rights. Moreover, an amendment of the corporate law introduced in the same year signaled that lower demands should be placed on the authorization of stock, as long as it amounted to less than 10 percent of total capital. In 1997 finally, the court put aside the specification requirement and accepted a waiver of preemptive rights with the general justification that the shares could be used for future control transactions.

The Deutsche Bank decision came seventy years after Delaware enacted an amendment giving shareholders the right to restrict preemptive rights in the charter. As of 1967, corporate charters must explicitly stipulate preemptive rights for them to be applicable at all. This was a 180-degree change from the early nineteenth century, when courts ruled that preemptive rights were a core right of shareholders that could not be taken away from them. Common law, however, cannot be held responsible for this opinion, as preemptive rights were not included in the English companies’ act. Preemptive rights were included only after the UK joined the EU and was required to harmonize its law with the EU directives on corporate law. France allowed preemptive rights to be waived by simple majority vote already in 1935 (i.e. shortly after Delaware). The EU directive does not require more than a simple majority for waiving

82 BGH, 7.3. 1994 – II ZR 52/93, published in NJW 1994 (21), pp 1410 (Deutsche Bank)
84 Quote provision of corporate code.
85 (Larcom 1937).
preemptive rights – although individual countries may establish higher requirements as Germany did.

The right of shareholders to ensure that their stake is not diluted by the issuance of shares to outsiders seems to follow directly from shareholders holding the residual rights of control. Preemptive rights were also used by LLSV as one of the indicators for minority shareholder protection. Why then has this right been dismantled over time? The reason can be found in the benefits arising from placing newly issued shares to the highest bidder rather than to existing shareholders. When markets are working effectively and shares are placed on the open market, shareholders gain little from preemptive rights. They can buy shares at market value and thus ensure that their stake is not diluted. When markets do not work well and/or shares are placed with targeted investors rather than on the open market, the position of shareholders is potentially at greater risk. However, even then placing shares with outsiders may benefit existing shareholders not the least because it opens new sources of funds.

Another example of the flexibility/rigidity continuum across jurisdictions in matters relating to corporate finance is the repurchase of a company’s own shares. Obviously, this may open the door for misuse, as directors may be tempted to manipulate share prices or use repurchase as a defense strategy against hostile takeovers. With the exception of Delaware, all countries prohibited the purchase of own shares by the corporation in early statutes. Initially, Delaware law did not explicitly allow the repurchase, but a provision in the 1899 law, stating that the corporation could not vote its own stock implied at least that the corporation could hold its own stock. By 1931 it was clearly established that the corporation could buy its own stock at any time and that directors were the ones in charge of this transaction. In other countries, exceptions were allowed only for repurchases as a means to reduce corporate capital, which had to follow other procedures established by law, including shareholder supermajority vote. England allowed the issuance of redeemable stock in 1929. In 1948 it also relaxed some of the restrictions on repurchasing common stock. In response to the economic recession in Germany in the early 1930s, two emergence regulations relaxed the prohibition and permitted share repurchase, if this was done to avoid major damages for the corporation. The 1937 law enumerated exemptions from the general prohibition of repurchase, provided that not more than ten percent of total stock was acquired. The list of exemptions was expanded in 1965 and again in 1998. This last amendment reflects the continued reservation of the legislature with respect to the repurchase of shares by stating that in no case is trading in company shares sufficient to justify share repurchases.
Allocation of Control Rights in Four Origin Countries

The four origin countries have pursued different strategies in allocating control rights over key decisions as the previous discussion reveals. Tables 8 and 9 below summarize the results in a schematic way. Table 8 documents the allocation of control rights in the first corporate statute after the introduction of free registration. Table 9 reflects the current allocation of control rights. We distinguish whether control rights are vested with the legislature, or are allocated with shareholders, directors, creditors, or labor. Control rights are vested with the legislature (law), when the law prescribes the outcome and stakeholders cannot change it.

Table 8: Initial Allocation of Control Rights

<table>
<thead>
<tr>
<th>Existence of company as independent entity</th>
<th>France 1867</th>
<th>Germany 1884</th>
<th>England 1844</th>
<th>Delaware 1883</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Governance</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
</tr>
<tr>
<td>Corporate Finance</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
</tr>
</tbody>
</table>

Note: SH = shareholders, CR = creditors, D = directors, L = labor.
Source: Compilation by authors.

Table 9: Current Allocation of Control Rights

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Governance</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
</tr>
<tr>
<td>Corporate Finance</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
<td>SH</td>
</tr>
</tbody>
</table>

Note: SH = shareholders, CR = creditors, D = directors, L = labor.
Source: Compilation by authors.

The tables reveal important differences across jurisdictions and over time. France and Germany exhibit stronger legal prescriptions already in the initial laws than England or Delaware. In the most recent laws, some of the provisions are relaxed in favor of shareholders. Moreover, creditors and labor have a voice in key decisions, including mergers (creditors in France) and the governance structure of firms (labor in Germany). In England control rights are vested primarily with shareholders. This has changed only recently and primarily as a result of EU legislation. Delaware differs from the other three jurisdictions in the extent to which directors are vested with primary control rights over key decisions. While in the initial law this has affected primarily the
governance structure of firms (directors were empowered to change bylaws), subsequently it was extended to other key areas including merger transactions and corporate finance. In the following section we explore the implications of the different allocation of control rights for the development of corporate law.

V. Flexibility, Legal Void and Complementary Control Devices

The allocation of control rights has implications for the responsiveness of the corporation to a changing environment, and for its ability to innovate and adapt in a competitive environment. If shareholders were to exercise all key control rights, the responsiveness of the corporation would be seriously impeded. Sharing control rights between shareholders and other stakeholders of the firm is therefore indispensable, if firms are to expand and to survive. The initial allocation of control rights and the use of mandatory rather than default provisions has influenced the evolution of corporate law. The appeal of the mandatory system is the clarity and certainty of the law, which avoids disputes and thus saves enforcement costs. But it also creates costs, as it rests on the assumption that lawmakers can make a superior allocation of rights than the parties themselves. If the lawmaker gets it wrong, but does not allow for change, this creates inefficiencies. A Coasian reallocation of rights is not possible under a system of mandatory legal allocation. Because of its rigidities, the mandatory allocation of rights impedes change and innovation.

A more flexible corporate law enhances the responsiveness of firms to changing market conditions. Proponents of the contractual theory of the corporation have long hailed the superiority of a corporate law that allows companies to opt out of the corporate law and design their own charter on a contractual basis. Opponents have warned that this may be to the detriment of shareholder rights. Our analysis suggests that both sides have a point. Greater flexibility has by and large led to a shift of control rights from shareholders to directors and not the other way around. The gain was greater flexibility, which enabled the corporation to react quickly to a changing environment and to implement strategic moves without going through cumbersome procedures to ensure shareholder rights. The puzzle is, why the greater flexibility of corporate law with the extended control rights it leaves with management we have seen in

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86 As (Priest and Klein 1984) have shown, disputes are selected for litigation, when the outcome of litigation is unknown to the parties. Otherwise they are likely to settle voluntarily. See also (Fisch 2000) at pp. 33 for a discussion of the standard arguments in favor of clear predictable laws.
87 (Easterbrook and Fischel 1991; Romano 1989; Romano 1993). Critical
88 (Bebchuk 1989)
Delaware since the early twentieth century, and which is now followed by other countries, has not led to a complete expropriation of shareholders, but has by and large enhanced shareholder value. The answer seems to lie in the control devices that have emerged to fill the control void that resulted from the reallocation of control rights. In the following we will discuss three control devices that filled the control vacuum that resulted from a more flexible law: exit rights, judicial recourse, and securities market regulation and supervision. Table 10 summarizes the relationship between flexible control rights and complementary control devices.

<table>
<thead>
<tr>
<th>Existence as independent entity</th>
<th>Rigid law</th>
<th>Flexible Law</th>
<th>Complementary Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unanimous vote/supermajority for mergers</td>
<td>Simple majority for mergers</td>
<td>Appraisal right</td>
<td></td>
</tr>
<tr>
<td>Mandatory takeover bid</td>
<td></td>
<td>Judicial Recourse</td>
<td></td>
</tr>
<tr>
<td>Corporate Governance</td>
<td>Two-tier board structure</td>
<td>Charter determines structure and rights</td>
<td>Judicial Recourse</td>
</tr>
<tr>
<td>In compatibility of dual seats</td>
<td>Directors may change bylaws and delegate management functions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delineation of shareholder and manager rights</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate Finance</td>
<td>Minimum capital requirements</td>
<td>Directors determine timing and placement of stock</td>
<td>Mandatory disclosure rules</td>
</tr>
<tr>
<td>Par value of shares</td>
<td>-authorized unissued stock</td>
<td>Capital market oversight</td>
<td></td>
</tr>
<tr>
<td>Restrictions on repurchase</td>
<td>-no preemptive rights</td>
<td></td>
<td></td>
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<td>Strict preemptive rights</td>
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**Exit Rights**

One way to compensate shareholders for less extensive control rights is to strengthen their exit rights. There has been much discussion in the comparative corporate governance literature about the costs and benefits of the two mechanisms of control, voice and exit. Voice refers to the control rights, discussed above, most important among them voting rights on key decisions. Exit refers to the right of shareholders to leave the corporation at any time by selling their shares. The early corporate statutes all recognized the rights of shareholders to freely sell their shares. The two common law jurisdictions were most explicit and declared that shares are personal asset, which may be freely traded. Nevertheless, corporate charters could subject the trading in shares to the approval of the board or the shareholder meeting. Even where an

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89 (Daines 2000)
90 The terminology goes back to Hirschman, see (Hirschman 1970). Representative for the extensive literature on this matter are (Coffee 1991); (Black 1998).
91 UK law of 1844. See also Section 18.3 of the Delaware law of 1883.
unrestricted exit option exists, it might be worth little, when the share value declines prior to exit as a result of a decision taken by the board or the shareholder meeting.

Recognizing the adverse effect these decisions might have particularly on the value of minority stock, dissenting shareholders were given the right to demand the repurchase of their shares at a fair price if they dissented key decisions that could affect their rights. Delaware introduced such a rule for merger transactions in 1899. Unlike other states, it never extended appraisal rights beyond merger transactions.

The appraisal right as it has developed in the United States should be distinguished from the mandatory appraisal of merger transactions under EU and the corresponding national laws of Germany, France, and the UK. In the latter case, any merger transaction triggers a mandatory appraisal and minority shareholders are bound by the outsider appraisers’ assessment. Minority shareholders’ exit option can also be strengthened by other means, such as mandatory takeover bids. They require that a bidder who acquires a stake exceeding a certain minimum must extend his offer to all remaining shareholders. Within Europe, the UK led the development of mandatory takeover law with its voluntary take-over code that dates back to the 1950s. The EU is currently in the process of adopting a takeover directive, which is loosely modeled on this model. However, the version currently under discussion has been much watered down in comparison to earlier versions.

Judicial Recourse

The function of shareholder derivative suits is to resolve disputes over the allocation of rights between shareholders and directors and/or management. Where stakeholders design their own governance structure and shift control rights during the lifetime of the corporation, the need for this control device is readily apparent. What is less clear is how the dispute can be resolved in light of the fact that the law itself offers little guidance as to how control rights should be allocated. As will be further discussed below, the existence of legal principles that deal with the shared or overlapping control rights outside the corporate law, in particular the common law principles of fiduciary duty, has proved an important resource for courts in common law jurisdictions. An important procedural device to enhance judicial recourse was to give shareholders the right to sue on behalf of the corporation (derivative action). Judicial recourse

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92 For an overview over the history of appraisal rights in the United States, compare (Siegel 1995).
93 For evidence on how divergent corporate statutes in the U.S. are to this day on this issue see Siegel, ob cit. footnote 92. She notes that there is probably no area in corporate law where states diverge as much from each other, as well as from the American Law Institute’s Principles of Corporate Governance, or the Model Business Corporation Act, as in the use of this remedy.
seriously restricted the scope of managerial power under Delaware law. As early as 1913 did the Delaware Supreme court state that a court would not be bound by formalities or the letter of the law when scrutinizing fraudulent action by corporate managers. By 1939 it was firmly established that directors were subject to principles of fiduciary duty. The increasing flexibility in the corporate law was thus paralleled by a strengthening of judicial oversight. As Professor Coffee put it, the fiduciary duty is “corporate’s law most mandatory core”. Interestingly, English law has been much more restrictive in allowing shareholders to bring suit on behalf of the company. In principle, it was held the shareholder meeting rather than individual shareholders should have the right to sue on behalf of the company. Case law has over time relaxed these provisions leading in substance, and since 1975 in words to the acceptance of derivative actions. Importantly, only since 1975 could shareholders be indemnified by the corporation for taking such action. Previously, shareholder bore the cost of litigation, while the corporation would benefit from any compensation the action would bring.

Courts in civil law jurisdictions are more confined to the letter of law. This may be a reason why Germany and France, the two civil law jurisdictions in the sample, have opted for a mandatory allocation of control rights by law. This has implied that courts have been much less developed in the development of corporate law in these jurisdictions. The law created substantial barriers for shareholders to turn to the courts. Derivative actions are still not recognized in either France or Germany. In Germany, shareholders must still turn to the supervisory board, which instigates the lawsuit or request the court to nominate special shareholder representatives. The threshold for the proportion of shares required for shareholders to demand an action of the supervisory board has been reduced in 1998 form 10 to 5 percent. However, the substantive requirements have been raised simultaneously. The court is required to nominate special representative who will instigate the lawsuit only, if evidence suggests that shareholders have been damaged by serious misuse or fraud.

The discussion of the development of preemptive rights above suggests that courts are increasingly recognizing their function to balance the tradeoffs between greater flexibility and the protection of stakeholders. Still, it will take some time for them to develop a complex set of

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95 Guth v. Loft, 5 A. 2d 503 (Del. 1939).
96 (Coffee 1989). See also (Moore 1994).
97 The restrictive elements were established in Foss v. Harbottle (1843) 2 Hare 461. The terminology “derivative action” was accepted in Wallersteiner v. Moir (no.2 1975) Q.B. 373, C.A. For the development of shareholder action under English law, compare (Davies 1997) pp. 658.
98 Art. 147 Section 3 as revised by the law on transparency and control for enterprises, 30 April 1998, BGBl 1998 I 786 (788).
principles. Moreover, substantial uncertainties remain as to the procedural prerequisites for more extensive shareholder suits. Thus, the choice of a highly regulated mandatory corporate law, which was first made in 1884 but substantially reinforced in 1937\footnote{Spindler 1998} has retarded the development of shareholder litigation as a complementary control device.

Securities Regulation

Litigation offers a mechanism of ex post control for disgruntled shareholders. With the development of capital markets legislatures increasingly felt that this was not sufficient to protect investors. Experiments with financial market regulation can be traced to the seventeenth century, when England first enacted legislation on brokers and jobbers, i.e. financial intermediaries.\footnote{Neal 1990} However, self-regulation remained the primary mode of financial market regulation in Britain to this day, even though this system is now undergoing extensive reforms.\footnote{Warren 1990; White 1996} In Germany, the first law on securities exchanges (Börsengesetz) was enacted 1896, as one of the legislative responses to the crash of the market in the 1870s.\footnote{An overview over the history of securities market regulation in Germany can be found in Merkt in (Hopt, Rudolph and Baum 1997). For the development since 1998, see (Weber 2000).} It dealt primarily with the regulation of financial intermediaries, but also included a provision on promoter liability for wrongful information related to a public issuance. The law did not specify the type of information that had to be disclosed in the prospectus, however. Moreover a central agency to enforce these regulations did not exist in Germany at the time. Market supervision was conducted by regional agencies in the individual states, and markets remained rather fragmented until the 1980s. A federal market supervision agency was established only in 1994. The triggering event was a EU directive, which required member states to establish effective supervisory agencies. France established a securities commission in 1967 to supervise capital markets. It was later replaced by the Stock Exchange Counsel (now Counsel of Capital Markets).

In the US, state legislation spearheaded the development in securities market regulation with the adoption of the blue-sky laws since 1913.\footnote{After the market crash during the Great Depression, the federal legislature felt compelled to intervene and establish a regulatory framework for interstate commerce in securities. The result was the securities market regulation of 1933/34, and the creation of the Securities and Exchange Commission (SEC). Unlike some blue-sky laws, which used merit requirements as entry barriers to the market, and gave a designated state agency the right to refuse a public offering unless it offered a ‘fair value’, the 1933/34 law established a national securities commission with broad regulatory powers and a national securities exchange act.} After the market crash during the Great Depression, the federal legislature felt compelled to intervene and establish a regulatory framework for interstate commerce in securities. The result was the securities market regulation of 1933/34, and the creation of the Securities and Exchange Commission (SEC). Unlike some blue-sky laws, which used merit requirements as entry barriers to the market, and gave a designated state agency the right to refuse a public offering unless it offered a ‘fair value’, the

\footnote{Spindler 1998} at p. 55.
\footnote{Neal 1990}. For a discussion of early English securities legislation see also (Cheffins 2000).
\footnote{An overview over the history of securities market regulation in Germany can be found in Merkt in (Hopt, Rudolph and Baum 1997). For the development since 1998, see (Weber 2000).}
federal regulation focused on disclosure. Although the requirements are mandatory, they do not attempt to allocate control rights or to interfere with the design of the governance structure or financial strategies of the firm. Their primary purpose is to ensure that those wishing to participate in the corporate enterprise are adequately informed to make rational decisions, but to let them judge the merits of the investment opportunity. Prior to the enactment of securities and exchange regulations, disclosure requirements existed in many corporate laws in the form of annual financial reports to be presented to shareholders. The novelty of securities regulation was to extend the right to adequate information from shareholders to the public at large.

The merits of a mandatory disclosure regime have been subject to much debate. Yet, there is empirical evidence that a strong mandatory disclosure regime has had a positive impact on capital market development. There is also substantial evidence that companies have migrated to strictly regulated markets in the past, rather than engaged in a race to the bottom by selecting less regulated markets for public issuances. A possible explanation for this trend is that securities market regulation is a functional substitute for weak corporate law protection of shareholders. The underlying assumption of this proposition is that shareholders value legal protection and therefore place a discount on shares in markets where their interests are not well protected. Firms wishing to raise funds at reasonable costs therefore migrate to markets that offer sufficient protection.

The analysis presented in this paper suggests a different argument. We propose that a shift of control rights from shareholders to management, and thus the dismantling of key shareholder rights, was crucial for enhancing the adaptability of the firm to a changing environment. This in turn raised the value of firms that were able to exploit new growth opportunities and to succeed in highly competitive markets. Securities markets, and by implication securities market regulation, play a more indirect role. They enable shareholders to cash in their earnings in successful firms and facilitate the placement of shares as a strategic device. The migration of firms to major markets, in particular the US in recent years can be explained by the high liquidity of this market and the high returns paid to investors. Reliable

103 On the history of blue sky laws see (Macey and P. 1991).
104 Add details of information requirements.
105 Even this rather limited function of securities regulation has been subject of much debate. See, for example, (Stigler 1961) and (Jarrell 1981). For a defense of the federal securities regime compare (Seligman 1983) and (Coffee 1984). Critical, however, (Romano 1998) who advocates state competition in securities regulation.
106 (La Porta et al. 1997) using accountant regulations as a proxy for disclosure. See also (Pistor, Raiser and Gelper 2000) who show that in transition economies, an index for securities market regulation correlates positively with market development, unlike other indices that capture corporate law provisions.
107 (Coffee 1999).
information is an important factor in this process and investors therefore pay a premium in markets where information is readily available, i.e. in markets with a mandatory standardized disclosure regime. But these rules are not substitutes for weak shareholder protection. In fact many firms that have migrated to the US in recent years have more extensive/rigid shareholder protection at home than companies that are registered in the state of Delaware. The dismantling of some of these rules, in particular of mandatory preemptive rights, was a precondition for firms to migrate to other markets.

Empirical evidence also questions the substitution hypothesis. Recent empirical evidence suggests that firms registered in Delaware are valued higher by the market than firms incorporated in other states in the US. However, if securities and exchange regulations fully substitute for deficiencies in the corporate law, companies listed on markets that are governed by the same securities rules should be valued equally. The premium investors pay for Delaware suggests that there is something in Delaware law they value, which is not captured by federal securities regulations. A possible explanation is that Delaware’s legal system offers more than just the law on the books; namely, a legal elite that is well trained in corporate law and that has gained a reputation effectively to settle disputes and develop guidelines for future cases. A related explanation would be that they value the flexibility this law affords them, subject to the flexible restrictions imposed by Delaware courts.

We therefore propose that strong securities market regulation is not a substitute for weak shareholder rights, but that the two are complements: lower protection allows for greater flexibility, which enhances the importance of the stock exchange. The potential for misuse the greater flexibility allows is controlled by effective securities market regulation. The discussion of shareholder litigation leads to similar results. Shareholder suits are an important governance device if the allocation of control rights is flexible and determined by stakeholders rather than by law. The responsibility to delineate the rights of various stakeholders in a particular conflict shifts to the courts. As long as the allocation of rights is determined ex ante by the legislature, there is little demand for litigation. The following testable propositions follow from this. First, we should observe a positive correlation between flexibility in the allocation of control rights on the books and the number of shareholder suits (controlling for procedural constraints). Second, the size and liquidity of capital markets is positively correlated with an allocation of control rights over corporate finance and corporate control that allows for substantial flexibility.

The previous discussion of the four origin countries tentatively supports these propositions. There is substantial evidence in the US that courts have come to play an increasing
role in interpreting and enforcing shareholder rights after the liberalization of corporate law. Shareholder suits have played an important role also in the UK, where the law placed comparatively few restrictions, even though the shift of control rights from shareholder to directors never went as far as in Delaware. By contrast, neither France nor Germany has witnessed a significant number of shareholder suits in the past, although numbers have increased in recent years after some earlier restrictions were relaxed.

VI. Legal Transplants

We now turn to an analysis of the development of corporate law in Spain, Chile, Colombia, Israel, Malaysia, and Japan. All countries received their formal corporate law from France, England, and Germany/US, respectively. We will discuss countries that received their formal law from the same source together and draw comparisons to the origin country in order to trace whether the transplantation of a particular legal system led to significant path dependency. The analysis follows the same structure as the analysis of the origin countries and addresses the existence of the corporation as an independent entity, its governance structure, and issues of corporate finance.

Existence of corporation as independent entity

Spain experienced substantial influx of French law during the reign of the Bourbons in the late eighteenth century. The law governing commercial activities, however, was based primarily on Spanish imperial law governing entrance to the market and customary trade law governing transactions among entrepreneurs. The Napoleonic codes arrived in Spain with the French troops. After they had left in 1815, the codes were kept on the books on a preliminary basis, but they were subsequently replaced with national legislation, which resembled the French law in many aspects, but was not identical with it. The Spanish Código de Comercio of 1829 broke with a long tradition of special privileges, which granted far-reaching autonomy to merchants in Spain. It legalized the relationship between the state and entrepreneurs as well as among them. Forty years before France introduced the system of free incorporation subject only to registration, Spain did so in the 1829 law. Although courts had substantial discretion in refusing registration, a special state concession was not required. In response to the liberalization

108 (Daines 2000).
109 (Coffee 1989).
110 (Coing 1986).
of entry requirements, Spain experienced a major founders’ boom, followed by a severe crash.\textsuperscript{112} The backlash occurred twenty years later, in 1848. The amended code demanded a royal decree as a condition for incorporation. This stifled the market and had adverse effects on economic development. In 1869, the pendulum swung back to free incorporation. At that time, the leading European powers, including France had also dropped the concession requirement, and rather than spearheading this development as in 1829, Spain now mimicked it. For the long term development of corporate law in Spain, the revision of the Código de Comercio of 1885 has been decisive. A major characteristic of this code was its emphasis on creditor rights. For example, merger transactions were made subject to creditor consent unless provisions were made to fully preserve their rights. Case law based on the 1885 code required unanimous approval of merger transactions. The 1951 revision of the code upheld most of these provisions.

After 1815, an independence movement swept Latin America. New states were formed and constitutions adopted, which were modeled after the French constitution of the first Republic, or the US constitution, or a combination of both.\textsuperscript{113} The enactment of civil and commercial law was delayed until mid century in most of the newly independent states. Chile was one of the first countries in Latin America to enact major codifications for civil and commercial law. It borrowed from France as well as Spain, which itself was strongly influenced by French law. The drafters of the code did not only copy the law on the books, but incorporated case law and in part legal doctrine that had developed in Europe since the codes had been enacted there.\textsuperscript{114} The 1854 law set the grounds for strong state control over commercial activities, which lasted in the areas of corporate law until 1981. Two royal decrees were required for a company’s complete incorporation; one authorizing incorporation, the other verifying lawful incorporation and allowing the commencement of business. Only then could a company be registered, but in any case only for a fixed term, which was to be stipulated in the charter. State control also extended to mergers and liquidation. An amendment of 1970 reallocated control rights over mergers to shareholders and required a supermajority vote of 2/3. In 1981, the Chilean corporate law experienced a major revision. The new law borrowed heavily from the US. It introduced the principle of free incorporation – over a hundred years later than the origin countries France and Spain and shifted control rights over liquidation and mergers to shareholders. Unlike Spain, it did not include strong creditor protections.

\textsuperscript{112} This resembled the experience of several origin countries. See above especially the discussion of Germany’s founders’ boom in the 1870s.
\textsuperscript{113} For a discussion of the American influence on Latin American constitutions, see (Kolesar 1990).
\textsuperscript{114} (Law 1972), ‘Chile’; (Merryman 1985).
Colombia introduced one of the most liberal incorporation regimes in the world in 1853. The lawmakers followed essentially the Spanish 1829 code, apparently without recognizing that Spain itself had moved back to a concession system in 1848. The country was economically backwards and had only few incorporated companies, all of which had been authorized under Spanish imperial rule. Even after the enactment of the new code, few entrepreneurs were aware of the possibilities it offered and continued to operate as unlimited partnerships rather than seeking the protection of limited liability the law now offered. Thus, in contrast to Spain in 1829 where the liberalization of entry requirements led to a founders’ boom, the equally liberal Colombian law had little impact on economic development. In 1887 the code was revised, most likely in an attempt to stay in tune with legal developments in neighboring countries, where major revisions of commercial laws took place in the 1880s. There were little internal reasons for a major revision of the code. The model chosen this time was the Chilean law of 1854. The copy was almost identical with the Chilean model, and included the rigid entry requirement of two presidential (rather than royal) decrees, this time ignoring that by then the Chilean model lacked far behind the European trends. Voluntary dissolution also became subject to governmental approval. The Colombian case is an interesting example of a country that was backwards in socioeconomic as well as in legal development. In particular, it lacked domestic legal expertise to assess the implications of particular laws. The choice of external models was determined primarily by the prestige of these models. Internal socioeconomic developments as well as systematic concerns were ignored. Similarly, when the code was amended again 1888 to introduce (again) free incorporation, other restrictive features of the Chilean law that served as a model were not adapted. There is little evidence that this approach to lawmaking has changed since. The last major revision of the Colombian commercial code was in 1971, which is surprising in light of the extensive legal reform projects around the world in the area of corporate law especially in the 1980s and 1990s.

The transmission of British law to its former colonies was more gradual, in part because unlike codified law, case law cannot be transplanted instantaneously. In most cases, a decree of the colonial power would rule that the English contract or company law as it existed at that particular date would now be applied in the colonized territories. Where English judges sat in court to apply the law, the evolving case law used English precedents. Yet, the different facts presented in the territories and recognition of local legal customs meant that the case law

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115 See (Means 1980) for a detailed account of the development of corporate law in Columbia in the nineteenth century.

116 For details see Means ob cit at note 115.
diverged from the origin country. Consistency of legal development was achieved by using the Privy Council in England as the Supreme Court for the colonial empire. Many countries continued to refer their cases to this court even after independence. In Malaysia this was the case until 1985. England also began to codify its law for the purpose of transplanting it to its colonies. India became the testing ground for this strategy. It was in this tradition that the English Companies Act was introduced in Israel and Malaysia in 1929. Israel had become a British protectorate after the dissolution of the Ottoman Empire following World War I. The territories that today comprise Malaysia were colonized by Britain in the late 1800s and the Federal Malay States established in 1896 leading to an influx of English law. The law was targeted primarily at English entrepreneurs in the colonies. Transactions among locals could be governed by customary law, which was recognized in English courts.

The 1929 law closely mirrors the timing of the transplantation. Free incorporation and shareholder control over major transactions were the hallmarks of the English law at the time and were introduced without change in Israel and Malaysia. Malaysia revised the corporate law in 1965 using Australia rather than the former colonial power as a model. Since the Australian law of the time was still very faithful to the English model, the law ultimately closely resembled the 1948 UK law. Since 1965 there have been few changes in the Malaysian corporate law itself, although important changes have taken place in the area of securities legislation, as will be further discussed below.

Israel left the English law unchanged for an even longer period. In 1967 a package of securities market regulations was introduced, but the corporate law itself was revised only in 1983. Some important changes affecting the control rights over the existence of the company as an independent legal entity were introduced at that time. Most importantly, the company’s registrar was given the power to refuse incorporation on public interest grounds. In 1999, this provision was repealed. The registrar is now obliged to incorporate any company unless there is evidence of violations of the law, including of the procedural requirements for incorporation.

Japan experienced two major corporate law transplants. In 1898 it enacted a commercial code that was largely modeled on German law. After World War II, Japan replaced this

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117 This is reflected in the development of entire bodies of law, which at least in England are referred to as, for example, “Chinese common law”. For a comparison of the influence of different Western laws on the law in Southeast Asia, see (Hooker 1978) and (Hooker 1988).
118 The starting point was the Indian Contract Act of 1872, followed by the Negotiable Instruments Act of 1882, the Indian Patents Act of 1911, the Indian Copyrights Act of 1914, and the Bombay Securities and Control Act of 1925. For a chronological overview compare (Pistor and Wellons 1999) Appendix 3A, p. 56.
119 See ibid at p. 57.
120 See (Baum and Takahashi 2000).
corporate law regime with a new one modeled on U.S. law, in particular the law of the state of Illinois. The change had little impact on incorporation, as free incorporation subject only to registration was recognized already in the 1898 law. Yet, merger rules were affected by the change. While under the 1898 law mergers required only public notice as well as a simple majority vote (by interest and number), the new law established a 2/3 majority requirement in number, provided that half of the stock was represented at the meeting. This amendment strengthened control rights of minority shareholders.

**Corporate Governance**

Corporations in the transplant countries considered here are governed by a simple one-tier board structure. This is true even for Japan, despite the fact that at the time Japan adopted the German law, a two-tier structure had already become mandatory in Germany. The details of the function of boards were left to the charter in all countries.

Where the state exercised control rights over entry and exit of corporations, it also ensured that it had some say over the governance of firms. This was the case in Spain between 1848 and 1868, i.e. during the period when the government tried to regain control over the economy after the initial liberalization of 1829, only to thwart the already ailing economic development. During this period, the government reserved the right to monitor the corporation as well as to call a special shareholder meeting at any time. Shareholders representing at least ten percent of total stock were vested with this right only in 1947. Chile adopted the idea of continuous state monitoring in 1854 by including a provision that allowed the government to appoint a special inspector to supervise the corporation. Colombia followed suit in the 1887 law, although the provision was dropped again in 1888, while it remained on the books in Chile until 1981. Creditor control in matters of corporate governance was strong in particular in Spain, but increasingly also in Chile. The Spanish code of 1829 stipulated that creditors can sue management for ultra vires acts, thereby giving them some control rights over the scope of business activities. Chile introduced strong protections for bondholders in 1929 and strengthened their rights in 1931. Bondholders were to organize in special bondholder associations. In case of default, the association of bondholders could demand the replacement of individual directors deemed responsible for the default. By contrast, minority shareholders were given comparatively few control rights in Chilean law, apparently because state control was sought to be sufficient to take care of their interests. Under the 1931 law shareholder representing at least 25 percent of

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121 See (West 2000b).
122 This threshold was lowered to 5 percent in 1989.
common stock could demand an extraordinary shareholder meeting. The threshold at the time in other jurisdictions was ten percent, or even as low as five percent in England and Germany. Chile adopted this rule only in 1981, and in Colombia the threshold is still 20 percent today.

As far as the delineation of powers between the shareholder meeting and the board is concerned, Spain, Chile and Colombia follow by and large the French model. This is also true for voting rights. As discussed above, in French law it was possible to disenfranchise shareholders who held less than a minimum number of shares. The same was true for the other countries belonging to the French civil law family. This rule enhances the control of blockholders and deprives minority shareholders of the right to exert voice in the corporation even in coalition with other minority shareholders. They also copied the concept of the *actions industrielles*, which gave founders special shares with the right to dividends. The shares were to compensate for services rendered, similar to contributions in kind. However, they did not confer voting rights and thus had no influence on the allocation of control rights among different groups of shareholders. These special shares were abolished in Chile in 1981, but still exist in the other countries of this family, including in France.

In Israel and Malaysia designing the governance structure was and still is primarily the task of the articles of incorporation (charter). Fundamental decisions, including changes in the charter or bylaws, the corporate capital as well as decisions on mergers or liquidation have to be approved by special resolution requiring 3/4 majority vote. The shareholder meeting appoints and dismisses the members. In Malaysia, the board exercises the right to dismiss individual members at any time by ordinary resolution (simple majority vote). Israel retained the 1929 requirement of a special resolution (3/4 majority vote) in 1983, but relaxed this provision in 1999. Since then a simple resolution suffices for dismissing members of the board. The 1999 amendment also introduced cumulative voting rights, which are optional. This change reflects the rather eclectic borrowing practice in the latest revision of the Israel law, which drew upon UK, EU, as well as US material.

In Japan, the American legal transplant established new requirements for firm governance structure. Perhaps the greatest innovation of the 1950 revisions was the creation of the board of directors as a legal entity. While the functions of the board are determined by law, the 1950 law only states that its function is to manage the business of the corporation.123 Board committees were not explicitly recognized in the Code, but after 1950, due at least in part to the large size of Japanese boards, firms formed committees, including executive committees, for more efficient

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123 Commercial Code art. 260.
At least three directors elected by the shareholder serve terms of up to three years and are responsible for management. The requirement that directors must be shareholders was dropped in 1950. While nonvoting shares were recognized already in the 1898 law, a 1938 provision stipulated that such shares could not comprise more than 1/4 of total capital. This provision may be interpreted as an attempt by the legislature to ensure that shareholders could exercise their allocated control rights.

Compared with other jurisdictions, minority shareholders in Japan had less control under the 1898 law. Major changes in the corporate charter, capital increases, and so on could be adopted with only a simple majority vote as compared to supermajority requirements in other jurisdictions. In 1950, the vote was changed to require 2/3 of the votes of shareholders present at a meeting who hold shares representing more than 1/2 of the total number of issued shares. This requirement ensures greater participatory power by shareholders. The 1950 law also extended the right to call an extraordinary shareholder meeting. While the 1898 law required shareholders representing ten percent of total stock to request a meeting, the 1950 law gave this right to shareholders with only three percent of a firm’s capital.

**Corporate Finance**

When discussing corporate finance provisions for the four origin countries in the sample, we noted the variance in the flexibility as indicated by the allocation of control rights over financial issues. One extreme, the German model, is characterized by the prescription of detailed capital requirements as well as strong shareholder control rights, with directors implementing decisions, but not making them. The other extreme, Delaware, requires that control rights be shared between shareholders on the one hand and directors on the other, the latter having substantial leeway in determining the pricing and placement of shares once shareholders have agreed to a capital increase.

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124 Although the Code contains no provisions regarding committees, they exist and often function under detailed rules, see Teikan Sakusei, Henko no Tebiki [Handbook of Articles of Incorporation Creation and Amendment] 335 (Shigekazu Torikai ed. 1998). The Jiroumukai often functions as an executive committee, see Kyoto Daigaku Shihonkenkyukai, Kabushika Kaisha Keiei Kikou no Jittai [The Reality and Management Mechanisms of Corporations] 289 Shi 12 (1963) (70% of companies have at least one Jiroumukai, and the percentage increases the larger the company).
125 Commercial Code art. 166.
126 Commercial Code art. 242.
127 Commercial Code art. 343.
128 Commercial Code art. 237.
The six transplant countries are closer to the German than to the Delaware model. Spain and in particular the two Latin American countries also stress creditor rights. While this is not unimportant under German law, the latter confines these rights to notification requirements, but does not give them veto rights over decisions on capital increase or decrease. By contrast, creditor consent is required for capital decrease under the Spanish Código de Comercio of 1885, a feature introduced in French law only in 1930. For ordinary creditors, the veto right has been transformed into a right to demand additional security in case of a merger in 1951, but bondholders still need to consent to the merger transaction. For capital increase shareholder approval is needed. Simple majority sufficed under the 1885 law. Since 1989 a quorum of 50 percent ensures that the majority of shareholders is present when taking such decisions. There is no evidence that authorized but unissued stock is allowed under Spanish law and that directors have much flexibility in the use of the corporation’s financial instruments.

The 1854 Chilean law established unanimous shareholder vote for any changes in corporate capital. Only in 1970 was this reduced to a 70% majority vote for capital increases, and since 1981 for both capital increases and decreases approval by 2/3 of stockholders is sufficient. Initially, the government determined the corporate capital on a case-by-case basis. In 1931 the law fixed the minimum capital requirement for all corporation at 500,000 Pesos. A decree of 1970 further gave the government the right to refuse incorporation in case the capital was deemed to be insufficient for the purpose of the enterprise. Both provisions were dropped in the 1981 revision of the law. A similar trend from full government discretion to general rules applicable to all companies, to a formal reversal of this rule can be observed for requirements on minimum subscription and minimum paid in capital. Since 1981, the general rule is that 1/3 of the capital must be paid in at the time the company is incorporated. Failure to do this leads to an automatic reduction of the corporate capital after three years. Thus, the Chilean law evolved from very rigid state control to a substantially more flexible law especially in the area of corporate finance. Still, some rigidities remain, among them the provision introduced only in 1981 that 30 percent of the company’s profits must be paid out in dividends.\(^{129}\)

Within the French/Spanish legal family, Colombia has retained the most rigid regime in the area of corporate finance. The 1897 law prohibited a decrease in capital. In 1931, the state acquired new control rights as it had to approve any change in corporate capital. In addition, a unanimous vote by shareholders was required, a provision that was replaced only in 1970 by a 70

\(^{129}\) According to La Porta et al. (1998) this is a feature of the French legal system. In fact it seems to be confined to several Latin American countries that followed the Chilean model.
percent majority rule. Government control was extended to the evaluation of in kind contributions in 1951. Share repurchases are restricted and require shareholder approval.

Malaysia’s regime for corporate finance as of 1965 combines some rigid elements with some more flexible ones. Under the 1965 law, a capital increase required only simple majority. However, the concept of authorized, but unissued share did not exist. Specifically, a 1987 amendment requires shareholder approval for the issuance of shares. Even in the absence of preemptive rights this makes it difficult to respond quickly to changing market conditions. Shares are required to have a par value, but they can be issued at a discount or premium. In kind contributions are explicitly allowed without any rules on the valuation of the contribution. There are more strings attached to decreases in corporate capital, which require a special resolution, i.e supermajority vote. Moreover, creditors can file a case claiming that the reduction in corporate capital was inappropriate. Share repurchase was flatly prohibited under the 1965 law. This provision was revised in 1997 permitting share repurchase under certain conditions, including capital decrease, solvency of the company, or the possible cancellation of all rights attached to the shares.

In Israel, under the 1983 law, changes in corporate capital, including capital increases and capital decreases, require a special resolution with a 3/4 majority vote. In addition, capital decreases require court approval. Moreover, minority shareholders could appeal to the court to prevent a capital increase. Since 1999 a simple majority suffices for capital increases and capital decreases can be decided by the board directors, unless the charter requires shareholder approval. Both creditors and shareholders can apply to the court and request a stop on capital decrease. As in England and Malaysia, preemptive rights did not exist in 1929, nor were they introduced in the 1983 revision of the law. Only in 1999 were preemptive rights introduced. Interestingly, this happened at a time when other countries that so far had strongly adhered to the principle of preemptive rights, were moving away from it. In kind contributions are permitted. There is no legally established procedure for evaluating the contribution. Under the 1983 law, a company could not repurchase its own stock, but since 1999 this is possible.

Corporate finance regulation in Japan is a true hybrid of the two systems from which it derived its corporate law. The country has been much more faithful to the German model than one might expect. Several restrictions that recall the German model were introduced only recently. An example is minimum capital requirements, which were introduced in 1990 and levied at 10 million yen. The 1898 law did not have minimum capital requirement – nor did the German law at that time. Like the German model law, the Japanese law specified the minimum
par value, which was levied at 20 yen and in 1950 raised to 500 yen. Like the German law, in-kind contributions were permissible, but the amount and the number of shares issued in return for the contribution had to be stated explicitly in the charter. The major amendment of the law prior to its replacement by the American-style law, the amendment of 1938, restricted in-kind contributions. Only promoters were allowed to make in-kind contributions and a court appointed inspector had to ensure that they were assessed correctly. This provision was relaxed in 1990 to require an inspector only if the contribution is more than one-fifth of the capital or five million yen.

Post-incorporation share transactions likewise are hybrid. With respect to share repurchases, the Japanese law takes an equally restrictive position as the German law. In principle, share repurchase is prohibited. The 1938 law exempted formal capital decreases and repurchases as part of merger transactions from this prohibition. The U.S.-style 1950 law lifted the prohibition on repurchases to compensate minority shareholders who exercised their appraisal rights. 1994 and 1998 Japanese amendments closely resemble recent changes in Germany, and allow repurchases also for employee compensation or stock option plans. While preemptive rights were not included in the 1898 law (despite the fact that they were known in Germany at the time), the 1950 law makes preemptive rights optional. In 1955, this provision was changed to give directors discretion over specifying the rights of shares with each new issuance, placing preemptive rights squarely under the control of directors.

Several features of the legal origins have influenced corporate finance provisions in transplant countries. The “Spanish” countries in the sample are much stronger on state and/or creditor control than other countries. Even though some of the provisions have been relaxed over time, there is still little flexibility. Malaysia’s law still resembles the English model before the UK joined the EU. Preemptive rights are not included, nor are other requirements, such as independent appraisals for merger transactions. In recent years, the law has become somewhat more flexible by reducing the veto power of minority shareholders in decisions concerning capital increases and by allowing the repurchase of shares, yet only under specific conditions. With respect to the latter issue, Israel as of 1999 is more flexible. However, Israel followed the UK and other European countries in enacting preemptive rights, which have to be waived by a shareholder meeting. As in Malaysia, there is no concept of authorized but unissued stock, an important prerequisite for enhancing the flexibility of directors in deciding matters of capital.

130 Commercial Code art. 168-4.
131 Note that Delaware had already relinquished par value requirements in its law.
132 Commercial Code art. 173.
structure and corporate finance. In Japan some provisions were relaxed, others hardened over
time. Recent changes give the impression that the legislature follows a trial and error strategy
embracing more extensive mandatory control rights on the one hand and giving directors of
corporations some flexibility to adjust to a changing environment on the other.

VII. Complementary Controls in Transplant Countries

There has been relatively little experimentation with complementary controls in
transplant countries, including in the two common law countries, Israel and Malaysia. Most
countries continue to focus on shareholder control rights rather than design more effective exit
rights as a remedy for dissenters, as has been the case in Delaware.

Exit Rights

Not surprisingly, Japan is the only country in which appraisal rights appear on the books,
an artifact of the 1950 U.S.-based revision. Under the 1950 law, appraisal rights can be invoked
in formal mergers, as well as in case all or substantial parts of the firm’s assets are sold, or when
the business is put up for lease. In 1966, the list of decisions that could trigger appraisal rights
was extended to include amendments of the corporate charter, and in 1999 to include compulsory
share exchange, a 1999 innovation.

Shareholder Litigation

We lack data on shareholder derivative suits for Malaysia or Israel to explore the extent
to which this control mechanism is used and to compare this with data from the UK or the US.
But Japan presents an interesting case from which to study the impact of introducing shareholder
derivative suits into a system that previously denied shareholders such rights. The 1898 law did
not provide for derivative suits. Under the 1950 law, shareholders holding shares for at least six
months could bring derivative action, if a request to the auditor did not result in legal action by
the company. But despite this change, and subsequent changes in the 1980s that were intended to
strengthen shareholder democracy, shareholders filed fewer than 20 derivative suits from 1950
to 1990. In 1993, however, the filing fee for shareholder suits was lowered from a percentage of

133 See Mark D. West, The Pricing of Derivative Actions in Japan and the United States, 88 Northwestern
University Law Reivew 1436 (1994); Mark D. West, Why Shareholders Sue: The Evidence from Japan,
134 (Taniguchi 1988)
damages claimed to 8,200 yen (about U.S. $75). The number of lawsuits including shareholders suits and derivative actions has since increased by over 10,000%.

Shareholder litigation in Spain was substantially restricted in light of the conditions for directors’ liability the law imposed. The 1829 code stipulated that managers were not liable for their actions as long as they acted within the limits established by the corporate bylaws. In 1869, shareholders were given the right to sue for the fulfillment of obligations of the charter. In principles, directors’ liability was confined to violations of general agency law.\footnote{Garrigues (1952) 137.} A more general liability was introduced in 1951, but this time procedural rules limited litigation. A lawsuit could be brought only, if the shareholder meeting or at least 10 percent of stockholder supported it. In 1989 this threshold was lowered to five percent. Chile was even more restrictive. Until 1981, shareholders could merely apply to the supervisory authority to make use of its discretionary powers to intervene. Consequently, the only course of action was for damages that resulted from the revocation of the government license as a result of directors’ misconduct. A general provision that shareholders could sue management for damages was introduced only in 1981, but derivative action is still not an option.

As in Chile, Colombian law did not provide for shareholder suits. In 1931, shareholder suits became permissible, but only for intentionally caused damages. The law did not specify the procedure for bringing a suit on these grounds and thus shifted the burden of uncertainty to the parties contemplating to bring such a suit.

\textit{Securities Regulation}

The transplant countries discussed have developed few control mechanisms inside the corporate law that would substitute for a final allocation of control rights by the law itself or at least provide them with additional recourse, should the law be violated. By contrast, all countries established a securities and exchange commission and enacted securities regulation, although some countries did this only very recently.

Japan received an only slightly modified version of the 1933/34 US securities legislation in 1948.\footnote{See Curtis J. Milhaupt, Managing the Market: The Ministry of Finance and Securities Regulation in Japan, 30 Stanford Journal of International Law 423 (1994).} Since 1941, the Ministry of Finance (MoF) was in charge of market oversight, and in 1952 the jurisdiction over capital market regulation and control was reverted back to MoF from the Japanese Securities and Exchange Commission. In 1992, this move was reversed in part by establishing the Securities and Exchange Surveillance Commission (SESC). This entity is not
formally independent from MoF, but an external bureau of the ministry. Outside the official exchanges, a spontaneous over-the-counter-trade (OTC) emerged in the 1950. Securities markets developed rapidly in Japan since the mid-1970s, and the OTC market was formalized in 1983. The Tokyo Stock Exchange is one of the largest capital markets by market capitalization, but the market is relatively illiquid.137

Malaysia had one of the most developed capital markets in East Asia in the early 1970s.138 At first, securities market regulation followed mostly the English system of market self-regulation.139 In 1973, a comprehensive securities act was enacted and the Kuala Lumpur Stock Exchange promulgated detailed listing requirements. Jurisdiction over market supervision was divided among several state agencies, including the Ministry of Finance, the Registrar of Companies and the Capital Issues Committee. In 1993 after a decade of rapid market development control was unified in the hands of a newly established Securities Commission (SC). Prior to the Asian crisis, the SC was set to replace the detailed merit regulations with a system based primarily on the disclosure. The crisis, however, resulted in the state capturing control rights over economic activities and the prospects for the liberalization of the securities regime are not clear at this point. Israel can also boast with a comparatively well-developed market. As in Japan and Malaysia, growth accelerated in the 1980s, despite the fact that the legal regime for securities markets had been put on the books already in the late 1960s. The 1968 law on securities introduced a mandatory disclosure regime, which was enforced by the Stock Exchange Authority (SEA). With the exception of rules that prohibit insider trading introduced in 1981, there have been few changes to this law.

Spain introduced a stock exchange regulator as early as 1854. The primary task of regulation at the time was to ensure access by intermediaries, i.e. to ensure order and decency in the exchange. The law explicitly ruled that the regulator had to watch that brokers would appear "without weapons, walking sticks or umbrellas, indifferent of their rank".140 However, the state did not intervene in the regulation of the exchange, which was governed by self-regulation. This has not fundamentally changed, although a state supervisory agency inspired by the U.S. model was established in 1988 to enforce the law.141

Chile established a securities market supervision authority in 1931, but as Spain authorized stock exchanges to self-regulate. The information rights corporations have to submit to

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137 Compare the data on Japan in (La Porta et al. 1997).
138 (Skully 1984). See (Pistor and Wellons 1999) on the development of the market since.
139 For a critique of this system in developing countries such as India, see (Rosen 1979).
140 Art. 3 N° 3 Decree, March 11 1854.
the authority prior to public offers as well as on a regular basis was substantially increased in the 1981 law. In addition, insider trading was prohibited. The definition of insider trading was expanded in 1994. Finally, Colombia created a supervisory authority for all corporations in 1931. In 1979 a supervisory authority for stock exchanges was created.

The proliferation of securities market regulation and exchange authorities is an interesting development. There is little evidence that the creation of these institutions alone has triggered market development. In several countries, including Japan, Israel, and Chile, market development did not accelerate for several decades after these institutions had been introduced. The reason may be found in part in the deficiencies in the legal rules themselves, a more detailed analysis could reveal. Yet, it is remarkable that capital market development in all transplant countries took off around the same time – with the exception of Colombia, which has not participated much in this development. This suggests that factors outside the law played an important role in triggering the surge in markets, including the development of an international capital market and changes in domestic policies that allowed fairly free capital flows. Once capital markets had taken off, we can observe more regulatory change, i.e. legislatures responding to market failures. Thus, legal institutions for capital market supervision were demand driven rather than a supply driven. The development of similar institutions in origin countries has followed a similar trajectory. Historians have described the history of financial market development as a history of financial crises. Similarly, the history of financial market regulation can be described as a history of legislative response to financial crises. In the next section we will explore in more detail whether the demand story also explains the development in corporate law and the variance across jurisdictions we documented in the previous sections.

VIII. Determinants of the Evolution of Corporate Law

After having discussed how changes in the corporate law have affected the allocation of fundamental control rights and the emergence of complementary control rights, this section explores the possible causes for change. The starting point of our analysis is that statutory corporate law was more similar at the time it was first enacted in the nineteenth century than it is today among both origin and transplant countries – some recent trends towards convergence not

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141 For serious violations, however, the Ministry of Economy has to be involved. Law 24/1988 of July 18 1988.
142 See also (Pistor 2000a) and (Coffee 2000a).
143 (Neal 1990).
144 See also Coffee ob cit footnote 142 at p. 25.
withstanding. Countries diverged relatively early and have been remarkably consistent in the approach to corporate law ever since. First consider origin countries. In the nineteenth century, corporate statutes were preoccupied with entry requirements as a substitute for state control. As the experience with the corporate sector increased, and countries went through a period of boom in the corporate sector followed by a crises in some, they responded to these events based on their perception of the experience, which was influenced by policy and ideological considerations. Transplant countries have also tended to diverge over time from the origin countries that had served as a model. Some transplant countries stagnated for years, while important changes were introduced in the origin country. In others, legal change has been volatile as legislatures experimented with solutions that differed from the origin countries, without offering the required institutional support. The following sections review the key determinants of legal change that are currently discussed in the literature and test them against the evidence presented in this paper.

Politics

Several authors explain differences in financial market or legal development with differences in politics. They argue that some countries protect property rights better than others, or that some distrust large financial institutions, while others favor labor and other social concerns over those of investors.

We suggest that we need a clearer concept of what is meant by politics. It is certainly difficult to link changes in corporate law to particular political events, such as the change of a government, or even a political regime change. The law that is widely regarded as the foundation of today’s corporate law in Germany, the 1884 law, was enacted when Germany was a constitutional monarchy. The next major revision occurred during the Third Reich in 1937. In 1965 when the next revision took place, West Germany was a democratic republic. While the 1937 law includes language reflecting the national-socialist ideology, the principles of the law were not altered fundamentally either in 1937 or in 1965. There seems to be an underlying hallmark of the German corporate law development, namely state paternalism. Before readily attributing this state paternalism to underlying cultural traits, it is however worth remembering 

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145 Countries did not remain in total isolation when making these choices. Lawmakers in continental Europe were acutely aware of legal change in the neighboring countries. Continental lawmakers looked across the channel and increasingly so with the growing gap between economic development in England and on the continent during the industrial revolution. England served both as a positive and a negative model. The Prussian corporate law of 1843, for example, rejected a more liberal approach to incorporation because of the negative side effects of the railway mania in England. Twenty years later, competition between French and English companies forced the French legislature to relinquish the concession system and replace it with free incorporation subject only to incorporation.
that the first national corporate law of 1861/1870 was much less regulated. It predated Bismarck’s unified Germany, as well as the founders’ boom and bust and was adopted in a period when economic liberalism influenced the thinking of policy makers. Perhaps this was an aberration. But if this was true, then it is reasonable to be cautious about the long-term implications of the recent signs of liberalization of the corporate law and by implication about continuing convergence.

In other origin countries the development of corporate law has been equally stable, despite significant political change. At the time the first comprehensive corporate law was enacted in France in 1867, Napoleon III ruled the country. The economic policies of his cabinet were indebted to Saint-Simon and relied on extensive state investment in transport infrastructure, concentration of the banking sector, industrial policies, and public procurement. The law was amended from time to time, but until 1966, i.e. one hundred years later, it was not substantially revised. Finally, if politics were an important determinant of the development of corporate law, one would have expected greater change in the UK after World War II. After all, the Labor government did not shy away from far reaching nationalization strategies. A shift towards the continental European model occurred only after the UK joined the European Union. Ironically, the 1980 Companies Act enacted under Thatcher contained many restrictive elements that had been characteristic of the continental European development, including minimum capital requirements, independent appraisals of mergers, and preemptive rights.

Compared to the European countries the political development in the US has been remarkably stable since the late nineteenth century. The US and Delaware in particular, were fortunate in experiencing an unprecedented economic boom after the civil war. Although the United States participated in both World Wars, none was fought on its own territory and its economy was less affected by state intervention and centralized administration as the economies of the European powers. As a result, it was never exposed to the type of state dirigisme the war industries of the European powers experienced, and which was institutionalized to a greater or lesser extent after World War II. The 1933/34 securities and exchange regulations may be attributed to the expansion of the regulatory state during the New Deal era. Yet, the regulation fell

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146 (Roe 1994) and (Roe 2000).
147 (Coing 1986); (Horn 1979).
149 The experience of central planning during the war greatly influenced the post war economic strategies not only of social democratic governments, but also of conservative ones. Winston Churchill developed the
short of establishing merit requirements, which would have replaced investors’ judgments with legislature’s assessment of what is to be considered a viable investment opportunity. Instead it established disclosure requirements aimed at informing investors, but not at deciding on their behalf.

In sum, politics as an explanatory variable for legal change cannot be dismissed. It is, however, important to realize that the factors that have shaped corporate law over time are not short-term shifts in politics.150 If the same approach to corporate lawmaking survives different political regimes, this argument is much closer to a cultural argument than many of its proponents may realize.

**Legal Families**

Recent studies have established differences in the contents of legal rules across countries. They propose that differences between countries belonging to the same legal family are statistically significant,151 and that these differences can be attributed to the legal traditions exemplified by the leading legal families, including the common law, the German, and the French civil law families. In other words, legal traditions determine the contents of legal rules. The puzzle then was to explain the causes for different preferences for legal rules. A number of studies have presented propositions and analyses based primarily on political economy arguments.152

Neither LLSV, nor most of the papers their study has inspired address the question whether the hallmark of the common law corporate laws is indeed the protection of property rights, and whether the indicators used to measure the level of minority shareholder protection in fact can be attributed to the common law. Our data allow a relatively simple analysis of the origins of minority shareholder protection and the explanatory power of legal families for differences across countries. Table 11 lists the six indicators of the LLSV antidirector’s index and indicates the date of their incorporation into English law, which is the mother country of the common law

Table 11: Minority shareholder protection in English law

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principles for the post war economy already in the early 1940s, which sought to modernize British industry through extensive state interventionism. See Strätling ob cit at p. 82.

150 This may be different for other areas of the law, or for regulations governing foreign capital flows. See, for example, (Rajan and Zingales 2000) for an argument that relates changes in financial market development to the relative openness of a country, which they argue reflects domestic politics. Unfortunately, they do not provide evidence for legal change in different countries to buttress their claim.

151 (La Porta et al. 1998).

152 (Mahoney 2000), (Levine 1999).
As these data show, only two of the six indicators can be traced to the early UK corporate law. Cumulative voting does not exist in England to this day. Preemptive rights were introduced as a result of EU harmonization requirements. Proxy voting in general (not only proxy by mail) was included as a general rule only in 1948. Previously, proxy voting was available only, if the articles of incorporation explicitly allowed for it. The right of minority shareholders to call an extraordinary shareholder meeting was established in 1862, but at that time only shareholders representing at least twenty percent of total stock could request its convocation. Only in 1909 was the threshold lowered to ten percent.

Of the remaining indicators, the absence of blocking of shares prior to the shareholder meeting distinguishes the English law from that of other common law jurisdictions, such as Delaware, where rules on blocking shares prior to the shareholder meeting have been common since 1883. The only indicator that can truly be traced back to common law is the right of shareholders to sue directors for damages. The principle is not explicitly stated in the law itself, but rules concerning directors’ liability imply the right to take recourse to the courts under common law principles. Nevertheless, it is interesting to note that derivative suits, i.e. suits by shareholders on behalf of the corporation, were much more restrictive than in the United States.

Since these data are difficult to reconcile with the notion that common law has always produced better shareholder protection than other jurisdictions, the puzzle is why common law

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153 Preemptive rights are the invention of the Massachusetts Supreme Court in 1807 (Gray v. Portland Bank, 3 Massachusetts, 363/1807). Thus, a common law jurisdiction, but not the common law country, developed this doctrine. See, for example, (Berle and Means 1932) at pp. 133.

154 In fact, since 1967 it is possible to block shares in Delaware for up to 60 days prior to the meeting. By contrast, in Germany, this is possible only for a maximum of ten days.
countries according to LLSV can boast better developed capital markets on average than either
the French or the German legal family. We propose that the answer lies in the process of
lawmaking and in particular the different role of the legislature and courts in common law as
opposed to civil law systems. A limited role of the legislature in determining the ultimate
allocation of rights or in prescribing key issues of corporate affairs leaves corporate stakeholders
greater discretion for designing their own governance structure and determining the boundaries as
well as the capital structure of the corporation. Critically, this discretionary power is limited by
the basic principles of corporate law as established, interpreted and enforced by the courts as well
as by effective securities market regulation.

The process of lawmaking has important implications for the responsiveness of law to
changing socioeconomic conditions. This is not a new argument. In fact, there is vast literature on
the efficiency of the common law and the tradeoffs between statutory and case law.\textsuperscript{155} The major
argument is that statutory law once enacted is costly to change. Case law, by contrast will be
challenged through litigation in case it produces inefficient rules. Parties are more likely to
challenge inefficient rules. Thus, through the process of litigation and re-litigation inefficient
rules will be replaced by efficient rules. This view has been challenged on the grounds that
selection biases distort the cases that make it to the higher level courts, which set precedents.\textsuperscript{156}

The argument made in this paper is different. We do not claim that common law results
automatically in efficient rules. Nor do we claim that it excels in clarity or in a clear allocation of
rights. We propose instead that the benefit of case law lies in its flexibility. Even where statutory
law is prevalent, as is the case in corporate law, in common law countries the law tends to leave
ample room for a reallocation of control rights among various stakeholders. It can afford to do
this, because courts are in a position to stop the most egregious misuses of this flexibility ex post.
This requires that private parties have extensive procedural rights and access to the courts.
Moreover, courts must be able to revert to legal principles to solve individual cases, for which the
statutory law does not provide a clear-cut answer. The common law has developed such
principles for the law on trusts, such as fiduciary duty,\textsuperscript{157} and these principles have been applied
to corporate law.

When statutory law is highly specific and little room exists for opt out, courts play only a
subordinate role in the developing the law over time. Even if litigation is available in principle,

\textsuperscript{156} (Bailey and Rubin 1994)
\textsuperscript{157} For the importance of fiduciary duty in American corporate law, compare (Clark 1985) and (Coffee
1989). For a comparison of the law on trusts under common law and comparable civil law arrangements,
see (Hansmann and Mattei 1995).
courts do not have to and/or are unlikely to develop general principles to settle disputes that are not covered by the law. This tends to slower the pace of legal change, including changes on the basis of case and statutory law. In the absence of case law, legislatures receive less information about problems private parties may face under the existing law and therefore may see little ground to invest in legislative change.\textsuperscript{158}

Our data lend tentative support to this argument. In particular, as suggested by the dates of legal changes presented in Table 12, statutory legal change in common law countries has been more frequent than in civil law countries.

Table 12: Frequency of statutory change

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<tr>
<th>Year</th>
<th>France</th>
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</table>

Note: Delaware corporate law has been changed almost annually since 1967.

The most remarkable development of corporate law during a short period of time is Delaware’s. Between 1883, when the first general corporate law was enacted until 1929 when it had developed into the most flexible, innovative, but also most manager friendly law of the jurisdictions analyzed, lie less than fifty years. During this period, the law witnessed five major changes.\textsuperscript{159} By contrast, with the exception of some minor amendments introduced in 1897, the German law of 1884 remained almost unchanged until 1937. This pattern has not changed substantially. Since the last major revision in 1967, the Delaware corporate law has been

\textsuperscript{158} On the corrective function of the legislature, see (Hayek 1973).
amended almost annually to take account of new developments in case law. The two most important changes in German corporate law since the last major revision in 1965 were the introduction of codetermination in 1976 and the law on enhancing transparency and control for corporations in 1998. Other amendments during this period can be attributed for the most part to EU harmonization requirements, that is their exogenous to domestic developments. The development in France follows closely the German pattern. After the major revision of the 1807 code in 1867, the law changed only incrementally until 1966. Since then, EU harmonization requirements have been the primary motor of change. By contrast, from the enactment of the first comprehensive companies act in 1862 until the UK joined the EU in 1972, the corporate law was revised on average about once every ten years, with more frequent change in the early decades.

These observations suggest that there is an inherent dilemma for law reform in emerging markets and transition economies. When institutions, such as courts are weak, or lack credibility, there is a tendency to bypass them and write highly specific law that leaves them little room for discretion. Ex ante, there may in fact be little choice. Once this pattern of lawmaking has been established, however, it will be hard to change. Courts will not be challenged to develop new case law on the basis of general legal principles that could help define the limits for a more flexible corporate law. Given the limited role of courts, there will be less litigation and thus less information revealed to lawmakers who therefore see less grounds to invest in costly amendments of the law.

Regulatory Competition

Regulatory competition has long been identified as an important motor for change in the United States. The major divide has been, whether this would lead to a race to the bottom or a race to the top. The evidence presented in this paper suggests that if one confines the analysis to the law on the books, regulatory competition has indeed led to a race to the bottom rather than a race to the top. Delaware’s sustained success in attracting companies to incorporate in that state and in enhancing rather than reducing the value of shares once a corporation is registered in Delaware is the result of the combination of a flexible ambiguous law, a very effective court system, and market supervision by the SEC.

159 (Arsht 1976) and (Larcom 1937).
160 Some advisors to the Russian government have explicitly made the case for the need to have “bright line rules” (Hay, Shleifer and Vishny 1996). See also more recently (Glaeser and Shleifer 2000).
161 The key papers that initiated the debate are (Cary 1976); (Winter 1977). For an excellent summary of the debate and further references see (Fisch 2000) pp. 6.
Regulatory competition also played an important role in the liberalization of corporate law in late nineteenth century Europe, especially in the transformation of state control into shareholder control. However, other conditions made regulatory competition a less important factor. In Europe the states with jurisdiction over corporate law were nation states characterized by different languages, court systems, laws, financial markets, and currencies. This limited the scope of economic activities for many national actors and did not produce the economies of scale the large market in the US did. Legal restrictions reinforced these conditions. Companies were (and still are) not free to incorporate anywhere they want and retain their headquarters in their state of origin. The so-called “seat theory” mandates that they incorporate where their headquarters are located. These conditions did not change with the advent of the European Union. On the contrary, rather than allowing regulatory competition, the member states sought to harmonize corporate law in order to prevent a race to the bottom, which they feared would ensue under more competition.\footnote{On the harmonization vs. regulatory competition debate in Europe, see the contributions in (Buxbaum and Hopt 1988) and (Buxbaum, Hertig, Hirsch, and Hopt 1991).} This model is currently undergoing change. The number of trans-border transactions and mergers has increased with the integration of financial markets. Moreover, in a much debated decision the European Court of Justice has opened the prospect for companies to incorporate outside the home jurisdiction, but operate at home under the guise of a representative office.\footnote{Cenros decision issued by the European Court of Justice on 9 March 1999. For an analysis of the decision and its implications on regulatory competition within the EU, compare for example (Zimmer 2000).} If confirmed, this decision could greatly enhance regulatory competition in the EU.

While most European laws do not allow companies to shop around for charters, lawmakers in Europe as well as in most transplant countries are well aware of legal change in other parts of the world. Extensive comparative research accompanies every major revision of the corporate law in most countries. As mentioned earlier, Prussia used the UK experience with the railway mania as a justification not to liberalize the corporate law in the mid-1840s. Germany did, however, follow France on the heels after it had allowed free registration. Spain always looked across the border to France, more often to distinguish itself from the model than to closely emulate it, but presumably in the belief that they could do better than French lawmakers and perhaps attract business from across the border. When Chile enacted its corporate law in 1854, legal experts sought not only to copy from the French and Spanish law on the books, but to incorporate the case law that had developed on the basis of these codes. The shift from French to a U.S. model in 1981 further evidences that lawmakers (rather than companies) shopped around
for models. In Japan as well, corporate legal change is usually preceded by extensive comparative legal research. German and U.S. law is given especially close scrutiny, but other legal systems are consulted as well. As discussed above, Israel has changed its corporate law recently by incorporation features from U.S. law as well as European Union legislation. Only Malaysia, has stayed most closely to the British pre 1970 model for corporate law, albeit intermediated by the Australian one, and there is little evidence that it has surveyed corporate laws outside the common law family. The country with the least efforts to look beyond the national borders when reforming its corporate legal system appears to be the U.S. Comparative analysis is limited mostly to what other states within the U.S. rather than what countries outside the U.S. do or don’t do.

The fact that lawmakers in most countries are quite aware of legal change in other countries makes it difficult to argue that they simply did not know better. Their response to the discovery of foreign law has been shaped by the current success or failure of that model, of what they perceived to be the main domestic problem at the time the new law was enacted, and by their general presumptions about what law ought and could do. It is also worth pointing out that for most of the period under investigation, different approaches for the organization of the economy as well as of firms competed quite successfully with each other without much evidence that one would be the clear winner. In fact, it is not so long ago that many authors, including in the U.S., hailed the German or Japanese model as superior to the American one. As the assessment seems to come and go with business cycle, we suggest to wait for a final judgment about the end of history at least until the next swing in business cycles.

**Transplant Effect**

Transplant countries received their first statutory corporate law from one of the four countries discussed above. As expected, the first law was almost identical with the origin country that had served as a model. More surprisingly perhaps is that several transplants clung to this model for decades without any change, despite substantial change both in the origin country’s law and in the socioeconomic conditions in the transplant country during this period. The stagnation of law applies even to transplants that belong to the common law countries, Malaysia and Israel, and seems to refute the proposition that common law per se can explain the patterns of legal change we observe. In the two countries, the newly transplanted law lay dormant for 34 and 54

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164 Note that the legal changes in Delaware were deplored by many American contemporaries. For a scathing critique of the developments in Delaware, compare (Berle and Means 1932). For a critique of the 1967 revision of the law, see (Becker 1969).
165 (Roe 1993).
years respectively. It took Japan forty years (from 1898 until 1938) to modify the law they had transplanted from Germany and another thirty years (from 1950 to 1980) until important changes were introduced in the American transplant. A possible explanation is that it takes time for a transplanted law to take root. The very process of lawmaking – transplantation as opposed to internal development – implies that domestic constituencies are not involved. In fact they may not even be aware of legal change, as the example of Colombia in the early nineteenth century suggests.

Spain seems to be a counter example to the passivity shown by other legal transplants. It initiated two complete turnarounds of its corporate law between 1829 and 1868. Both times this was in response to domestic market developments, suggesting that the law actually had an effect, i.e. that there was a demand for law, only that the law proved unable to meet it. Clearly, the socioeconomic conditions for market entry were very different from those in Colombia, where an equally liberal legal regime had no effect at all. A possible reason for the negative effects of the liberal law in 1829 is that Spain lacked a developed system of complementary control mechanisms that would make a rather liberal law sustainable.

An important lesson from this is that liberalization in an environment that lacks complementary control mechanisms may entail substantial readjustment costs. High volatility of legal change is also detrimental for the investment climate, as it undermines the credibility of the legal system.

_Socioeconomic Development_

Law development programs rest at least on the implicit assumption that law promotes economic development. It has, however, proven difficult to establish a causal relation between the two, and the same is true for corporate law. Great Britain, for example, was well advanced as the first industrializing country by the time it enacted a general corporate law (1844) or accepted limited liability (1855). In France, the enactment of the commercial code in 1811 was as much an attempt to build a common legal framework for a national market, as a response to increasing economic development. In Germany and Delaware a unified general corporate law came rather late in the day.

By contrast, most transplant countries received the law before they experienced substantial economic development. In Spain, most domestic companies were small, family run firms until well into the middle of the twentieth century. The only large companies by 1930 were foreign companies. The same is true for Colombia for most of the period under investigation. An
exception is Japan, where relatively large enterprises existed before the legal modernization of the late Meiji period and the incorporation of German law.\textsuperscript{167}

There may be different reasons why firms would not make use of the growth potential the corporate form offers. Firms may want to avoid joining the formal economy and disclosing activities to the state, which they are bound to do under registration requirements.\textsuperscript{168} Political and or economic conditions may not be conducive to growth and development.\textsuperscript{169} Or the provisions of the corporate law may make it too costly and disadvantage this particular legal form over others.\textsuperscript{170} Whatever the reasons for the lack of use of the corporate law, the experience of many transplant countries around the world suggests that the enactment of corporate law \textit{per se} is unlikely to have much of an impact on growth and economic development.

\textit{Integration of Financial Markets}

The integration of international financial markets and the lowering of barriers to capital flows have created new challenges for corporate law and securities market regulation. Companies are tapping international capital markets and are extending their operations and control far beyond national or regional boundaries. For them to exploit these new opportunities, many countries first had to relax their corporate laws. The relaxation of control is risky in the absence of complementary mechanisms of control. The importance of such mechanisms has become apparent in recent financial market crises in emerging markets, most notably in the Asian Financial Crisis. The opening of countries to international capital markets in the early 1990s had not been matched by domestic legal and institutional development. Extensive legal reform programs, including reforms of corporate law and securities market regulations are now under way to remedy for these weaknesses. This reform process has accelerated borrowing from Western models. Irrespective of their legal origin, some countries have borrowed extensively from the US model, while others use an eclectic mix of remedies borrowing from the US as well as EU or continental European law, as our discussions of recent changes in Japan and Israel have demonstrated.
The increasing integration of financial markets has given rise to an intensive debate about the possible convergence of corporate governance systems.\footnote{Bebchuk and Roe 1999} The integration of international financial markets has certainly influenced the evolution of corporate law in origin countries. The development of the legal regime for preemptive rights discussed for Germany is a case in point. The most recent comprehensive change in the corporate law, the law on control and transparency for enterprises (KonTraG) of 1998 was preceded by an extensive debate on the merits of particular features of the US law, including the role of the board, shareholders suits, stock options for management, and repurchase of shares.\footnote{Coffee 1999; Coffee 2000b} Yet, the changes that were finally adopted were only a step towards a US style corporate law rather than a full embrace of that model. Thus, despite far reaching formal legal change in recent years, we do not see formal convergence in response to the integration of international financial markets.

Several authors have argued that instead of formal convergence (i.e. convergence in the law on the books), we may observe functional convergence.\footnote{Gilson 2000} Unfortunately, there is little clarity on what different systems will converge, and thus how to measure functional convergence. It seems clear that under competitive pressures, corporate governance regimes respond. But it is also apparent that their existing institutions, including legal institutions and financial systems, implicate the nature of the response, suggesting that even when countries adopt elements from other governance systems, most systems will retain their own distinctive features.

The most extreme convergence argument is that all governance systems have come to hail shareholder value, even though structural change may still lag behind.\footnote{Hansmann and Kraakman 2000} But this confines convergence to the level of ideology. As the experience of the almost universal acceptance of human rights, or to democratic elections has shown in the past, it is a rather long shot from underwriting legal principles to their realization in practice. One may argue that financial market development will pressure firms and ultimately governments to accept the wisdom of the markets. Yet, the experience of transition economies has taught us that this simple formula may not work in practice. Firms in transition have taken multiple responses to capital scarcity, including building up inter-enterprise arrears, integrating into company groups or large conglomerates, participating in multi-national enterprise, establishing their own banks as milking cows, or

\footnote{Bebchuk and Roe 1999} who argue that corporate governance systems will continue to diverge; \footnote{Gilson 2000} (Coffee 1999; Coffee 2000b) argue that functional convergence is taken place; for a more radical statement of convergence, see (Hansmann and Kraakman 2000).

\footnote{Coffee 1999}

\footnote{Hansmann and Kraakman 2000}
lobbying the state for direct or indirect subsidies. The last strategy they have reverted to is issuing shares to the public and sharing control with outsiders.

Even for developed market economies, the evidence for convergence on one particular governance model (the Anglo-American model) under pressure from financial markets is sketchy at best. Take the example of firm migration. This process has not been confined to a one-way road on which firms would migrate from elsewhere in the world to the US. Within Europe there has been a substantial migration of firms from the London Stock Exchange to the Paris Bourse after the introduction of the automated auction system, which reduced the cost of trading. The LSE was able to attract some firms from Europe in return, especially those that had blocks to trade, which is easier on the London dealers’ market. This suggests that firms with different characteristics will select markets that best suit their needs, rather than all converging on the same model.

Firms that migrate to the US market have to adjust to US style securities legislation. From the US perspective, this looks like convergence. From the perspective of their home countries, it looks rather like an increasing fragmentation of the market. The global players leave, but firms that cannot afford the transaction costs are locked into their home jurisdiction. Unless the legal framework in their home jurisdictions changes, convergence will remain partial. As the large players exit, this may create pressure on national legislatures to reform. Yet, the remaining firms may not have the cloud to push through the required reforms, or they may still benefit from the existing system and therefore lobby for its protection. As a result, there may be less rather than more change in the home jurisdictions.

Another piece of evidence that is used to demonstrate convergence is ownership structure. Recent empirical studies demonstrate that concentrated rather than dispersed ownership is the hallmark of most countries outside the US. Ownership structures are changing in some of the core origin countries, including in Germany, but also in France, where they are becoming less concentrated. It is questionable, however, whether this is a universal trend. In many emerging markets, including some of the transplants discussed in this paper, we see a strong trend towards the formation of company groups and conglomerates rather than fragmentation of ownership.

175 (Steil 1996).
176 It is certainly no accident that Daimler Benz was the first German company to list on the NYSE. While a number of mid-size firms have listed on NASDAQ, for many the cost of migration have remained to high.
177 (Hirschman 1970) has long ago made the important point that exit may lead to change, but that it also may lead to stagnation.
178 (La Porta, Lopez-de-Silanes and Shleifer 1999)
179 (Gilson 2000)
180 (Khanna and Palepu 1999)
This process may be reversed by improvements in information and transaction costs, but there is still a long way to go.

Moreover, it is by no means clear that capital markets are the most efficient way for financing firms irrespective of industry sector and level of economic development. Recent studies show that there is a remarkable affinity between industries, skill endowment of the work force employed by these industries, ownership structure and modes of firm financing. This would suggest that we should continue to see a variety of financing methods around the world and thus substantial divergence in firm behavior that use different financing methods.

Finally, speculations about the future of the firm may render much of the current convergence debate obsolete. If the most valuable asset in the “new firm” is labor (human skills) rather than capital, the relevance of firm finance might be declining. This would require a reconsideration of the impact of financial market development on the evolution of the firm and of the function of corporate law and securities market regulation.

IX. Conclusion

The purpose of this paper was to investigate the patterns of legal change in ten jurisdictions over the course of a 200 year period, to identify key determinants of legal change, and to assess the findings against the claims about convergence of divergence of legal and corporate governance systems. We summarize our findings in this concluding section and draw some normative conclusions from the positive explorative research presented in this paper.

Patterns of Legal Change

- The evolution of corporate law can be divided into three major periods: The period prior to free incorporation; the legal response to the experience with free incorporation; and the consolidation of corporate law and its development since.
- Corporate law prior to free incorporation was primitive and addressed only the most basic features of corporate law.
- After free incorporation had become (almost) universal, attention of legislatures was drawn to incorporation, creditor protection, and the governance structure of firms, including the relation between shareholders and management.

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181 (Carlin and Mayer 2000)
182 (Zingales 2000)
• By the end of this nineteenth century, these issues had been settled in most jurisdictions. The evolution over the first one hundred years of corporate law shows remarkable parallels in timing and the legal issues addressed. This changed during the next century.
• The area of the law where we can observe greatest divergence over time is corporate finance. By 1929, most provisions in corporate finance had become optional in Delaware. Control rights were increasingly shifted from shareholders to management. Other countries have moved in the opposite direction (the UK under EU harmonization requirements), or have begun to relax these provisions only in recent years.
• Another area of divergence is the law governing merger activities. Whereas some jurisdictions reduced shareholder control rights on the books, others continue to require supermajority requirements and mandate independent appraisal of each merger transactions.
• The differences in corporate finance and merger regulations are indicative of different approaches to corporate law more generally. While some jurisdictions favor a highly regulatory approach to corporate law, mandating the contents of corporate charters and leaving little room for the reallocate control rights among stakeholders, others have given control rights to shareholders and have even allowed them to further delegate these rights to management. In other words, countries position themselves differently on the rigidity-flexibility axis of corporate law.
• Countries that lean to the right hand side of that axis (flexibility) have increasingly relied on complementary control mechanisms to protect shareholder rights, including the strengthening of exit options, judicial recourse, and securities regulation.
• Countries that lean to the left hand side of that axis (rigidity) have refined the methods of legislative control, but have not developed strong complementary controls.

Determinants of Legal Change
• In origin countries corporate statutes were enacted in response to economic development.
• In transplant countries the timing of their enactment may have coincided with accelerating economic development (as in Japan), but in many countries it occurred independent of domestic demand.
• Subsequent changes reflect each country’s experience with the corporate sector. They also give evidence of the basic features of the legal system, in particular the role of the legislature as opposed to courts in the process of lawmaking.
• Most change has been incremental rather than radical.

• Important determinants of more substantial legal change are backlash, competition, and harmonization. Table 13 lists legal change in the ten jurisdictions that falls in one of these three categories.

<table>
<thead>
<tr>
<th>Backlash</th>
<th>Competition</th>
<th>Harmonization</th>
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<tbody>
<tr>
<td>Spain 1848/1869</td>
<td>France 1862</td>
<td>Japan 1950</td>
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<td>Germany 1884</td>
<td>Germany 1870</td>
<td>France since 1960s</td>
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<tr>
<td>United States 1933/34</td>
<td>Delaware since 1883</td>
<td>Germany since 1960s</td>
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<td>Japan 1898</td>
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<td>Israel 1999</td>
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• Backlash refers to a legal change that is motivated and shaped by a serious financial crisis. There have been relatively few legal changes that can be clearly identified as backlash laws. However, laws that were enacted in response to financial market crises have been very resilient. This is true in particular for the German 1884 law (which was buttressed by a 1896 law on stock markets), and the 1933/34 securities market regulations in the US. Spain’s extreme reaction in 1848, however, proved to be unsustainable and was reversed twenty years later.

• Laws that are enacted under competitive pressures include the shift from concession to registration systems in late nineteenth century Europe, Delaware’s competition with New Jersey and New York since the late nineteenth century, and responses by Chile in the 1980s, Japan, Germany, and Israel in the 1990s to increased global competition. There are two clusters of primarily competitive lawmaking: the late nineteenth century and the late twentieth century – both periods of relatively open markets and international competition.

• Harmonization of corporate law has been a hallmark of European integration since the 1960s. Harmonization has focused on creditor and shareholder protection and has required member countries to include mandatory rules in their corporate laws. Especially in the case of the UK, this has led to a leftwards shift on the rigidity-flexibility axis. In addition, the enactment of the 1950 corporate law in Japan under American occupation can be classified as a harmonization attempt.
Divergence or Convergence of Legal Development

- Of the three determinants of legal development singled out above, backlash tends to result in divergence from other jurisdictions, competition may lead to convergence or divergence, harmonization leads to convergence of the law on the books among countries included in the harmonization drive, but may lead to divergence from other jurisdictions.

- **Backlash:** The 1848 backlash in Spain led to strong state control over corporate activities, which was followed in Latin America, but was deviation from the general trend in nineteenth century Europe away from state control. In Germany, the 1884 manifested a rigid mandatory structure with little flexibility that has shaped the corporate legal development since and distinguishes it not only from common law countries, but also from other civil law countries, such as France. In the US, the 1933/34 legislation established a federal securities commission and established a mandatory disclosure system, which was unique at that time.

- **Competition:** Competition among European powers in the nineteenth century led to a shift from state concession to free registration systems, i.e. to convergence on this matter. Delaware’s law of 1883 closely copied the law of New Jersey, another piece of evidence that competition may lead to convergence. The final success of Delaware, however, is attributed to its ability to build its own niche and distinguish itself from other states.\(^{183}\)

- Increasing competition in the 1990s has led to multiple responses. There is little evidence that this has led to a strengthening of shareholder rights around the world. In some countries (Germany) the reverse happened and mandatory shareholder rights provisions were relaxed. In others we observed a combination of strengthening of shareholder rights and stricter state control rights (Japan), or an eclectic mix of elements borrowed from different models, including the US, UK and Europe (Israel).

- There is some evidence that securities regulations are converging on the disclosure system and that merit requirements may be phased out over time. However, the backlash in Malaysia after the recent financial crisis has halted this process for now.

- **Harmonization:** Harmonization has aligned the different corporate laws of member states of the EU, with perhaps the greatest impact on UK law, which hitherto had followed

\(^{183}\) (Kamar 1998) and (Fisch 2000).
quite a different path in legal development. Harmonization has, however, led to
divergence from the US model.\textsuperscript{184}

- Initial harmonization of the law is no guarantee that countries will continue on the same
  path. All transplant countries have diverged from the models they copied at the outset in
  response to domestic events and outside competition. The implementation of European
  harmonization requirements has been slow and difficult to enforce.\textsuperscript{185}

- Legal development is primarily response driven. The event that causes a legal response
  shapes the contents of legal change. Dramatic events, such as financial crises, lead to
  radical change. Smaller events tend to re-enforce path dependent legal evolution. Given
  the diversity of responses to competitive pressures and the divergence of legal system
  subsequent to initial harmonization we question the proposition that legal systems are in
  the process of converging.

Normative Implications

Our analysis holds some important lessons for future law reform in developed market
economies as well as in emerging markets.

- Corporate law is not a simple device for promoting economic development. In many
  transplant countries, corporate law has lived only a book-life for decades after it was first
  enacted. Its relevance depends on other conditions, including the level of socioeconomic
  development and the business environment.

- Legal transplantation can have adverse effects in the long term. The pattern of legal
  change in transplant countries is less consistent than in origin countries. Lawmaking
  tends to be either highly volatile or long periods of stagnation are followed by major
  revisions of the law. This is detrimental to economic development, as firms and investors
  favor consistency and stability of the legal systems.

- There is a tradeoff between strong mandatory provisions in the law, including provisions
  designed to protect shareholders on the one hand, and a flexible legal regime on the other.
  While the mandatory law may avoid egregious misuses of shareholder rights, it makes the
  company less responsive to a changing business environment.

- A more flexible corporate law is sustainable only, if complementary control devices are
  in place. The problem most jurisdictions face that start with a rigid corporate law is that

\textsuperscript{184} (Carney 1997)
\textsuperscript{185} For the difficulties encountered in implementing the financial service directive, compare (Ferrarini
1998).
its very rigidity prevents the development of complementary control devices. The transition from a rigid to a more flexible law therefore entail substantial risk.
### Table A1: Legal Change in 10 Jurisdictions

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<tr>
<th>France</th>
<th>Spain</th>
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References


Hirschman, Albert O. 1970. *Exit, Voice, and Loyalty; Responses to Decline in Firms, Organizations, and States*.


