Corporate Law and Economics

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Syllabus

Course description

This course will examine how corporate law helps to mitigate the economic challenges posed by the organization of business enterprise. After discussing the fundamental legal and economic aspects, we will discuss issues such as (1) incentive problems, (2) executive compensation, (3) shareholder voting, (4) investor activism, and (5) the market for corporate control, as well as (6) corporate social responsibility.

We will begin with some fundamentals: What are the core legal characteristics of the corporate form of a legal entity and what purposes do they serve? One of those legal characteristics is to provide stronger forms of "asset partitioning," by designating a pool of business assets that are distinct from the personal assets of the firm's owners and managers and giving the claims of the firm's creditors priority over those assets ("entity shielding") and in turn shielding the assets of the firm's owners from the obligations of the firm ("limited liability"). Entity shielding in particular is sometimes referred to as an aspect of the "legal personality" of a corporation. After considering the economic functions of the asset partitioning provided by the corporate form, we will turn to a closely related legal characteristic that distinguishes the corporation from some other forms of legal organization: fully transferable ownership interests.

The final two core legal characteristics of the corporate form that dominates modern economic life are closely related: the centralization of managerial authority in an elected board of directors that in turn hires professional managers to run the firm and the allocation of ownership rights (meaning residual financial claims and control rights) to investors of equity capital in the firm. In addition to exploring the functions served by these features, we will discuss alternatives to investor ownership (e.g., nonprofit status and consumer and supplier cooperatives) and why they play relatively large roles only in certain sectors of the economy.

We will then turn to the incentive problems that result from the centralization of control over the corporate form and examine a range of legal institutions that attempt to address them. First, we will consider in more detail the legal authority and duties of boards of directors, which are charged with supervising the managers of the firm. To frame our analysis of the economic function of fiduciary duties, we will read several judicial opinions from the United States that illustrate the role of fiduciary duties in corporate governance, beginning with perhaps the most famous case in all of American business organizational law, *Meinhard v. Salmon*. That case illustrates an underlying economic principle, which is the inevitable "incompleteness" of enterprise contracts (that is, the contractual arrangements that establish how the various participants in a business enterprise will cooperate). That insight in turn leads to an understanding of fiduciary duties as a legal device for filling in the gaps in enterprise contracts.

Second, we will consider the role of executive compensation in aligning the incentives of managers with the interests of investors. But in addition to considering the optimal design of executive compensation as a matter of economic theory, we will also consider the forces that lead real-world executive pay to often be poorly designed from an incentive perspective and how legal rules attempt to address these institutional problems in pay setting.

Third, we will consider shareholder voting and investor activism. While in principle the right of shareholders to elect the board of directors and to vote on certain fundamental transactions should help protect shareholders' interests and compensate to some extent for their lack of hard contractual rights as residual claimants rather than fixed claimants, in practice shareholder voting suffers from collective action problems. But in recent decades the growth of institutional investors and the resulting so-called "reconcentration of ownership" has led to various forms of institutional investor activism that to some extent surmount those collective action problems. We will examine the recent empirical literature on such shareholder activism as well as consider a detailed case study of a particular activist intervention.

Finally, we will consider the market for corporate control. This is often viewed by corporate law theorists as the ultimate "structural" backstop that protects investor interests—if agency costs grow sufficiently large, the value of the firm's shares will fall to the degree that another firm will be able to profitably acquire the firm and replace its management. But for the market for corporate control to function well requires corporate law to facilitate it. We will examine these issues from both a theoretical perspective as well as by reading several classic takeover cases from the U.S., including *Unocal Corp. v. Mesa Petroleum Co.* and *Paramount v. QVC*.

We will conclude by examining the debate over corporate social responsibility. The traditional legal norm, and more importantly the basic structure of corporate control rights, privileges shareholder interests over the interests of other constituencies of a business corporation. But recent innovations in conceptualizing corporate purpose aim to address social concerns about corporate behavior, including with respect to the environment and to the firm's treatment of workers. We will analyze these competing conceptions of corporate purpose and the advantages and disadvantages of each, including with respect to the interests of workers, other suppliers, customers, and the broader community.

While the course will focus on U.S. corporate law, given the instructor's background, the legal and economic issues we will analyze emerge in every jurisdiction, and we will on occasion take a comparative perspective by discussing variations in corporate law across jurisdictions.

Recommended prerequisites

Introductory courses in both business (e.g., Principles of Business) and economics (e.g., Principles of Economics) are recommended. The Master course "Theory of the Firm" (No. 62651) is highly complementary to this course but distinct—this course will focus on the role of organizational law in constituting and facilitating economic organizations. No prior coursework in corporate law is necessary.

Work groups

Students in the class will be divided into "work groups." Your group assignment will be posted to the course website. A part of some class meetings will be devoted to discussing issues and working on problems in your groups. In addition, in some cases group homework will be assigned that must be completed as a group (see below).

Assignments

For each class meeting there are a set of readings assigned, detailed below. For some class meetings there are also homework problems assigned. You are free—indeed, encouraged—and in some cases required (as indicated in the assignment) to work on the homework problems with your work group, but ultimately each student must hand in their own homework assignment. Homework will be graded on a "check" / "no check" basis (with a "check" awarded for turning in a completed assignment on time). Your timely completion and submission of the homework will factor into the class participation component of your grade.

You are also encouraged (but not required) to subscribe to Matt Levine's "Money Stuff" column on Bloomberg and to read it regularly over the two weeks of the course. Levine covers current events about finance and corporate law and is read widely by corporate lawyers, bankers, and the like (even here in Europe!). We will sometimes discuss issues raised by his columns in class. By the end of this course I hope you read his columns in a whole new light. To subscribe, go to this link: https://www.bloomberg.com/account/newsletters/money-stuff?source=NLshare

Assessment

You are expected to prepare for and attend every class and participate actively. Grading will be based on class participation (30%) and a final written, closed-book exam (70%). The exam will cover the material in the reading assignments as well as additional material covered in class.

Readings and Homework Assignments

Notes to students:

- Be sure to pay attention to the page ranges assigned—for some articles only a portion of the article is assigned.
- For some classes I assign portions from my Corporations Course Materials, denoted "CCM." I will post the entire CCM document as a pdf to serve as a useful reference for those of you interested in going beyond this course in your study of corporate law.
- For some class meetings additional optional readings on the topic are provided. These readings are truly optional and you will not be tested on them.

Class 1. The Fundamental Legal Characteristics of the Corporate Form.

- Reinier Kraakman et al, The Anatomy of Corporate Law: A Comparative and Functional Approach (Third Edition, 2017), Chapter 1, "What Is Corporate Law?," pp. 1 – 28.
- **Excerpt from:** Blair, Margaret. 2003. "Locking in Capital: What Corporation Law Achieved for Business Organizers in Nineteen Century America." *UCLA Law Review*, 51: **pp. 388 - 397; 423 - 449.**
- CCM, pp. 87 – 103, Valuation and Accounting. *NB:* I expect that for many of you, this reading on basic corporate finance concepts will be a review of material you already know. I include it to make sure we all have the foundations in place, which are critical to understanding the material in this course. Feel free to skim this and only carefully read the material that is new to you.

Optional additional readings:

- Guinnane, Timothy, Ron Harris, Naomi R. Lamoreaux and Jean-Laurent Rosenthal. 2007. "Putting the Corporation in its Place." *Enterprise & Society 8*: 687-729.
- Hansmann, Henry and Reinier H. Kraakman. 2000. "The Essential Role of Organizational Law." *Yale Law Journal*, 110: 387-440.
- Hansmann, Henry, Reinier H. Kraakman and Richard Squire. 2006. "Law and the Rise of the Firm." *Harvard Law Review*, 119: 1335-403.
- Dari-Mattiacci, Giuseppe, Oscar Gelderblom, Joost Jonker, and Enrico Perotti 2017. "The Emergence of the Corporate Form." *Journal of Law, Economics, and Organization*, 33: 193-236.

Class 2. Capital Structure and the Agency Problems of Corporate Governance

- CCM, pp. 60 – 64, excerpt from Jensen, Michael C. and William H. Meckling. 1976. "Theory of the firm: Managerial behavior, agency costs and ownership structure." *Journal of Financial Economics* 3: 305–360.
- CCM, pp. 103 – 136, 4.3 Corporate securities and capital structure.
  - *Note to students:* I expect that for many or even all of you, the Certificate of Designation for Preferred Stock and (especially) the *HB Korenvaes Investments, L.P. v. Marriott Corporation* case will be quite challenging. Work through those materials carefully as best you can, and rest assured we will discuss them in detail in class.

Homework (due by 8:00am on the day of the class):

- Problems: Certificate of Designation for Preferred Stock on CCM, pp. 105 – 106.

Class 3. Boards of Directors and Fiduciary Duties

- **Excerpt from**: Hopt, Klaus J. 2011. "Comparative Corporate Governance: The State of the Art and International Regulation." *The American Journal of Comparative Law* 59 (1): **Section III.A. ("The Board"), pp. 19 - 44.**
- CCM, pp. 38 – 44, *Meinhard v. Salmon*.
- CCM, pp. 168 – 171, *Kamin v. Am. Express Co*.
- CCM, pp. 220 – 235, *Benihana of Tokyo, Inc. v. Benihana, Inc*. and *In re PNB Holding Co. Shareholders Litigation*.

Optional additional readings:

- Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991), Chapters 1 and 4.

Homework (due by 7:00pm on the **day before** class):

- Divide your work group into two sides: (1) Meinhard's representatives; and (2) Salmon's representatives. Imagine you are negotiating the terms of the original joint venture agreement between Meinhard and Salmon. Bargain over the term in the agreement that will govern potential follow-on opportunities to the original hotel lease. That is, what obligations and rights should each of Meinhard and Salmon have with respect to any additional business opportunities beyond their initial hotel business under the original hotel lease? What constitutes the set of such opportunities with respect to which they should have these obligations and rights?
  - Think about your business objectives and the incentives created by alternative arrangements. What is in the best interest of your side?
  - Think about how to express the desired business agreement in contractual language so that it will be enforced correctly ex post. (This is hard, even for trained lawyers! Do your best.)
  - Write down the agreed on contract language and submit it as your homework, along with a brief summary of the negotiations that led to it.

Class 4. Executive Compensation.

- **Excerpt from:** Kevin J. Murphy, "Executive Compensation: Where We Are, and How We Got There, in *Handbook of the Economics of Finance* (2013), **pp. 217 – 248.**
- Lucian A. Bebchuk and Jesse M. Fried, "Pay without Performance: Overview of the Issues," 30 *Journal of Corporation Law* 647 (2005).
- Alex Edmans, Tom Gosling & Dirk Jenter, *CEO Compensation: Evidence From the Field*, ECGI Working Paper (2023).

Class 5. Voting and Institutional Investor Activism

- Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUMBIA LAW REVIEW 863 (2013).
- Ryan Bubb, A Tale of Two Proxies: The Barnes & Noble Proxy Fight (2015).

Optional additional readings:

- Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991), Chapter 3.
- Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Funds Activism*, 115 COLUM. L. REV. 1085 (2015).
- Ryan Bubb & Emiliano M Catan, *The Party Structure of Mutual Funds*, 35 THE REVIEW OF FINANCIAL STUDIES 2839 (2022).

Class 6. Takeovers and the Market for Corporate Control

- Reinier Kraakman et al, The Anatomy of Corporate Law: A Comparative and Functional Approach (Third Edition, 2017), Chapter 8, "Control Transactions," pp. 205 – 242.
- Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARVARD LAW REVIEW 1161 (1981).
- CCM, pp. 417 – 427, *Unocal Corp. v. Mesa Petroleum Co*.
- CCM, pp. 467 – 480, *Paramount v. QVC.*

Class 7. Alternatives to Investor Ownership

- **Excerpt from:** Henry Hansmann, Ownership of Enterprise (1996), **pp. 11 – 65, 227 - 264**.

Optional additional readings:

- Ryan Bubb & Alex Kaufman, *Consumer biases and mutual ownership*, 105 JOURNAL OF PUBLIC ECONOMICS 39 (2013).

Class 8. Corporate Social Responsibility

- CCM, pp. 79 – 86.
- Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 THE UNIVERSITY OF CHICAGO BUSINESS LAW REVIEW 195 (2022).
- Robert P. Bartlett, III and Ryan Bubb, Corporate Social Responsibility through Shareholder Governance, ECGI Working Paper (2023).

Optional additional readings:

- Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020).