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The Modern Corporation
Statement on Company Law

SUMMARY: FUNDAMENTAL RULES OF CORPORATE LAW

Corporations play a central role in modern economies. Certain beliefs about corporations and corporate law are widely held and relied upon by business experts, the financial press, and economists who study the firm. Unfortunately, some of these widely-held beliefs are mistaken. This has led to numerous common errors in the way corporate law concepts are understood and applied.

The authors of this Summary are experts versed in a variety of national legal systems, including those of the U.S. and U.K. as well as the E.U. We provide this simple Summary of certain fundamentals of corporate law, applicable in almost all jurisdictions, in an effort to help prevent analytical errors which can have severe and damaging effects on corporations and corporate governance.

1. Corporations are universally treated by the legal system as "legal persons" that exist separately and independently of their directors, officers, shareholders, or other human persons with whom the legal entity interacts. Legal separateness or "personhood" is not a metaphor or fiction but a powerful legal reality. It ensures that corporations have certain rights, including especially the rights to own property, enter contracts, and commit torts in their own names.

2. Corporations can raise capital by issuing various types of securities. One type of security that many but not all corporations issue is stock shares, which are sold to shareholders. Shareholders own shares. Contrary to widely held 'common sense', shareholders do not own corporations; nor do they own the assets of corporations. Shareholders only own shares of stock – bundles of intangible rights, most particularly the rights to receive dividends and to vote on limited issues.

3. A shareholder can acquire shares by exchanging assets or cash that the shareholder transfers to the corporation when the shares are initially issued by the corporation in the "primary market." Alternatively, a shareholder can purchase preexisting shares from another shareholder in the "secondary market." As nearly all shares are fully paid up, only shareholders who purchase shares in the primary market directly contribute assets or cash to the corporation. Shareholders who purchase shares in the secondary market do not contribute capital (or anything else) to corporations. When they buy shares the purchase price is paid to the selling shareholder. The notion that shareholders contribute capital to corporations is thus wrong in the great majority of cases. The contribution of stock markets to new investment capital is also greatly exaggerated.

4. A key feature of corporate personhood is that corporations – as separate, property-owning legal persons – own their own assets and incur their own liabilities. Corporate assets and liabilities are separate from shareholder assets and liabilities. As a result of the 'limited liability' of shareholders the creditors of corporations can only enforce their claims against the corporation's assets, not against those of the shareholders. In reality, therefore, for shareholders, 'limited liability' means 'no liability.' Shareholders are affected by the corporation's failures only indirectly and their losses limited to any decline in the value of the shares they hold.

5. Another critical consequence of corporate personhood is that the assets of the corporation are "locked in" and protected against shareholder claims. Shareholders have no direct claim to the assets of the corporation, which they do not own. Capital lock-in is a fundamental feature of the corporate form which makes it possible for corporations to pursue long-term, large-scale economic projects under uncertain conditions. Shareholders cannot force the corporation to disgorge its assets. If they want liquidity, they must sell what they own: their shares. The sale of shares in the secondary market or the transfer of shares through inheritance does not directly affect the business of the corporation. Its assets, contracts and liabilities are left unchanged.

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6. Shares typically give shareholders only limited economic rights, in particular the right to receive dividends if and when a distribution of corporate profits is legally permissible, and a dividend is actually declared by the board of directors. Directors have legal discretion to decide whether or not a dividend should be declared. Shareholders do not have the legal right to demand dividends. As a result, while it might be reasonable to describe the shareholders of a firm which is being liquidated in bankruptcy as the firm's sole "residual claimants," this is not an accurate description of shareholders in operating companies.

7. Shares typically also give shareholders limited political rights, in particular the (usually) exclusive collective right to elect the members of the corporation's board of directors. The exact scope of shareholders' political rights differs substantially from jurisdiction to jurisdiction and from corporation to corporation. For example, some corporations issue multiple "classes" of shares that give some shareholders greater voting power than other shareholders enjoy. In some jurisdictions, shareholders must vote to approve a dividend distribution (assuming one is proposed by the board of directors), while in other jurisdictions shareholders do not vote on dividends. Moreover, the practical effect of shareholders' formal political rights depends on patterns of share ownership. Shareholders exercise their voting rights far more effectively when a single large "controlling shareholder" holds all or most of the company's voting shares, than when share ownership is widely dispersed. No substantial empirical evidence indicates that one pattern of shareholding or shareholder political rights is necessarily superior to another.

8. Corporate officers and employees are agents for the corporation as a separate, property- owning legal entity. They are not the agents of the shareholders or any subset of shareholders, and are under no legal obligation to obey the directives of the shareholders or any subset of shareholders. Moreover, the law usually recognises that the medium to long term interests of this separate entity may not be synonymous with the short-term financial interests of its shareholders.

9. The attitudes of many commentators about the relationship between corporations and their shareholders are inconsistent. For some purposes, they ignore separate corporate personality and treat corporations and their shareholders as identical, arguing that directors should pursue the interests of shareholders and only the interests of shareholders, often on the legally indefensible ground that shareholders 'own' corporations. For other purposes, however, relating to shareholder liability for corporate contractual debts and tortious wrongs, they take separate corporate personality very seriously, treating corporations and their shareholders as radically separate.

10. Contrary to widespread belief, corporate directors generally are not under a legal obligation to maximise profits for their shareholders. This is reflected in the acceptance in nearly all jurisdictions of some version of the business judgment rule, under which disinterested and informed directors have the discretion to act in what they believe to be in the best long term interests of the company as a separate entity, even if this does not entail seeking to maximise short-term shareholder value. Where directors pursue the latter goal, it is usually a product not of legal obligation, but of the pressures imposed on them by financial markets, activist shareholders, the threat of a hostile takeover and/or stock-based compensation schemes.

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