Private Ordering and Public Policy:

The Paradoxical Foundations of Corporate Contractarianism

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Abstract – This article critically examines the dominant contractarian theory of the firm, and the extent to which its main descriptive propositions are actually manifested within the UK's legal framework of corporate governance today. The article's doctrinal analysis is focussed on those principles and rules that together determine the division of decision-making power at the heart of the corporate structure, especially the longstanding contractual principle that underpins both the practical enforceability and normative character of the corporate constitution. The article highlights how the widespread existence of mandatory rules within the UK corporate governance system represents a major empirical aberration to contractarianism's flexible, private-ordering paradigm of law. It furthermore demonstrates that, whilst contractarianism attempts to rationalise mandatory rules as being ultimately consistent with a quasi-contractual theory of rule selection, those explanations are either inappropriate to the UK's law-making environment or else plagued by inherent and self-defeating contradiction. On this basis, the article concludes that contractarian logic is on its own incapable of legitimizing the core legal features of UK corporate governance, and in particular the controversial normative principle of shareholder exclusivity. It

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accordingly identifies the need to develop a defensible public policy justification for shareholder exclusivity based on public-democratic, as opposed to private-contractual, rationality.

Keywords – corporate governance, UK company law, theory of the firm, contractarianism, regulation, politics.

1. Introduction

Over recent decades, the topic of corporate governance has become an increasingly high profile aspect of legal scholarship and practice in the UK. In the process, it has risen from being a relatively niche area of company law to a popular subject of study in its own right. Broadly speaking, corporate governance can be defined as the body of legal rules and other institutional mechanisms that determine the legitimacy of decision-making authority within large, socially significant private enterprises. A growing number of graduate law courses in the UK are now dedicated exclusively to corporate governance, and mainstream company law textbooks are devoting ever more attention to controversial governance issues such as shareholders' rights, board structures, and financial risk oversight. On a practical level, meanwhile, the corporate governance consultancy profession has grown in direct variation with corporate boards' ever-increasing governance responsibilities, to the extent that it is now widely recognized as a distinct City sub-industry in its own right alongside traditional sectors such as commercial law and investment banking.

However, the exponential growth of corporate governance laws and regulations in the UK has proceeded largely in the absence of any unifying, home-

grown conceptual framework on an academic level.[1] In this regard, the UK's experience can be contrasted starkly with that of the United States, where from a very early stage in the development of the modern corporation, corporate[2] law scholars were involved in vigorous academic debates over the purported nature, structure and rightful beneficiaries of the corporate wealth-creation process.[3] The relative dearth of indigenous British corporate governance theory can be attributed to a range of possible factors, such as the more doctrinal (or 'black letter') tradition of corporate law scholarship in the UK relative to the US,[4] and also the comparatively high financial opportunity cost of pursuing a scholarly career in corporate law in the UK.

As a result, the general thrust of modern development in British corporate governance scholarship has been the progressive convergence of ideology and logic in line with the dominant schools of thought developed in the United States. In particular, both American and, increasingly, British scholarship on corporate governance today is influenced heavily by the so-called 'contractarian' theory of the firm which has been dominant within US law and finance theory since the 1970s.[5] In essence, contractarianism regards corporate governance rules as the endogenous outcome of a process of private bargaining between a business firm's various participants, so that the purpose of legal rules is effectively to mimic the market by providing the set of

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[1] As one commentator has remarked, '[a]cademic company lawyers in the UK have not generally been noted for their fascination with theory.' See P Ireland, 'Property and Contract in Contemporary Corporate Theory' (2003) 23 Legal Studies 453, 453.

[2] Whereas the term 'corporate law' is ordinarily used in the United States, in the UK it is still fairly common to refer to the law of incorporated business entities as 'company law'. For purpose of authorial convenience, though, I will tend to use the former of these terms in this article.

[3] See eg EM Dodd, 'For Whom are Corporate Managers Trustees?' (1932) 45 Harvard L Rev 1145; AA Berle, 'For Whom Corporate Managers *Are* Trustees: A Note' (1932) Harvard L Rev 1365; WW Bratton and ML Wachter, 'Shareholder Primacy's Corporatist Origins: Adolf Berle and "The Modern Corporation"' (2008) 34 Journal of Corporation Law 99, esp 100-105, 122-135. On this general trend in US corporate law scholarship, see H Wells, 'The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century' (2002) 51 Kansas L Rev 77.

[4] BR Cheffins, 'Using Theory to Study Law: A Company Law Perspective' (1999) 58 CLJ 197, 208; M Stokes, 'Company Law and Legal Theory' in W Twining (ed), Legal Theory and Common Law (Blackwell 1986) 155, 155.

[5] Ireland (n 1) 453-454; Cheffins, ibid 209.

devices that participants would most likely have chosen themselves in the absence of inhibiting transaction costs.[6] The contractarian theory of the firm is also heavily intertwined with the shareholder wealth maximization norm in Anglo-American corporate governance, insofar as contractarian approaches tend in general to justify shareholders' exclusive residual entitlement to corporate profit streams based on notions of free contracting and efficient institutional evolution.[7]

The influence of contractarianism has undoubtedly been most profound within the United States, where for the past two decades it has constituted the mainstream scholarly take on corporate governance (and, indeed, corporate law in general) as a subject of academic enquiry.[8] At the same time, the spread of influential US-inspired contributions to British scholarship over recent decades,[9] coupled with a shortage of viable home-grown counter-theories,[10] have together ensured the prevalence of American-esque contractarian logic to a significant extent within UK thinking and policy-making today.[11]

Whilst the normative impact of contractarianism – in providing ideological support for prevailing intra-firm distributions of power and wealth – is undeniable,

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[6] As explained in one of the most influential contributions to the contractarian school of corporate law scholarship, 'corporate law as a standard-form contract…should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low.' See FH Easterbrook and DR Fischel, The Economic Structure of Corporate Law (Harvard University Press, 1991) 15.

[7] On this, see P Ireland, 'Defending the *Rentier*: Corporate Theory and the Reprivatisation of the Public Company' in J Parkinson, A Gamble and G Kelly (eds), The Political Economy of the Company (Hart 2000) 141, 162; J Parkinson, 'The Contractual Theory of the Company and the Protection of Non-Shareholder Interests' in D Feldman and F Miesel (eds), *Corporate and Commercial Law: Modern Developments* (Lloyds 1996) 121, 125.

[8] Amongst the most influential academic expositions of this model of corporate law are Easterbrook and Fischel (n 6), Kraakman *et al*'s The Anatomy of Corporate Law: A Comparative and Functional Approach (2nd edn OUP 2009), and Stephen Bainbridge's The New Corporate Governance in Theory and Practice (OUP 2008).

[9] Most notably Brian Cheffins' excellent book Company Law: Theory, Structure and Operation (OUP 1998) and, more recently, David Kershaw's Company Law in Context (2nd edn OUP 2012).

[10] One notable exception to this general trend is John Parkinson's Corporate Power and Responsibility: Issues in the Theory of Company Law (OUP 1993), which provides a comprehensive and path-breaking critical polemic on corporate law theory in a UK context.

[11] Ireland (n 1) 454.

there is cause for considerable scepticism as to the theory's descriptive validity when applied to the UK (as opposed to US) legal environment. The contractarian tenets of private bargain and flexible rule selection could be said to depict with some accuracy the formal nuances of US state (and especially Delaware) corporate law, which typically affords individual companies with significant scope for 'opting out' of important statutory corporate governance requirements via appropriate constitutional charter provision.

By contrast, the UK Companies Act 2006 is established on a default mandatory footing, with the effect that the bulk of its requirements – including important provisions relating to shareholder powers, directors' duties and other corporate governance matters – are rendered concrete and irreversible notwithstanding any attempt by individual companies to stipulate otherwise in their articles of association. Coupled with the sheer volume of the Act – which, at 1300 sections, constitutes the longest enactment in British legislative history – one is given the distinct impression that UK corporate governance is, in reality, *anything but* the flexible, dynamic and privately responsive phenomenon that contractarians seek to depict it as. On the contrary, it is a field that looks and smells highly *prescriptive* and *regulatory* in character, thereby putting into question the descriptive – and, in turn, normative – persuasiveness of scholarly attempts to portray it in a contractarian light.

Accordingly, this article critically examines the dominant contractarian theory of the firm with a view to identifying the extent to which its key propositions are actually borne out within the UK's legal framework of corporate governance today. The article's doctrinal-legal analysis is focussed on the body of statutory rules and supporting common law principles that together determine the division of decision-making power at the heart of the corporate structure. In the discussion that follows,

this category of laws is referred to as *corporate governance law*. This is in distinction from *corporate law* more generally, which deals with numerous issues additional to the division of corporate decision-making power including corporate personality, capital structure, directors' duties and minority shareholder litigation. Except to the (limited) extent that such additional issues have indirect ramifications for the prevailing division of corporate decision-making power, they lie outside the scope of the present study.

The term 'corporate governance law' should additionally be understood in distinction from the broader field of *corporate governance* in general. The latter topic includes many 'soft' quasi-regulatory norms and institutions such as the UK Corporate Governance Code,[12] Stewardship Code[13] and Takeover Code[14] that – whilst of undoubted significance to the division of decision-making power within listed companies – are not formally embodied as *laws* in the orthodox sense of the term.

In any event, few would seek to dispute the notion that the evolution of soft law mechanisms such as the above can validly be attributed to private ordering mechanisms. Also, whilst the practical importance and functionality of soft law mechanisms in UK corporate governance should not be underestimated, they are ultimately dependent for their effectiveness on the underpinning body of 'hard' (i.e. statutory and judicial) laws and principles that establish the basic formal allocation of governance entitlements between shareholders and the board of directors. It is this latter category of doctrines that establishes the initial terms of the contractual bargaining dynamics within the firm, and which accordingly conditions any subsequent allocations of soft law entitlements between key corporate participants. It is therefore to this body of rules that one must turn in order to understand the

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[12] See UK Corporate Governance Code (September 2012), available at: www.frc.org.uk

fundamental legal nature of UK corporate governance, and also the root source of its normative legitimacy as a system.

Of particular significance to the enquiry at hand is the longstanding contractual principle that underpins both the practical enforceability and normative character of the corporate constitution. As will be explained below, the contractual principle is – on a normative level at least - the most fundamental legal principle of UK corporate governance law insofar as it establishes the quintessentially private and self-ordered nature of a company's 'indoor' management affairs.[15] This provides the ideological bedrock for an associational conception of the firm based upon the logic of membership and association, which in turn legitimizes the exclusive entitlement of shareholders to hold and exercise formal governance power over the board.

The article highlights how the widespread existence of mandatory legal rules within the UK corporate governance system represents, at least at first sight, a major empirical aberration to contractarianism's flexible, private-ordering paradigm of institutional evolution. And, whilst contractarian logic attempts in various ways to rationalize mandatory rules as being ultimately consistent with a quasi-contractual theory of rule selection, those explanations are either inappropriate to the UK's law-making environment or else plagued by inherent and self-defeating contradiction. On this basis, the article concludes that contractarian logic is incapable of explaining and legitimizing the significant presence of mandatory rules within UK corporate governance without implicitly accepting an intrinsic public-policy-making role for the interventionist regulatory state. Or, to adopt the theological metaphor, it asserts that prevailing corporate governance rules must by logic be regarded as the product of

[13] See The UK Stewardship Code (September 2012), available at: www.frc.org.uk
[14] See The Takeover Code, 11th ed (May 2013), available at: www.thetakeoverpanel.org.uk
[15] On the significance of this principle of UK (or English) company law generally, see RC Nolan, 'The Continuing Evolution of Shareholder Governance' (2006) 65 CLJ 92.

(exogenous) public-regulatory 'artificial design', as opposed to (endogenous) market-evolutionary 'survival value'. It is the author's intention that this finding will provide the conceptual prelude to a much-needed debate about the diverse social objectives that corporate governance law should be designed to serve today.

To this end, the article is structured as follows. Section 2 explains the key features of contractarianism: both as a conceptual lens through which to study and understand corporations, and as a political ideology for legitimizing their prevailing structural features. Section 3 critically assesses the main contractarian rationales for mandatory corporate governance rules. Section 4 queries whether contractarianism can be said to provide a valid rationalization of the most fundamental aspects of UK corporate governance law, by examining the combination of quasi-contractual and mandatory rules that together shape the contours of the corporation's internal decision-making structure in the UK. Section 5 concludes by highlighting the political challenges for academic corporate lawyers posed by the article's core claim, which is that the private ordering paradigm of corporate law evolution is prone to logical implosion when subjected to close analytical scrutiny.

Before continuing, an important substantive proviso should be noted. The discussion that follows is relevant principally to public companies, which in the UK are typically characterized by widely-held share ownership, professional directors and management, and the ensuing phenomenon known as the separation of ownership and control.[16] This is in line with how corporate governance is conventionally regarded as a subject of academic enquiry, at least within the Anglo-American environment. Admittedly, the legal rules and principles that are examined in section 4 of this article

[16] On this notion generally, see AA Berle and G Means, *The Modern Corporation and Private Property* (4th ed Harcourt, Brace & World 1968; first published 1932); MT Moore and A Reberioux, 'The Corporate Governance of the Firm as an Entity: Old Issues for the New Debate' in Y Biondi, A

are also of potential relevance to private companies, and some of the insights in section 5 may additionally be relevant to larger closely-held companies with relatively diverse ownership bases. If so, though, it will be a matter of happenstance rather than authorial intention. Accordingly, readers should interpret the discussion and arguments in this article from a public company perspective only.

2. *The contractarian theory of corporate governance law*

A. *The corporation (or 'firm') as a nexus of contracts*

Corporate contractarianism was developed initially by US financial economists and corporate lawyers over the course of the late twentieth century,[17] as part of a more general ideological transition in the Anglo-American political economy: from the mid- and post-war consensus of state-centric corporatism, towards the market-centric neo-liberalism that became an increasingly pervasive reference point for intellectuals and policy-makers in the century's latter half. As a not-insignificant microcosm of this wider institutional paradigm shift, corporate contractarianism represented a

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Canziani and T Kirat (eds), *The Firm as an Entity: Implication for Economics, Accounting and the Law* (Routledge 2007) 348, 349-352.

[17] The seminal works of this school of thought include AA Alchian and H Demsetz, 'Production, Information Costs, and Economic Organization' (1972) 62 American Economic Review 777; MC Jensen and WH Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305; EF Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 Journal of Political Economy 288; EF Fama and MC Jensen, 'Separation of Ownership and Control' (1983) 26 Journal of Law and Economics 301; FH Easterbrook and DR Fischel, 'The Corporate Contract' (1989) 89 Columbia L Rev 1416; Easterbrook and Fischel (n 6). Although the foundational piece of scholarship in the contractarian tradition is commonly regarded to be Ronald Coase's landmark 1930s article 'The Nature of the Firm' (1937) 4 Economica 386, this work is arguably better regarded as a significant influence for the (later) contractarian movement, rather than as a constituent part of that movement itself.

crucial antidote to the modern business corporation's progressive intellectual removal over previous decades from the orthodox field of economic analysis.[18]

Against this historical and intellectual backdrop, contractarianism essentially sought to reinvigorate the business corporation as a subject of orthodox economic analysis, and thus to portray the modern public corporation as being continually subject to the 'invisible hand' of market governance as opposed to the 'visible hand'[19] of technocratic managerial or state control. In this regard the theory can be regarded as a key and characteristic component of the wider neo-liberal agenda, which essentially sought (ultimately with widespread success) to assert the superiority of decentralized markets over technocratic organisations (both statist and non-statist) in achieving the allocative efficiency and political legitimacy of socio-economic arrangements.[20]

The conceptual starting point of corporate contractarianism is at first sight somewhat paradoxical. In essence contractarianism asserts that, analytically, the institution known as the business corporation is not an 'institution' at all in any meaningful metaphysical sense.[21] Rather, a corporation (or 'firm') is from a practical point of view comprised of nothing more than the particular collection of individuals who are at any one time involved in the carrying on of its productive operations.[22] These individuals will typically include equity and debt investors, workers (including

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[18] For a statement of intent to this effect by two early protagonists of the contractarian position, see Jensen and Meckling, ibid 307.

[19] This latter term is attributable to the US business historian Alfred Chandler, who developed it as a modern counterpose to the well-known former notion as developed in Adam Smith's classical economic text The Wealth of Nations (1776). See AD Chandler, The Visible Hand: The Managerial Revolution in American Business (Harvard University Press 1977).

[20] On the origins and history of neo-liberalism generally, see C Crouch, The Strange Non-Death of Neoliberalism (Polity 2011) ch 1.

[21] P Ireland, 'Recontractualising the Corporation: Implicit Contract as Ideology' in D Campbell, H Collins and J Wightman (eds), Implicit Dimensions of Contract (Hart 2003) 255, 260.

[22] In this regard, the contractarian model of the firm could be said to bear a certain parallel with Margaret Thatcher's famous (or, depending on one's political perspective, *infamous*) adage that 'there is no such thing as society…[only] individual men and women'. Ireland refers to this conceptual

directors and managers), trade creditors and customers. If the firm deserves any independent recognition as a 'thing' in itself, it is merely the notional 'nexus'[23] or 'hub' around which these various micro-agents contract with one another,[24] each offering their respective 'inputs' to the production process (e.g. equity, debt, physical or human capital) in exchange for a corresponding 'output' (e.g. dividend, interest, price or wage).[25]

Accordingly the key analytical characteristic of contractarianism is its capacity to explain the structure and operation of the firm anatomically in terms of the collective pattern of economic incentives motivating its various individual

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phenomenon as 'the corporate vanishing trick'. See P Ireland, 'The Myth of Shareholder Ownership' (1999) 62 MLR 32, 56.

[23] See Easterbrook and Fischel (n 6) 11-12. For this reason corporate contractarianism is commonly referred to in the alternative as 'nexus of contracts' theory. Although now a generic term of reference, the literal phrase would appear to be attributable to the financial economist Eugene Fama, who coined it in his 1980 article 'Agency Problems and the Theory of the Firm' (n 17) 290.

[24] In reality, of course, the 'nexus' or 'hub' will be represented by the firm's senior management team, them being the one party that is (at least theoretically) common to the negotiations with all input-providers. However, managers are ultimately themselves no more than a mere input-provider to the firm's production process (insofar as they supply their human capital) like everyone else, so that it arguably makes no sense at all to speak of 'the corporation' in the sense of an autonomous, reified institution 'in itself'. Rather, in the words of Jensen and Meckling, the corporation is ultimately just a 'legal fiction which serves as a nexus for contracting relationships'. See Jensen and Meckling (n 13) 311.

[25] In defence of their atomistic model of the business corporation, contractarian theorists typically play down the practical significance of any aspects of corporate law averse to this conceptualisation. In particular, the two legal qualities that are arguably most fundamental to the autonomous corporeal identity of the modern commercial company – namely separate corporate personality and limited shareholder liability – are interpreted by contractarians as effective products of individual bargaining between shareholders and creditors with respect to apportionment of the risk of business failure. This renders these qualities consistent with the rationality of private ordering. The logic is that – if corporate personality and limited shareholder liability were not made generally available by law – it would be technically feasible for shareholders, directors and creditors to achieve the same basic effect as these rules via mutual contractual stipulation. Hence creditors could individually agree to surrender their right to recover money due from shareholders up to a specified limit in return for a compensatory higher rate of interest on their debts. Meanwhile, directors could agree – in exchange for a correspondingly higher rate of remuneration – to act as formal owners of the company's property and also defendants to any business-related litigation, thereby rendering the shareholders' individual identities irrelevant to the continuing functioning of the firm. In these ways, corporate contractors could feasibly ensure the same form of risk-shifting that occurs as a result of the corporate personality and limited liability doctrines, albeit at the expense of higher transaction costs. It therefore follows that the only real function of these doctrines is to enable efficient individual risk apportionment to take place at a cheaper cost to contractors than would otherwise be possible. Accordingly, the formal notion of corporate personality should not be regarded as detracting from the fundamentally individualistic nature of the firm as a network of prudential contractual relationships. On this, see Cheffins (n 9) 31-41; FH Easterbrook and DR Fischel, 'Limited Liability and the Corporation' (1985) 52 U Chicago L Rev 89. For a critical counter-perspective on this position, see Ireland (n 1) 473-474.

participants. Through this neo-classical economic lens, it becomes possible to ascribe theoretically rational behavioural modes to a corporation's various constituent groups based on the conceptual framework of an implicit and ongoing 'bargain' over their respective entitlements to share in the wealth generated by the firm's productive operations.[26] Allied to this contractual bargaining hypothesis of corporate governance is a passive-instrumental conception of corporate law, whereby legal rules and structures are essentially flexible and facilitative 'tools'; reflective of the commercially expedient arrangements that corporate participants would otherwise tend to establish with one another via private transacting, and correspondingly not as coercive embodiments of moral-political norms established via public consensus and teleological debate.[27]

B. Contractarianism and shareholder exclusivity

On the above conceptual basis, corporate contractarianism in particular attempts to resolve a pressing social-scientific dilemma thrown up by the structure of the modern corporate enterprise, by recourse to orthodox economic methodology. This is the question as to why shareholders continue in general to enjoy exclusive profit and governance rights in public corporations, when they no longer fulfil any distinct ownership or even control function in the firm having been substantially externalised from the productive process. In confronting this dilemma, contractarianism typically relies on the dual notions of individual rationality and internal agreement as a source of a priori legitimacy for the institutional status quo. In other words, rather than seeking to demonstrate on the basis of empirical enquiry and reasoned moral-political

[26] See Fama (n 17) 289.

debate whether prevailing corporate rules and structures are socially desirable, contractarian logic presumes their legitimacy by virtue of the fact of their continuing existence (by implicit agreement).[28] Accordingly the primary question for academic corporate lawyers is that of *why* these notional 'agreements' are generally struck within firms, rather than whether the ensuing norms should exist in the first place. For this reason contractarianism could justifiably be described as a pathologically conservative framework of analysis.

In seeking to explaining why the normative principle of shareholder exclusivity retains prominence within managerially-controlled public corporations, contractarian theorists seek to re-invent the classical economic concept of entrepreneurial risk-taking in a revised form appropriate to the characteristics of modern corporate (as opposed to individual) enterprise.[29] Hence contractarianism portrays the modern corporate equity investor as a 'residual risk bearer', who voluntarily undertakes the risk of periodic business underperformance by entering into a notionally 'incomplete' contract with the firm under which her periodic economic returns are unspecified. By contrast other corporate constituent groups, notably workers and lenders, are (in theory at least) usually able to specify in advance their economic return from the firm plus the conditions upon which they agree to advance their respective input to the firm's production process.[30] The logic continues as follows.

[27] See Easterbrook and Fischel (n 6) 4-6.
[28] On this, see generally Ireland (n 21).
[29] On the inappositeness of classical entrepreneurial concepts as a means of rationalising large-scale corporate enterprise, see D Campbell, 'Adam Smith, Farrar on the Company and the Economics of the Corporation' (1990) 19 Anglo-American Law Review 185.
[30] On this, see G Kelly and J Parkinson, 'The Conceptual Foundations of the Company: a Pluralist Approach' in J Parkinson, A Gamble and G Kelly (eds), The Political Economy of the Company (Hart 2000) 113, 114 – 121.

As compensation for bearing the 'downside' risk of receiving little or nothing in the event of the firm being loss-making, the equity investor will rationally bargain for the corresponding upside entitlement to the whole of the 'residual' profit generated by the firm over a successful period: that is to say, for any outstanding net returns remaining once all other factors of production (e.g. employees, lenders, suppliers) have been paid their respective fixed contractual entitlements.[31] Furthermore, in order to exert a degree of influence over how managers use their invested funds, equity investors as a group will tend to demand certain extra-contractual (i.e. hierarchical) governance protections entitling them at a minimum to: (i) the collective ex ante power of appointment (and re-appointment) over the board of directors at specified intervals; and (ii) the capacity to remedy managerial misconduct on an ex post facto basis in court by means of the directors' fiduciary principle in corporate law.[32]

Meanwhile other corporate constituent groups will in the typical case be able to achieve satisfactory protection for their various investments under their respective 'complete' contracts with the firm, thus making hierarchical governance rights unnecessary. Moreover, non-shareholder groups will be prepared to concede governance entitlements to equity investors on the understanding that this arrangement will on the whole prove to be mutually beneficial for them. This is because equity investors are uniquely placed to diversify their capital on an economy-wide basis and thus hedge against the risk of individual firm failure, meaning that the failure of any one firm in which a shareholder is invested will generally not be catastrophic for her overall economic position.[33]

[31] Fama and Jensen (n 17) 302-303; Easterbrook and Fischel (n 6) 11.
[32] Easterbrook and Fischel, ibid 91; Bainbridge (n 8) 71.
[33] Fama (n 17) 291; Easterbrook and Fischel, ibid 29.

Equity investors are consequently much more capable than other groups at absorbing the occasional losses resulting from risky but potentially pathbreaking ventures which, although liable to increase temporarily the likelihood of firm failure, if successful will generate long-term economic benefits for the firm and its participants as a whole. However other corporate constituent groups, such as workers and suppliers, are by nature 'over-invested' in specific firms in the sense that they usually stand to lose considerably in the event of individual corporate failure. Such groups, therefore, it vested with corporate governance rights would arguably not be prone to support risky strategies by management even where they promise positive risk-adjusted returns for the firm.

Moreover, to the extent that making boards of directors answerable to multiple constituencies is arguably prone to engender conflicts of interest and thus undermine consensus decision-making, it is universally preferable from the viewpoint of the corporation's participants as a whole to establish a system of clear and unitary directorial accountability to one single, roughly homogenous group.[34] And, for the above reason, shareholders generally stand out as the most desirable candidate in this regard. It follows therefore that a company's various participants will have a mutual incentive to agree to the vesting of corporate governance entitlements in shareholders *exclusively*, as this is the only distribution of rights within the firm that is consistent with the advancement of the productive dynamism and overall wealth-generating capacity of its business.

At the same time, though, contractarianism does not regard shareholders' exclusive voting rights as having any direct use value other than in the most

[34] See Easterbrook and Fischel, ibid 38; Bainbridge (n 8) 66-67; MC Jensen, 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function' (2001) 7 European Financial Management 297, 301.

exceptional of instances.[35] In particular, given the informational and collective action impediments to the effective functioning of the shareholder franchise within large public corporations, it is for the most part purportedly irrational for shareholders to do anything other than endorse those candidates proposed by the board itself for periodic election or re-election as directors.[36] Likewise, within the contractarian paradigm it makes little sense for shareholders to attempt collectively to second-guess the strategic decisions of management even on major issues such as proposed mergers or corporate restructurings, given the latter's superior awareness and understanding of the complex factors underlying such initiatives.[37]

The only situation in which shareholder voting rights are expected to be directly instrumentalized vis-a-vis the board as a matter of course is in the extraordinary case of a hostile tender offer or proxy fight, where a third party attempts to gain control over a firm's voting franchise (whether by outright acquisition of its share capital or by soliciting the voting rights of existing shareholders) as a prelude to ousting its incumbent board from office.[38] Whilst such instances are uncommon and usually restricted to egregious cases of managerial underperformance, the very possibility of shareholders' votes being aggregated in this way is sufficient to instil the shareholder franchise with significant 'threat' value. In this indirect capacity, shareholders' voting rights theoretically operate as a tacit but nevertheless crucial disciplinary mechanism insofar as they compel corporate managers to maintain the market value of a firm's equity, via adherence to the general shareholder interest, so

[35] Bainbridge (above n 8, 235) argues that '[p]roperly understood, shareholder voting…is not an integral aspect of the corporate decision-making structure, but rather an accountability device of last resort to be used sparingly, at best.'
[36] Easterbrook and Fischel (n 6) 87.
[37] Bainbridge (n 8) 43-44; Easterbrook and Fischel, ibid 67.
[38] Bainbridge, ibid 235.

as to pre-empt any potential contest for control and the associated likelihood of displacement.[39]

Besides the market for corporate control, there are other important market-institutional pressures acting on corporate managers within the contractarian paradigm that further remove the perceived need for direct shareholder involvement in a firm's business affairs. As a precondition of ensuring the continuing provision of capital to the firm on favourable terms, managers will rationally be driven to establish institutional 'bonding' mechanisms that provide credible assurances to outside investors against the risk of misappropriation of their funds or other forms of mismanagement. These mechanisms include the voluntary formation (by managers) of independent boards staffed by a majority of outside (i.e. non-executive) directors, which are typically vested with the principal responsibility of supervising high-level managerial decisions and conduct in the interests of shareholders, as backed up by the collective board power to remove managers in the event of underperformance.[40]

Additionally such bonding devices include the voluntary establishment (by managers and/or independent boards) of performance-related remuneration systems (e.g. executive stock options) that render managerial compensation sensitive to changes in the firm's share price, so as theoretically to provide the further assurance to shareholders that managers will be motivated proactively to maximize shareholder wealth on a continuing basis.[41] Furthermore, corporate managers are purportedly subject at all times to labour market pressures operating both within and outside of the firm, which can be said to reinforce the above mechanisms by ensuring the

[39] On the (at least theoretic) role of the so-called market for corporate control as a market-disciplinary device within the contractarian frame of logic, see HG Manne, 'Mergers and the Market for Corporate Control' (1965) 73 Journal of Political Economy 110.
[40] On this, see generally Jensen and Meckling (n 17).

availability of competent substitute personnel in the event of an incumbent's removal from office in one of the aforementioned ways.[42] Finally the directors' fiduciary principle at common law – itself a purported manifestation of shareholder agreement within the contractarian paradigm – acts as a crucial contractual 'gap-filling' device by encouraging continual managerial deference to the collective shareholder interest even in developing or unforeseen circumstances that could not reasonably be provided for in advance via private ordering.[43]

Accordingly contractarianism succeeds in establishing an instrumental rationale for shareholder exclusivity based on the logic of implicit bargain and private ordering. In doing so, it seeks to highlight the purportedly key corporate function of equity investors in effectively underwriting entrepreneurial risks, notwithstanding the typical absence of direct shareholder involvement in the firm's internal management affairs.

C. Contractarianism and the political principle of 'unanimity'

In re-conceptualizing the evolution of corporate governance norms – and, in particular, the shareholder exclusivity principle – as an endogenous process governed ultimately by the collective and de-centralized rational choices of shareholders, contractarianism establishes a strong ideological presumption against regulatory 'interference' in corporate governance on public policy grounds. Any such deliberate state intervention in internal firm affairs accordingly represents a clumsy intrusion into the nuanced

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[41] On the (theoretic) role of managerial performance remuneration as a contractual gap-filling device within the contractarian model, see MC Jensen and KJ Murphy, 'Performance Pay and Top-Management Incentives' (1990) 98 Journal of Political Economy 225.
[42] On this, see Fama (n 17).
[43] See Easterbrook and Fischel (n 6) 91.

private ordering process that underlies the development of efficient corporate rules and structures at a micro level.

Within the contractarian paradigm, the role of the courts and regulatory state in corporate governance is instead restricted to that of providing on an 'off-the-shelf' basis those 'default' rules and structures that are likely to be adopted in the majority of hypothetical agreements concerning the governance of individual firms. This saves incorporators the extensive transaction costs that would otherwise be involved in establishing those rules on an ad hoc contractual basis. At the same time, those firms for whom the default norms are unsuitable in any respect(s) are theoretically permitted to 'opt out' of the standard system and put in place their own alternative corporate governance arrangements instead.[44]

From the point of view of establishing the political legitimacy of the corporate governance system as a whole, the contractarian conception of law as a facilitative, politically neutral and freely derogable framework is crucial in imbuing prevailing governance rules and structures with the neo-liberal characteristics of unanimity and non-coerciveness.[45] The politico-economic quality of 'unanimity', in the words of Milton Friedman, entails that '[i]n an ideal free market resting on private property, no individual can coerce any other, all cooperation is voluntary, all parties to such cooperation benefit or they need not participate.'[46] It follows from this logic that within a market-governed social environment '[t]here are not values, no "social" responsibilities in any sense other than the shared values and responsibilities of

[44] See Easterbrook and Fischel (n 17) 1444; Bainbridge (n 8) 35-37.

[45] As Ireland explains: '[d]epicted in this [contractarian] way, corporations are deemed to be fundamentally 'private' affairs, the non-coercive products of agreements voluntarily and consensually entered into by a range of private property owners.' See above (n 1) 485.

[46] M Friedman, 'The Social Responsibility of Business is to Increase its Profits' (1970) The New York Times Magazine in TL Beauchamp, NE Bowie and DE Arnold, *Ethical Theory and Business* (8th ed Pearson 2009).

individuals', on the understanding that '[s]ociety is a collection of individuals and of the various groups they voluntarily form.'[47]

Accordingly, in the context of corporate governance, since theoretically: (i) no individual firm need ever be subject to an internal corporate rule that its shareholders do not collectively signal their assent to; and (ii) no shareholder (or any other corporate constituent for that matter) need ever remain invested in a firm whose internal governance structure they are unhappy with; it follows that corporate governance law is an intrinsically *non*-coercive institution, whereby no person need be compelled to abide by a state of affairs that they would not otherwise be inclined to accept on the basis of free contracting.

With the theoretical absence of violation of individual free will under corporate governance law, there is correspondingly no need for prevailing corporate rules and structures to derive legitimacy by recourse to the political-democratic principle which, according to Friedmanite neo-liberal logic, comes into consideration within a social environment where 'conformity' is called for on the part of individuals. That is to say, where '[t]he individual must serve a more general social interest' with the consequence that it becomes 'appropriate for some to require others to contribute to a general social purpose whether they wish to or not.' [48]

In the latter type of situation, it is politically imperative within a democratic system for citizens to be able to reach collective agreement on the particular substantive outcomes that accord most fully with the majoritarian conception of the public interest. However, since within the contractarian paradigm corporate governance laws already derives their social legitimacy from the market-based unanimity principle, it is consequently unnecessary and, moreover, politically

[47] Ibid.

illegitimate to engage in this wider democratic debate about the overall socio-economic objectives that the legal framework of corporate governance should be designed to achieve.

It follows from this that regulatory state intervention in corporate governance – where geared to the advancement of collective social (as opposed to individual prudential) values – arguably risks blurring the divide between state and civil society by substituting the 'consensus' rationality of democratic politics for the 'unanimity' rationality of the marketplace. Within the latter system, *all* participants theoretically remain free to opt out of a particular relationship or arrangement that does not accord with their individual preferences, with the effect that no person can be compelled to submit to a state of affairs that they do not wish to be part of. However, public regulation by nature entails the imposition of given obligations, limitations or structures onto citizens for the purpose of achieving some wider social objective that the affected individuals may or may not share.

When applied in respect of issues such as corporate governance that would otherwise fall to be determined by the collective prudential decisions of individual citizens (principally investors and corporate managers), such purported state 'interference' with the supposed invisible hand of private ordering becomes highly problematic from a contractarian point of view. Largely for this reason, interventionist regulation of corporate governance affairs in the name of protecting the wider public interest is widely regarded by Anglo-American legal scholars today, whether in express or implied terms, as an illegitimate constraint on private sector autonomy within a 'free' (i.e. market-liberal) political economy.

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[48] Ibid.

3. Rationalizing mandatory rules within the contractarian paradigm

A. Mandatory rules as a difficult empirical pill for contractarians to swallow

It was explained in section 2 above that, within the contractarian paradigm, legal rules in respect of the structure and operation of business firms derive their perceived effectiveness and legitimacy largely from their inherent qualities of flexibility and practical instrumentality. From this perspective, it is commonly argued that – wherever possible – corporate governance norms should be readily adaptable and reversible so as to be responsive to the individual preferences of key corporate participants (principally shareholders and managers) as expressed in the market-determined 'bargains' that they are notionally inclined to strike with one another. From a political point of view, meanwhile, flexible and reversible rules could be said to resonate with the basic pluralist values of a liberal civil society, on account of their apparent status as the product of decentralized private ordering as distinct from governmental imposition or 'grand design'.

It follows that, for proponents of the contractarian position, the presence of *mandatory* – that is to say, formally 'rigid', universal and irreversible – rules within corporate governance law is a difficult empirical pill to swallow. From a contractarian perspective, the purportedly problematic characteristics of mandatory corporate governance laws are twofold. First, there is their perceived effect in undermining individual contractual autonomy, by seeking to pre-empt institutional outcomes that *can* and – thus, arguably – *should* be determined privately by contractors. Secondly, mandatory rules in private law could be said to prevent contracting parties from rationally calculating what arrangements are best suited to improve their own joint

utility or welfare, instead seeking to prescribe a state-determined outcome that is likely to be unreflective of the affected parties' individually rational preferences.

However contractarian theorists, far from ignoring or seeking to cover up the difficulties that mandatory rules pose for their conceptual model of corporate governance, have contrarily opted to recognize and subsequently tackle this empirical phenomenon head on. Hence, in recent decades, an important element of contractarian scholarship on corporate governance has comprised attempts to explain the presence of the prima facie mandatory or regulatory aspects of law in a manner that actually *supports*, rather than detracts from, the basic private ordering rationality behind the contractarian position. The two principal rationales that contractarians have developed in an attempt to render mandatory rules consistent with their model are: first, the 'take-it-or-leave-it' rationale; and, second, the 'market mimicking' rationale. Each of these arguments will now be critically examined in turn.

B. The 'take-it-or-leave-it' rationale for mandatory rules

The 'take-it-or-leave-it' argument basically asserts that mandatory corporate governance rules are in practice not mandatory at all, because corporations ultimately can choose to incorporate or re-incorporate in any jurisdiction offering an alternative 'menu' of regulatory choices.[49] An analogy can be drawn with a store selling only one variety of a particular good, say sandwiches for instance. Assuming that there are stores selling other types of sandwich, and that these stores can easily be accessed in the alternative to visiting the first store, the consumer's choice will in reality not be restricted at all.

By a parallel course of reasoning, one can conclude that an investor who chooses to invest her wealth in a corporation governed in accordance with a particular 'bundle' of mandatory rules is doing so at the opportunity cost of investing in a firm subject to another state's regulatory system, or alternatively putting her wealth into a non-corporate use such as real estate, commodities or unincorporated enterprise. The chain of logic is that since: (i) investors will rationally seek to put their equity into those firms offering the most economically advantageous set of governance 'terms', and (ii) firms will in turn seek to incorporate (or re-incorporate) in those jurisdictions offering the most investor-friendly set of terms on an off-the-shelf basis (given that the system of corporate law to which a firm is subject is generally determined by its state of incorporation); it follows that (iii) state regulators will compete with one another to offer the terms that investors (and, in turn, incorporators) find most attractive with a view to enhancing the revenues that states derive from incorporations carried out within their respective jurisdictions.[50]

Accordingly mandatory rules, in spite of their prima facie rigid, draconian and anti-contractual form, can be regarded in themselves as the dynamic product of a market-evolutionary process involving investors, firms and regulators. The political implication is that mandatory corporate governance rules, just like reversible-default provisions, represent the outcome of a free private ordering process in which no individual participant in the proverbial 'bargain' (whether an investor or even an entire firm) need be compelled to conform to a sub-optimal institutional outcome. As Stephen Bainbridge eloquently puts it:

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[49] See eg Easterbrook and Fischel (n 17); SM Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 Harvard L Rev 1735.

[50] Easterbrook and Fischel, ibid 1419-1420.

> 'the rights of the shareholders are established through bargaining, even though the form of the bargain typically is a take-it-or-leave-it standard form contract provided off-the-rack by the default rules of corporate law and the corporation's organic documents.'[51]

Notwithstanding its conceptual elegance, the above contractarian rationalization of mandatory rules is severely limited when considered in the context of the UK. The argument has been developed with specific regard to the competitive-federal corporate law-making system that exists in the United States, whereby incorporators have an effective 'menu' of 51 different state-level corporate law systems to choose from. Moreover in the United States there are no deliberate legal barriers either to inter-state reincorporation or to the setting up or transfer of a company's business operations outside of state boundaries.[52]

The UK by contrast, in spite of being comprised of two traditionally autonomous legal systems and four separate national legislatures today, nonetheless by and large exhibits a unitary corporate law system. At the wider EU level, meanwhile, in spite of the principle of community-wide freedom of establishment[53] it remains possible for Member States to restrict companies incorporated within their national jurisdiction from having their primary business establishment in another Member State.[54] The effect of this legal position – known as the 'real seat' doctrine – is to prevent incorporators in general from deciding on a company's state of

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[51] Bainbridge (n 8) 33.

[52] Arguably the most influential and comprehensive rationalisation (and defence) of the US competitive-federal system of corporate law-making is provided in R Romano, The Genius of American Corporate Law (AEI 1993).

[53] The strongest affirmation of this principle in the context of cross-border incorporation/establishment disputes remains the well-known Centros case. See Case 212/97, Centros Ltd v Erhvervs- og Selskabsstyrelsen [1999] ECR I-1459.

incorporation independently from the question as to where it intends to conduct its principal business operations.[55] This precludes firms (and, indirectly, investors) from engaging in the type of unencumbered corporate law 'shopping' that contractarian theorists commonly laud as a key strength of the US law-making system.[56] By implication, it means that mandatory corporate governance rules established within an EU (including UK) context cannot readily be regarded as the product of rational free choice and are thus largely out of kilter with the private ordering hypothesis.

A further problem with the 'take-it-or-leave-it' rationale for mandatory corporate governance rules is that it does not on its own satisfactorily explain why, even within the parameters of an American-esque competitive-federal system, mandatory rules are chosen by regulators in preference to the more flexible and prima facie market-responsive option of reversible-default provisions. Accordingly some further explanation is required to account for the widespread prevalence of mandatory rules pertaining to the division of corporate decision-making power between shareholders and directors, especially within the UK's substantially unitary corporate law-making environment where, as explained above, the range of alternative regulatory choices available to incorporators (and prospective re-incorporators) remains significantly restricted.

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[54] See Case C210/06, Cartesio Oktato es Szolgaltato bt [2009] ECR I0000 ('*Cartesio*'); Case C81/87, The Queen v HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc [1988] ECR 5483 ('Daily Mail').

[55] On this, see P Syrpis and A Johnston, 'Regulatory Competition in European Company Law after Cartesio' (2009) 34 European L Rev 378.

[56] On the potential benefits of engendering US-style regulatory competition in the EU context, see J Armour, 'Who Should Make Corporate Law? EU Legislation versus Regulatory Competition' (2005) 58 Current Legal Problems 369; J Lowry, 'Eliminating Obstacles to Freedom of Establishment: The Competitive Edge of UK Company Law' (2004) 63 CLJ 331; WG Ringe, 'Sparking Regulatory Competition in European Company Law - The Impact of the Centros Line of Case-Law and its

C. *The 'market mimicking' rationale for mandatory rules*

An arguably more convincing contractarian explanation for the existence of mandatory corporate governance rules is provided in the form of what may broadly be referred to as the 'market mimicking' rationale. The argument is that despite the overall economic benefits of natural rule selection, there are inevitably occasions where rules will be 'mispriced' by the stock market: that is to say, where investors will fail to discount adequately the projected returns from a corporate equity investment to reflect latent weaknesses or inefficiencies in the relevant firm's governance structure.

Rule mispricing is prone to occur in situations where the 'search' costs that investors must incur in order to ascertain the importance of any particular corporate governance 'term' are prohibitively high. This could be said to be true in respect of complex, niche or infrequently used governance powers of shareholders in the UK such as their rights to propose members' resolutions in General Meetings, or to effect amendments to a company's articles of association.[57] In the absence of mandatory and universally-applicable rules setting out these powers, the likely outcome is that investors will systematically fail to acquire the degree of legal awareness and understanding required to recognise: (i) those cases where any such provisions are excluded under the terms of a particular company's constitution; and (ii) the consequences of such exclusion for the overall balance of decision-making power between that company's shareholders and board/management.[58]

Concept of "Abuse of Law"' in R de la Feria and S Vogenauer (eds), Prohibition of Abuse of Law - A New General Principle of EU Law (Hart 2010).

[57] On these legal provisions, see part 4 below.

[58] Easterbrook and Fischel (n 13) 1436.

Accordingly, the function of mandatory state regulation of corporate governance affairs is, in effect, to tease out the purportedly optimal bargaining outcomes that are liable to ensue in the absence of transaction costs and other impediments to efficient contracting, so that contracts can be made to work.[59] That is to say, the regulatory state – via appropriately targeted interventions in private ordering – can succeed in providing 'what the parties would ideally have wanted' as the outcome to their mutual bargain, but for whatever reason were unable to arrive at – or perhaps even recognize as optimal – under the given circumstances. In other words, the purpose of regulation is in effect to 'mimic' the operation of an efficiently functioning market, whereby contracting parties are impulsively inclined towards those agreements that are best calculated to advance their respective material interests.[60]

Mandatory corporate governance rules are argued to be particularly important in respect of issues on which managers' interests are likely to diverge substantially from those of shareholders, such as those provisions of UK law discussed in part 4 below. The expectation is that managers, if presented with the opportunity to propose constitutional amendments that have the effect of disapplying such provisions in respect of any individual firm, will rationally be inclined to exploit their informational

[59] For instance, Jeffrey Gordon claims (somewhat paradoxically) that '[t]he existence of some mandatory rules may lead to *better contracts* [and therefore] may be best even from an essentially contractarian perspective.' See JN Gordon, 'The Mandatory Structure of Corporate Law' (1989) 89 Columbia L Rev 1549, 1554, 1549 (emphasis added). For a similar defence of mandatory corporate governance rules on fundamentally contractarian grounds, see LA Bebchuk, 'The Debate on Contractual Freedom in Corporate Law' (1989) 89 Columbia L Rev 1395.

[60] For example, Bernard Black argues that '[s]ome mandatory rules [in corporate law] may survive because they mimic the market', and thus 'would be universally adopted by contract, assuming the parties knew about them.' Black claims that such rules are consequently 'trivial', in the sense that they 'have no bite' (that is, no socially-determinative effect in their own right). See B Black, 'Is Corporate Law Trivial?: A Political and Economic Analysis' (1990) 84 Northwestern University L Rev 542, 552, 551.

and positional advantages vis-à-vis shareholders in order to do so.[61] And, given the general inclination of shareholders to acquiesce in resolutions proposed by management in General Meetings, there is correspondingly a strong likelihood that such opt-outs will be formally approved irrespective of their overall economic effect on the company and its investors.[62]

D. The limitations of the 'market mimicking' rationale

In spite of its conceptual sophistication and explanatory eloquence, the 'market mimicking' rationale for mandatory corporate governance rules is – on closer inspection – highly problematic. Above all, it would appear to be premised on a fundamental contradiction. This is the apparent tendency of the argument simultaneously to both proclaim *and* deny the capacity of private contracts to produce distributive outcomes that are optimal – or, at least, broadly desirable – from the perspective of the contracting parties themselves.

Indeed, of particular noteworthiness in this regard is the fact that that the market mimicking rationalization supports a relatively extensive (for contractarian standards) role for regulation – not just for the orthodox facilitative purpose of 'filling gaps' in (otherwise independently constituted) agreements, but – moreover – with a view to effecting *outright displacement* of actual contractual outcomes, and their substitution with a regulatory embodiment of those outcomes that allegedly would

[61] On this, see Bebchuk (n 59); MA Eisenberg, The Structure of Corporation Law (1989) 89 *Columbia Law Review* 1461. Arguably a common example of such a practice in the US is the traditionally widespread 'classification' of boards, which enables firms to opt out of the default 'shotgun' power that would otherwise be available to shareholders under Delaware law. On this, see MT Moore, *Corporate Governance in the Shadow of the State* (Hart 2013) 102-103.
[62] See Gordon (n 59) 1573-75.

have ensued within some sort of fictional alternatively reality. This presents two significant and mutually reinforcing problems.

The first problem with the market mimicking argument for regulatory state interventionism concerns the methodology of its underpinning hypothetical bargaining construct. As useful as this conceptual device is, a hypothetical bargain is ultimately what it purports to be – that is, *hypothetical*. As such, it has no actual empirical content but – rather – begins life as nothing more than a theoretical 'empty vessel' that requires subsequent 'filling' by scholars on an artificial and counter-factual basis. However, far from being a weakness of hypothetical bargaining rationality, the theory's characteristic counter-factuality is its most powerful feature, in that it establishes a normative case for social or regulatory outcomes different to those prevailing under (inferior) real world bargaining conditions.[63]

But given that the point of deploying the hypothetical bargaining construct is to justify desirable outcomes from purported 'first principles', everything depends on *how* – exactly – the identity of the contractors is constructed within the theory's notional 'original position' of the fictional bargaining table.[64] Absent convincing and generally acceptable reasons to justify *why* the hypothetical contractors were constructed in a given way, any conclusions that result from the deployment of such logic are prone to be rejected as invalid on grounds of their perceived arbitrariness or political partiality.[65]

The defensibility of the answers given to methodological questions such as the following are hence crucial to the validity of any particular application of hypothetical

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[63] On the counter-factuality of the hypothetical bargaining construct, and the conceptual problems that this poses, see R Dworkin, 'Why Efficiency?' (1980) 8 Hofstra L Rev 563.
[64] On this, see V Brudney, 'Corporate Governance, Agency Costs, and the Rhetoric of Contract' (1985) 85 Columbia L Rev 1403, 1415-16.
[65] On this difficulty generally, see D Charny, 'Hypothetical Bargains: The Normative Structure of Contract Interpretation' (1991) 89 Michigan L Rev 1815.

bargaining rationality: *How rational should the notional contractors be presumed to be as economic actors? How much awareness should they be deemed to have of their specific circumstances? And what should their presumed risk appetite be?* It is contended that none of these points of uncertainty have been satisfactorily settled by those who – consciously or subconsciously – deploy hypothetical bargaining rationality in attempting to justify regulatory interventionism in corporate governance affairs on market mimicking grounds.

A second and more fundamental weakness in the market-mimicking rationalization of mandatory corporate governance rules is its unintended normative effect in undermining the conceptual validity of the contractarian account of regulation in its entirety. Above all, it may justifiably be queried whether the hypothetical contracts that are forwarded in support of purportedly 'market mimicking' regulatory outcomes are really 'contractarian' in nature at all, at least in the ordinary sense of the word. In this regard, David Charny has observed that '[i]t is by no means clear that individuals should be bound to hypothetical – as opposed to actual – contracts, or even that it is appropriate to call such hypothetical contracts "contracts" at all.'[66] On this basis, Charny doubts the relevance to hypothetical contracts (whether as embodied statutorily or judicially) of traditional arguments for contractual obligation based on the individual autonomy of voluntary parties to an agreement, given that no actual or explicit assent has ever been signalled by the notionally 'contracting' parties to the terms thereof.[67] Moreover, the fact that in such cases no actual agreement has been either promulgated or assented to means that there are no specific terms – whether express or even implied – that can be used as a

[66] See ibid, 1817. Likewise, Ronald Dworkin asserts that "a counterfactual consent provides no reason *in itself* for enforcing against me that to which I would have (but did not) consent", and indeed "is *no consent at all*." Above (n 63) 578 (emphases added).
[67] Ibid.

working basis for constructing the hypothetical contract. This means that the relevant rule-maker (whether legislative, judicial or administrative) must in effect pluck a hypothetical agreement out of thin air by seeking to determine what the contracting parties *would have* bargained for in respect of the situation at hand.[68]

But in the absence of any concrete evidence as to what the parties themselves would have been inclined to bargain for in the circumstances at hand, the only available proxy for such are what Charny calls 'socially extant expectations of fairness or reasonableness.'[69] These expectations are inevitably derived from the rule-maker's perception of the 'general social consensus about how various types of transactions should be structured', so that there is 'little need for inquiry into variations of perceptions or preferences among individual transactors.'[70] Accordingly, in cases where individual contractors exhibit differing private preferences from one another, those individual preferences that do not align with the perceived general social consensus with respect to a particular matter can be rejected by the rule-maker a priori as examples of erroneous adverse selection.[71]

Thus by means of the above course of logic, substantive concepts of fairness or welfarism in social arrangements are effectively brought into contractarian argumentation via the proverbial 'back door'. This demonstrates the methodological inescapability of using substantive outcomes as the *starting point* – rather than end point – of hypothetical bargaining rationality. As Kronman highlights, '[t]he inference in all hypothetical bargains must…be *from mutual benefit to consent*, rather than the

[68] See JC Coffee, 'The Mandatory/Enabling Balance in Corporate Law' (1989) 89 Columbia L Rev 1618, 1628. Coffee claims that the 'greatest defect' of hypothetical bargaining rationality is its focus on seeking artificially to provide 'what parties would have wanted', rather than attempting to compel them to bargain 'for what they do want' (ibid).
[69] Above (n 65) 1838.
[70] Ibid.
[71] Ibid.

other way around, as in the case of actual agreements.'[72] In other words, the fact that a given regulatory arrangement is objectively judged to be mutually welfare-enhancing is *in itself* a reason for treating it as a substantive outcome of some hypothetical bargain, even though no underpinning contractual agreement to this effect has ever occurred between the parties who are subject to the rule in question.[73]

Kronman explains how, on this basis, 'the assertion that …[the parties] would themselves hypothetically agree to…adoption [of a relevant term] *adds no justificatory force of its own*, for this last claim follows automatically from – it is entailed by – the rule's welfare enhancing character.'[74] It follows that '[h]ypothetical contract arguments are not really contractualist at all', given that '[t]hey explain and justify their conclusion by an appeal to considerations of welfare alone, the latter providing their necessary and sufficient conditions.'[75] For this reason, the market mimicking rationalization of mandatory rules – to the extent that it is premised on hypothetical bargaining outcomes – is more appropriately understood as a *welfarist*, rather than contractualist, line of argument. Insofar, therefore, as the market mimicking rationalization of state interventionism in private ordering does not even fit the necessary characteristics of a 'contractarian' argument at all in the accepted sense, it can justifiably be concluded that private ordering rationality is on its own incapable of accounting for the existence of mandatory corporate governance rules.

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[72] See AT Kronman, 'A Comment on Dean Clark' (1989) 89 Columbia L Rev 1748, 1750 (emphasis added).
[73] On this, see PS Atiyah, The Rise and Fall of Freedom of Contract (Clarendon 1979) 51.
[74] Above (n 72) 1750.
[75] Ibid.

4. *Does contractarianism provide a descriptively valid rationalization of UK corporate governance law?*

A. *Why does it matter?*

At first sight, the above question might be dismissed as being of mere fanciful or theoretic interest. On the contrary, though, it is an issue of considerable political concern for academic corporate lawyers. This is because – if the core elements of UK corporate governance law can validly be regarded as existing on a quasi-contractual basis – then it will be possible for the relevant rules and principles to derive legitimacy by reference to their notional adoption by consensual agreement.

If, however, such a conceptualization cannot validly be made, then it follows that corporate lawyers must have recourse to some alternative criterion of legitimacy in order to determine the conditions under which these institutional features can be regarded as normatively defensible. Accordingly, this part of the paper provides a thoroughgoing analysis of the main rules determining the division of decision-making power at the heart of the British corporate structure, in order to determine whether the fundamental aspects of UK corporate governance law are indeed consistent with the contractarian paradigm.

B. *The quasi-contractual nature of the corporate constitution in the UK*

Arguably one of the main reasons for the rapid absorption of US contractarianism into the study of UK corporate law over recent decades is the fact that, at least in some highly conspicuous respects, the theory would appear to provide a strikingly accurate

depiction of the relevant laws. One might even claim that in certain ways the British legal model of the company conforms much more closely to the contractarian paradigm than its US counterpart.

Indeed the basic contractarian notion of private ordering lies at the very heart of UK corporate (or 'company') law by virtue of the contractual principle that has traditionally underpinned the corporate constitution, and which gives binding legal force to the stipulations in a company's articles of association concerning the firm's internal governance affairs. This longstanding doctrine, which today takes the form of section 33 of the Companies Act 2006, gives express quasi-contractual effect to a company's articles by providing that the provisions therein 'bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions.'

Furthermore, the terms of the multi-partite agreement between the company and each of its individual members embodied in the articles of association is, rather like a partnership agreement, freely alterable by the members at will. Whereas in a partnership the unanimous consent of partners is required to effect an alteration to the terms of the agreement, UK corporate law permits alteration of the articles subject to approval by a special majority (i.e. 75% or more) of votes cast by the members collectively in General Meeting.[76] The basic contractarian qualities of flexibility and private ordering are accordingly rendered common constitutional features of both types of firm.

The centrality and normative significance of the contractual doctrine within the fabric of UK corporate law as a whole is emphasised by Richard Nolan, who explains that:

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[76] Companies Act 2006 ss 21 and 283(1).

> ‘English law has at its core a simple – but very flexible – empowering, facultative principle, through which shareholders can establish in a company’s articles of association…how they will interact with each other, and with other participants in the company. This principle…giving enduring legal effect to shareholders’ bargains as to how their company is to be run – is vital, flexible and powerful.’[77]

The somewhat peculiar contractual nature of the corporate constitution stems from the historical origins of British joint-stock company law in the mid-nineteenth century as a derivation of partnership law. Under the latter system, formally internal issues of firm governance procedures and partners’ rights and obligations are embodied literally in the form of an inter-personal private agreement between partners. On the introduction of free incorporation upon registration, however, this associational logic was in effect carried over to the developing field of company law where it likewise became the doctrinal basis for regulating internal disputes between ‘members’ (i.e. shareholders) of incorporated firms.

In the case of incorporated firms however there was the key difference that the company itself, as an autonomous legal entity (and, indirectly, its controlling board), became recognized for internal purposes as a central party to the notional contractual agreement embodied in the articles. This enabled members’ constitutional rights, notably including their basic voting and dividend entitlements, to be enforced directly against the company itself in the form of a quasi-contractual action. The major normative effect of the contractual principle was to engender a doctrinal

[77] Above (n 15) 95.

understanding of companies in terms of the logic of inter-personal association. Indeed even the literal terms ‘company’ and ‘members’ are evocative of this fact, connoting the fundamentally humanistic and quasi-partnership quality of the incorporated firm, and the private associational basis of shareholders’ status therein. That is to say, irrespective of its formally autonomous personality from the perspective of creditors and other third parties, when distilled down internally the company in effect ultimately *is* its collective body of members (i.e. shareholders) and owes its existence to their common endeavour.[78]

From a negative perspective, meanwhile, the logic of membership and association by definition carries implications of privilege and selectivity, in the sense that those *not* entitled to membership status within the company’s contractual order are correspondingly excluded from the enclosed realm of internal firm affairs. Thus from the initial phase of its development British company law had, largely by virtue of its own doctrinal path dependence, developed a somewhat curious ideological perspective on corporate entities whereby shareholders are positioned ‘inside’ the company from a governance perspective, and, correspondingly, non-shareholder constituents such as creditors and employees deal *with* the company-member contractual nexus ‘from the outside’ only.

The contractual principle’s dual themes of private ordering and shareholder exclusivity have been particularly influential in establishing the contours of the UK’s characteristic approach to resolving what is arguably the core structural dilemma in respect of public corporations: that is, determining the appropriate division of decision-making power between the company’s shareholders and board of directors.

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[78] In the US, by comparison, the term ‘corporation’ is conventionally used to refer to widely-held incorporated firms, thereby emphasising their corporeal/organizational dimension rather than their inter-personal/associational quality. On this, see WW Bratton, ‘The New Economic Theory of the Firm: Critical Perspectives from History’ (1989) 41 Stanford L Rev 1471, 1483-1485.

In contrast to the United States where the powers of the board are generally established under state legislation, UK corporate law has traditionally left the crucial issue of the board's authority to be determined privately in the articles of association. The standard rule to this effect, namely the decision-making primacy of the board in respect of management affairs, is conventionally applied to newly incorporating companies by default when they implicitly adopt, on an 'off-the-shelf' basis, the relevant set of Model Articles provided by the government under secondary legislation. However, Model Article 3 makes clear that the board's executive authority is not an absolute prerogative, but rather is held subject to the ultimate entitlement of the shareholders collectively to revoke any or all management powers by means of an appropriate constitutional amendment to this effect.[79] The Model Articles additionally permit shareholders, by way of special resolution, to make specific positive or negative orders to the board concerning the latter's running of the business, thus further affirming the former group's sovereign status within the corporate constitutional structure.[80]

The essentially private, quasi-contractual basis of the board's authority in the UK is likewise explicated within early English judicial rationalizations of the company's decision-making power structure. In contrast to the United States, where directors' powers were recognized by courts from an early stage as being 'original and undelegated…in the sense of being received from the State in the act of

[79] This is made clear by the words 'Subject to the articles' at the beginning of the relevant provision. See The Companies (Model Articles) Regulations 2008 (SI 2008/3229), Sch 3 ('Model Articles for Public Companies').
[80] See ibid Model Article 4(1).

incorporation',[81] the corresponding English tradition has been to regard the board's authority as a thoroughly contingent phenomenon.[82]

Dignam and Lowry have noted that from a judicial point of view 'the role and position of directors within the corporate management matrix is coloured by the fact that company law is rooted in the law of partnership which is based upon agency principles', and whereby 'each partner is an agent of his fellow partners.'[83] However, whereas in a partnership each member of the firm herself represents the collective body of partners in management affairs,[84] in companies this collective representational role is vested by mutual agreement in the board of directors, which consequently has power to bind the totality of members indirectly via the medium of the corporate entity. It follows logically from this that a company's shareholders are prohibited from attempting to give ad hoc orders to directors or otherwise interfering with the board's management discretion except in the specific ways provided for in the company's articles.[85] To do otherwise would amount to a usurpation of the members' collective constitutional agreement as to the centralization of corporate decision-making authority, which would be contrary to the contractual principle underpinning the legitimacy of the company's governance framework.[86]

In summary, consistent with the contractarian paradigm in corporate theory, UK law affirms the view that a company's board of directors holds its decision-making powers subject to the ultimate behest of the general body of shareholders. It furthermore affirms the general contractarian belief that shareholders alone - as the

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[81] Hoyt v Thompson's Executor 19 NY 207 (1859), 216 (per Comstock J).
[82] See eg Automatic Self-Cleansing Filter Syndicate Co v Cunninghame [1906] 2 Ch 34, 45 (per Cozens-Hardy LJ): '[Directors] are in the position of managing partners appointed to fill that post by a mutual arrangement between all the shareholders.'
[83] A Dignam and J Lowry, Company Law (7th ed OUP 2012) 289.
[84] In the UK, this longstanding rule is established by section 5 of the Partnership Act 1890.
[85] On the formal defensibility of the board's powers against outside interference (in particular vis-à-vis shareholders), see Automatic Self-Cleansing Filter Syndicate (n 50); Gramophone and Typewriter Co v Stanley [1908] 2 KB 89; John Shaw & Sons (Salford) v Shaw [1935] 2 KB 113.

sole signatories to the notional corporate contract embodied in the corporate constitution - are entitled to determine the shape of the company's internal governance structure in exclusion from other 'non-member' constituents in the firm such as its workforce. On a fundamental doctrinal level at least, therefore, the core features of UK corporate governance law can be characterized as significantly contractarian in nature.

C. Mandatory (irreversible) aspects of UK corporate governance law

Other features of UK law pertaining to the division of corporate decision-making power are however less readily reconcilable with the contractarian paradigm. In fact, some of the most crucial and comparatively distinctive shareholder rights in the UK are mandatory and thus irreversible in form. This means that their legal effect in respect of any individual company cannot validly be 'undone' by insertion of an appropriate offsetting provision in that firm's articles of association. From the perspective of the above discussion, the significant presence of mandatory rules challenges the notion that the UK legal framework of corporate governance can be validly rationalized in accordance with contractarianism's private ordering rationality.

As will be discussed below, an especially difficult conceptual dilemma is thrown up by the fact that those provisions of UK corporate governance law which together represent the basis of the aforementioned contractual principle are *themselves* enshrined largely in the form of mandatory rules. At least at first sight, this appears fundamentally contradictory to the purpose that those provisions are designed to serve, which is to imbue laws and institutional structures with the perpetual qualities of

[86] See Automatic Self-Cleansing Filter Syndicate, ibid 45.

flexibility and malleability.[87] It will therefore be further examined below whether and to what extent this curious paradox underlying the UK's system of corporate governance law represents an issue of concern for academic corporate lawyers.

(i) The (paradoxical) mandatory basis of the contractual principle

Like any effective institutional feature of a supposed 'free' and 'deregulatory' market system, the contractual principle in UK company law - in spite of outward appearances - does not arise spontaneously out of thin air but rather is underpinned by a sophisticated and pre-ordained public-regulatory infrastructure. For this reason the whole conceptual notion of 'private ordering' in UK corporate governance can be regarded as a classic example of Orwellian 'double speak'.

Most fundamentally, as acknowledged above the very formal status of the corporate constitution as a supposedly 'private' contractual document rests paradoxically on a *public* statutory basis. Moreover, this has been the case since the inception of the modern registered company in Great Britain. Likewise, the corporate constitution's quasi-contractual characteristic of free alterability is also traditionally a creation of statute, and continues in this form today in the guise of section 21 of the Companies Act 2006, which provides for alteration of a company's articles by special resolution of its members.

Of particular interest from the point of view of the current discussion is that both of the above Companies Act provisions are also rendered mandatory in form.[88] Therefore, with the exception of the very limited prescribed circumstances in which

[87] On this, see Nolan (n 15).
[88] This is because of the default mandatory status of the provisions of the Companies Act 2006, which are incapable of constitutional ouster or amendment in respect of any individual firm unless expressly stated otherwise in the relevant sections of the Act itself.

entrenchment of the articles is permitted today under statute,[89] the above provisions are generally incapable of being reversed or otherwise amended by constitutional provision regardless of the level of shareholder support to this effect.[90]

In addition to having the aforementioned collective right formally to pass proposed changes to the articles, shareholders of UK companies are also empowered proactively to initiate proposals for constitutional amendment, which will subsequently be voted on by the company in General Meeting. Partly to this end, section 338 of the Companies Act 2006 permits one or more shareholders representing at least 5% of the company's total voting rights, or alternatively 100 or more shareholders each holding at least £100 of voting shares, to propose special members' resolutions to be added to the agenda for a forthcoming company General Meeting. In a public company, any proposed members' resolutions must also be added to the proxy card[91] that is conventionally sent out by the company to its shareholders in advance of a General Meeting.[92]

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[89] Section 22(1) of the Companies Act 2006 admittedly introduces for the first time into UK company law a limited constitutional entrenchment provision. However, the permissible scope for entrenchment of a company's articles under this provision is significantly limited, being possible only on the initial formation of the company or else by the unanimous resolution of members. In view of the practical near-impossibility of gaining unanimous support for a proposed resolution in a public company, coupled with the likelihood of strong investor hostility to proposed entrenchment provisions in respect of listed firms' constitutions, it can be confidently surmised that this innovation to UK company law will have a negligible impact outside of the closely-held private company sector (although its significance in this latter context is not disputed).

[90] The logical rationale for this was explained by Lord Lindley MR in Allen v Gold Reefs of West Africa [1900] 1 Ch 656, 671, on the overt public policy basis that '[b]e its nature what it may, the company is empowered by statute to alter the regulations contained in its articles from time to time by special resolutions; and any regulation or article purporting to deprive the company of this power is invalid on the ground that it is contrary to statute…'

[91] The proxy mechanism is a common procedure in public companies that enables a shareholder to appoint a specified person (normally an individual suggested by the company) to attend a General Meeting and vote in a specified way on her behalf in respect of each resolution tabled therein. The proxy card is the (originally American) term that is used to describe the form that each shareholder receives prior to a General Meeting, and which normally lists the various resolutions to be voted on at the meeting along with three boxes 'Yes', 'No' and 'Vote Withheld' for each resolution.

[92] The company is furthermore obliged to pay the expenses incurred by the members in preparing the statement if sufficient requests for a resolution are received by the company before the end of the previous financial year.

The relevant shareholders may additionally request circulation, at the company's expense, of a written statement (of 1,000 words or less) in support of their proposed resolution to be voted on at the meeting.[93] And, in urgent instances, shareholders representing at least 5% of the total value of the company's voting shares may even request the board to convene an Extraordinary General Meeting outside of the normal annual meeting cycle, so as to enable any particularly pressing members' resolutions to be voted on.[94] Similarly to the aforementioned provisions, moreover, these powers of shareholders are established on a mandatory and irreversible footing.

Although rarely used within UK public companies, shareholders' statutory initiation rights are a crucial component of the contractual principle insofar as they have the effect of re-balancing the constitutional amendment process in shareholders' favour vis-à-vis the company's board and senior management. If shareholders of public companies did not possess the power of initiation in respect of constitutional amendments, their role would in effect be restricted to that of either approving or vetoing proposals made by the board to this effect on an ex post facto basis, as has traditionally been the standard practice in US public companies.[95]

Accordingly the above provisions as a whole together establish the important normative position that, in UK companies, directors' executive authority is subject to the inalienable collective prerogative of the shareholders to limit or even revoke entirely the board's managerial powers under the corporate constitution at any given moment in time. However somewhat curiously from a contractarian perspective, the set of company law rules that make up this fundamental norm take the form of

[93] Companies Act 2006 ss 314-316.
[94] Companies Act 2006 s 303.
[95] On this, see LA Bebchuk, The Case for Shareholder Access to the Ballot (2003) 59 *The Business Lawyer* 43.

mandatory statutory pronouncements and thus, as a matter of legal form at least, are antithetical to the rationality of private ordering.

(ii) Shareholders' statutory 'shotgun' right

Allied to and reinforcing shareholders' sovereign status within the corporate constitutional structure is the most coercive of their rights vis-à-vis a company's board and senior management. This is the collective power that a company's members enjoy under section 168 of the Companies Act 2006 to dismiss (or 'fire') any or all of the firm's directors, even without due contractual cause, by passing an ordinary (i.e. majority) resolution to this effect in General Meeting. This important corporate governance provision – which may be referred to for want of a better term as the shareholders' 'shotgun' power – is superimposed by statute onto the standard constitutional procedure for rotational retirement and reappointment of directors of public companies at three-year intervals.[96]

Under UK law the shareholders' shotgun power is mandatory and irreversible.[97] Thus shareholders' mandatory shotgun power – allied to their above rights of access to the company's proxy card (if necessary, by means of a specially-convened EGM) – gives them the capacity to propose the dismissal of any or all of the board, and their replacement with nominated substitutes, at any time. Admittedly, as a

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[96] Model Articles for Public Companies (n 47) arts 20-21. In the case of those public companies that: (a) have a Premium Listing on the Main Market of the London Stock Exchange; and (b) are in the FTSE 350 group of companies; the most recent (September 2012) version of the UK Corporate Governance Code further recommends that all directors of the firm subject themselves to re-appointment by shareholders on an annual basis. See Provision B.7.1 of the Code (n 12).

[97] Admittedly, the controversial House of Lords decision in *Bushell v Faith* [1970] AC 1099 rendered it permissible for directors indirectly to entrench themselves in office by virtue of weighted voting rights exercisable in their capacity as a shareholder, which could be used in order to defeat any dismissal resolution proposed against them. However, the likelihood of strong investor hostility to so-called Bushell v Faith clauses in widely-held public companies is likewise liable to restrict the use of such

practical matter, the exercise of shareholders' power in this regard is significantly constrained by a number of well-known factors. Section 168 does not deprive a director who is fired without cause of any compensation or damages due to him on account of his premature termination, which in the case of highly remunerated directors can make the use of this provision cost-ineffective from the company's perspective.[98] Further factors discouraging the ready use of this power are the likelihood of causing disturbance to the company's business and/or generating negative publicity (especially where the intended target of the proverbial shotgun is the board as a whole), the difficulties of finding superior replacements for the sacked directors, and also the immense challenge of mobilising sufficient shareholder support within a listed company both to propose and carry a dismissal resolution in the first place.[99]

But although the above impediments invariably restrict the actual exercise of shareholders' aforementioned rights of intervention to the most exceptional or manifest cases of corporate mismanagement, from a private ordering perspective the shotgun power can potentially have a significant indirect effect. Through a contractarian lens the shotgun power can be depicted metaphorically in terms of a legal 'nuclear deterrent': in that whilst its direct use can inflict considerable collateral costs on all parties involved, the mere prospect of it being mobilized as a last resort configures in shareholders' favour the terms of their notional 'bargaining game' with management concerning the ultimate objectives of the firm. In turn, it can help to engender the reflexive development of powerful extra-legal substantive norms that

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provisions almost exclusively to the closely-held private company sector (in which latter context they can fulfil a highly valuable regulating function in respect of inter-personal membership disputes).

[98] See Companies Act 2006 s 168(5).

[99] On this, see A Keay, 'Company Directors Behaving Poorly: Disciplinary Options for Shareholders' (2007) Journal of Business Law 656, 673-75.

exert an ongoing low-level influence on managers independently of the company's formal governance mechanisms.

Indeed, the statutory shotgun provision is for the above reasons arguably the most significant legal-institutional factor underlying the centrality of the so-called 'shareholder wealth maximization norm' within UK corporate governance today, notwithstanding the absence of any explicit judicial or legislative decree to this effect in the annals of UK corporate law.[100] As such, it is a crucial component of shareholders' privileged quasi-contractual status within the UK corporate governance model. However, like shareholders' other statutory rights of intervention in corporate decision-making discussed above, the shotgun power rests on a mandatory statutory basis. Prima facie, this renders it thoroughly *anti*-contractual in form, and consequently puts into further question the validity of private ordering as a normative rationalization of the UK corporate governance system's prevailing characteristics.

(iii) Shareholders' statutory anti-dilution rights

In the preceding examination of shareholders' statutory rights of intervention or 'voice' in corporate decision-making, it was emphasized that such rights remain highly significant within the broader framework of UK corporate governance notwithstanding the relative rarity of instances where they are actually invoked. However, a further comparatively distinctive characteristic of UK corporate governance law (particular in relation to the corresponding US/Delaware legal

[100] As one leading commentator has pointed out, '[h]istorically there has been in most jurisdictions no legislative proclamation or unequivocal judicial statement which provides directors with a clear answer to what is the corporate objective.' See A Keay, 'Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 MLR 663, 666.

framework[101]) is the role of mandatory corporate finance regulation – and, in particular, shareholders' statutory anti-dilution rights – in protecting the prevailing distribution of equity interests and resulting voting power within the corporate-constitutional structure. Insofar as shareholders' anti-dilution rights (unlike their aforementioned 'voice' rights) are in fact frequently exercised in UK public companies, they can consequently be said to be of foremost practical influence in mitigating management's scope for exploitation or unilateral disempowerment of investors within the UK environment.

The key statutory provisions in this regard – both of which are today contained within the Companies Act 2006 – are: first, the prohibition on unauthorized share allotments;[102] and, second, the phenomenon of shareholders' pre-emption rights.[103] By virtue of the former provision, the directors of a public company (or private company with one more than one class of shares) may only exercise the company's power to issue new shares with the approval of the shareholders in General Meeting.[104] Consequent to the latter provision, meanwhile, a company's existing shareholders must be granted a 14-day or more period of 'first refusal' over any new ordinary shares that that company proposes to allot, in proportion to their respective existing equity stakes in the company.[105] Although neither of these rights can properly be regarded as an aspect of authorized shareholder 'voice' in the sense of the other rights described above, they are nonetheless both crucial aspects of the division of corporate decision-making power in the UK, insofar as their joint effect is to restrict

[101] On the conflicting position of Delaware corporate law in these regards, see Moore (n 61) 115-126.
[102] See CA 2006 ss 549-551.
[103] See CA 2006 ss 561-563, as reinforced by the additional (and longer standing) pre-emption rights requirement applicable to UK-listed companies under Listing Rule 9.3.11.
[104] CA 2006 ss 549(1) and 551(1).
[105] CA 2006 s 561(1) and 562(5). In the case of the corresponding Listing Rule requirement, the relevant minimum offer period is stated as 10 *business* days (excluding weekends and bank holidays), although the effect is by and large equivalent (see LR 9.5.6).

the discretionary leeway that management would otherwise enjoy in making decisions with respect to the firm's capital structure.[106]

Notably, disapplication of the relevant provisions is expressly deemed to be possible for a specified period of no more than five years from the formal date of disapplication.[107] The effect in practice within many public companies is to establish a periodic process of dialogue between management and shareholders, whereby management is compelled to elicit reasons in support of its request for original or further disapplication of either or both the above procedural requirements.[108] The resulting process of management-shareholder communications, whilst overtly quasi-contractual in nature, is nonetheless possible only in the persisting proverbial 'shadow' of the mandatory regulatory requirement for management to renew its free allotment mandate from shareholders at specified minimum intervals.

From an investor protection perspective, the above provisions are crucial in safeguarding shareholders against unauthorized dilution of their equity interest, and also against uncompensated transfers of wealth from existing to new shareholders following a share issue at below the prevailing market price of a company's equity. The same rules can also be regarded as fulfilling an important managerial-disciplinary function by preventing a company's controlling officers from allotting new equity on a covert and/or selective basis in response to capitalization or cash flow shortfalls. As

[106] On this, see PL Davies, 'Shareholder Value, Company Law and Securities Markets Law – A British View' (2003) in KJ Hopt and E Wymeersch (eds), Capital Markets and Company Law (OUP 2003) 261.

[107] See Companies Act 2006 s 551(3)(b). Strictly speaking, this restriction only applies to general authorisations of directors' share allotment power. However, since (under s 570(1)) general disapplication by shareholders of the pre-emption rights scheme is only permissible in companies where general allotment authorisation has already been given, it follows that the disapplication period for pre-emption rights is necessarily limited in accordance with the same time frame.

[108] In deciding whether to vote in approval of a disapplication request (ie where the board wishes to allot new equity securities on a non-pre-emptive basis), institutional shareholders will in practice be guided by the non-legally binding Statement of Principles (July 2008) on disapplication of pre-emption rights promulgated by the Pre-Emption Group of the Financial Reporting Council. On this, see P

a result, managers are compelled to 'return to the market' to raise new capital, whereby they will be expected in effect to 'submit' both their past performance record and future capital allocation plans for collective investor scrutiny, as a precondition to the firm being able to continue to raise external (i.e. non-internally-retained) capital or funds on relatively advantageous terms.[109]

Most significantly of all from a corporate governance perspective, both of the above provisions also provide shareholders with legally guaranteed control over the corporate voting franchise. This is crucial in the context of contests for corporate control because, in the absence of legal protection against equity dilution, poison pills and other US-style selective stock issue schemes could potentially be implemented by managers in response to an unwanted bid for the company.[110] In this regard, shareholders' statutory anti-dilution rights reinforce the UK Takeover Code's 'no frustration' rule, which operates as an effective prohibition on unauthorised share dilutions and other managerial actions that have the effect of frustrating an actual or imminent bid for a UK public company.[111]

Moreover, shareholders' anti-dilution rights are themselves reinforced by the longstanding proper purpose doctrine at common law.[112] This latter principle, which is today embodied in statutory form within section 171 of the Companies Act 2006, essentially dictates that it is 'unconstitutional for directors to use their fiduciary powers over the shares in the company for the purpose of destroying an existing

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Myners, Pre-Emption Rights: Final Report (DTI 2005), available at: www.bis.gov.uk/files/file28436.pdf.

[109] On the corporate external capital-raising process as a managerial disciplinary mechanism generally, see FH Easterbrook, 'Two Agency Cost Explanations of Dividends' (1984) 74 American Economic Review 650.

[110] On this, see Parkinson (n 10) 137.

[111] Above n 14, General Principle 3 and Rule 21.

[112] On the contours of this doctrine generally, see Hogg v Cramphorn [1967] Ch 254; Teck Corporation v Millar (1973) 33 DLR 288; Howard Smith v Ampol Petroleum [1974] AC 821; Criterion Properties v Stratford UK Properties [2003] BCC 50; Parkinson (n 10) 140-47.

majority, or creating a new majority which did not previously exist.'[113] According to Lord Wilberforce, '[t]o do so is to interfere with that element of the company's constitution which is *separate from and set against their powers*',[114] thereby putting directors in breach of their fiduciary duty to the company *irrespective of* whether their actions in this regard were carried out in good faith for the perceived benefit of the company itself.[115] This clearly establishes that the fiduciary prohibition on directorial equity dilution under the proper purpose doctrine is *logically prior* to the board's continuing possession and exercise of the discretionary administrative power vested in it under the corporate-constitutional framework. Moreover, like any directorial duty under UK law, the proper purpose doctrine is established as a mandatory and innate legal component of the equity relation, thus rendering it incapable of reversal or modification via offsetting contractual or constitutional provision.

It can thus be surmised that shareholders' core anti-dilution rights – on which their continuing constitutional 'sovereignty' within the UK corporate governance model can be said principally to hinge - *cannot* rightfully be regarded as a contractually-determined phenomenon. On the contrary, these centrifugal rights are for the most part attributable at root to *public-regulatory* – rather than private-contractual – initiative. This finding further underscores a revisionist conception of shareholders' corporate governance rights in the UK as existing on an exogenous and entrenched institutional basis, and thus as largely *transcending* the endogenous domain of decentralized private ordering.

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[113] Howard Smith v Ampol, ibid 837, per Lord Wilberforce.
[114] Ibid (emphasis added).
[115] As Buckley J emphasised in Hogg v Cramphorn (n 112) 268: 'It is not … open to the directors in such a case to say, "We genuinely believe that what we seek to prevent the majority from doing will harm the company and therefore our act in arming ourselves or our party with sufficient shares to

D. Summary of this part

The discussion above has demonstrated that – whilst certain core features of UK corporate governance law are overtly consistent with the contractarian paradigm – a number of other such features are not so readily reconcilable with the rationality of private ordering. The essential point is not that a greater number of such laws conform to a regulatory rather than contractual characterisation (although this would indeed appear to be the case), nor that the mandatory or regulatory characteristics of the system are necessarily more significant than the flexible or contractual features.

Rather, the key insight of this part is that even those aspects of UK corporate governance law (such as the dynamic contractual principle) that appear thoroughly conformant with the contractarian model are themselves ultimately the product of a body of underpinning mandatory rules. It can therefore justifiably be said that the very operation of the quasi-contractual dimensions of UK corporate governance law would be rendered impossible in the absence of the foundational regulatory building blocks of the system discussed above.

Hence UK corporate governance law is, at root, an unequivocally regulatory phenomenon.

5. Political implications of the breakdown of the contractarian paradigm

The above legal rules represent the institutional backbone of UK corporate governance's characteristic and mutually reinforcing dual features of private ordering and shareholder exclusivity. As highlighted above, though, a curious feature of the

outvote the majority is a conscientious exercise of our powers under the articles, which should not be

legal framework is that the very legal-doctrinal foundations of private ordering in UK corporate governance *themselves* rest on a mandatory, irreversible and formally public statutory footing. This observation has significant normative consequences insofar as it calls into question the continuing legitimacy of the UK's corporate governance regulatory framework. In particular, it suggests that mandatory corporate governance rules rest on a fundamentally *anti*-contractual basis insofar as they represent a largely wholesale *substitute to*, rather than supplementary facilitator of, the market-driven private ordering process.

It follows from this that prevailing corporate governance norms and structures can no longer be regarded per se as the endogenous outcome of efficient institutional evolution based on rational rule selection methods. Rather, with the intrinsic involvement of the active-interventionist (as opposed to passive-instrumentalist) state in core corporate governance law-making processes, there arises the corresponding need to legitimize prevailing regulatory outcomes in corporate governance by reference to the political criterion of *democratic consensus*, as opposed to the market-liberal notion of unanimity based on the (arguably now defunct) logic of mutual quasi-contractual agreement.

Indeed, a fundamental feature of UK corporate governance law (and, indeed, UK corporate law in general) is the dominant scholarly perception of the subject as a dynamic and self-determinative aspect of *private* law lying beyond the meddling reach of the 'public' or interventionist regulatory state. Thus corporate (or 'company') law is still conventionally rationalized and taught in the UK as an offshoot of 'building blocks' English private law subjects such as contract, agency, equity and trusts. A uniting feature of all these areas of law, and the root of their purportedly

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interfered with".' On this, see Parkinson (n 10) 141.

‘private’ nature, is their common focus on giving legal effect (or, vice versa, non-effect) to the terms and essential substance of arrangements constituted by decentralized persons acting on their own behalf, whether in an individual or private-organizational capacity.

In contrast, those subjects which are usually placed within the ambit of ‘public’ or regulatory law, including tort, criminal, antitrust and tax law, are inherently interventionist and redistributive (whether monetarily or in terms of distribution of risk or market power) in nature. In commercial environments, these areas of law seek in differing ways from one another to regulate directly the social outcomes of business activity via the super-imposition of externally-determined standards or norms, over and above the actual or imputed preferences of contractors or business associates.

The analysis presented in this article suggests that it is the *latter*, rather than former, of these two categories that corporate governance law should most appropriately be located within. As such, it should be understood fundamentally as a regulatory or outcome-*imposing* aspect of law, as opposed to its conventional depiction as a contractual or outcome-*facilitating* aspect. It follows that corporate governance legislation should rightfully be understood as *substituting* democratically-determined allocations of corporate decision-making power in place of those alternative allocations that would tend to ensue from decentralized contractual determination.

This revised understanding of the subject necessitates, inter alia, developing a defensible public policy justification for the shareholder exclusivity doctrine, on the understanding that this regulatorily-constituted phenomenon can no longer be presumed to be socially instrumental on account of its purported evolutionary survival

value. Rather, if shareholders' formally exclusive status within the corporate-constitutional structure is to retain its political legitimacy, the socio-economic value of this arrangement must be empirically ascertained and thereafter rigorously defended against competing normative models of corporate governance that purport to realize more effectively the democratically agreed objectives of the private enterprise system in twenty-first century Britain.

6. Conclusion

Despite exhibiting some manifestly contractarian features, the UK's framework of corporate governance law is – on the whole – significantly regulatory in nature. This observation automatically calls into question the relevance of contractarianism as a descriptive and normative template for rationalizing and justifying the core features of the law. But in spite of their general deregulatory and anti-statist hue, contractarian accounts of corporate governance tend to admit – albeit to varying extents from one another – the inevitability of mandatory state-formulated rules as a supplement to private ordering. Through this conceptual lens, mandatory rules are presented as an antidote to the inherent limitations of private ordering resulting from investors' bounded rationality. This leads to the paradoxical argument that universal regulatory standards imposed by a centralized public law-maker can actually *facilitate* - rather than undermine - decentralized private ordering of corporate governance norms.

However, the contractarian case for mandatory rules in the name of investor irrationality is, at least beyond a certain point, logically self-defeating. As I have sought to demonstrate above, a fundamental problem with the so-called 'market-mimicking' rationale for mandatory corporate governance rules is its unintended

normative effect in undermining the conceptual validity of contractarianism's private ordering hypothesis *in its entirety*. In accepting the case for state-promulgated mandatory rules on the basis of systematic investor irrationality, contractarianism could be said to stray inadvertently over the very fine line between advocating: on the one hand, the essentially quasi-*private* state function of market correction by means of contractual 'gap-filling'; and, on the other, the manifestly *public* state function of 'regulatory paternalism'. In this sense, regulatory paternalism entails the interventionist state substituting its own (publicly-constituted) conception of what makes a purportedly effective or desirable corporate governance framework in place of those (sub-optimal) structural outcomes that are likely to result from privately-driven, market-based rule selections.

It follows that any attempt to rationalize UK governance law by reference to the contractarian paradigm is akin to trying to fit a square peg into a round hole. Thus, as argued in section 5 above, scholars of the subject would be better advised to develop an explicit understanding of corporate governance law as an inherently regulatory and publicly driven phenomenon, whose content and evolutionary dynamics are dependent on democratic rather than contractual forces. Moving beyond the existing legal framework, meanwhile, the diminution of the conceptual validity of the contractarian paradigm furthermore highlights the need for genuine teleological debate amongst scholars as to the rightful democratic objectives of UK corporate governance law today. And, whilst the parameters of any such future discussion are still to be defined, one thing for certain is that it will demand a significantly greater degree of cognitive diversity than orthodox Anglo-American theorizing has hitherto been known for.