

LIBERALISM, CONSERVATISM, AND ECONOMIC EFFICIENCY: TRADITION AND CHANGE IN THE VALUES OF CORPORATE LAW

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The values guiding the evolution of Anglo-Australian corporate law fall into distinct periods. The first classical period, lasting until the end of the 1920s, was characterised by strong classical liberal values. The following modern period involves a struggle between a progressive regulatory agenda pursued by the legislature and a conservative formalism in the court. Some evidence of a new postmodern period has also appeared in which those roles have either reversed or been harmonised. I chronicle these periods by examining the relation between liberalism and conservatism in corporate law over time. In doing so, I identify corporate law's four classical values - contractibility, adjudicatory passivity, doctrinal pragmatism, and prudentialism - and demonstrate how these furthered economic efficiency. I demonstrate the demise of these values in the modern era.

I. INTRODUCTION

For all its impressive penetration of many doctrinal areas, the economic analysis of law has always struggled to answer a quite basic question: why, if its positive claim that the law furthers economic efficiency is accurate, would those who make and apply law wish, or bother, to further economic efficiency? There are many answers to this question,¹ which I pose in order to understand a fundamental difference between the English and American traditions in corporate law.² The orthodox position of American lawyer-economists is

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1 Compare G Priest, "The Common Law Process and the Selection of Efficient Rules" (1977) 6 *J Legal Stud* 65; P Rubin, "Why is the Common Law Efficient?" (1977) 6 *J Legal Stud* 51; R Cooter, "Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant" (1996) 144 *U Pa L Rev* 1643.

2 L Gower, "Some Contrasts between British and American Corporation Law" (1956) 69 *Harv L Rev* 1369.

basically as follows.³ Competition for incorporations has encouraged states to adopt those doctrinal principles which will be valued by parties to corporate contracts, while disabling states from using their laws to indulge the rent-seeking propensities of interest groups. The claim has been the subject of much criticism, qualification, and empirical scrutiny, but one crucial point cannot really be questioned — the American legislatures have been the principal source of doctrinal innovation, and have taken an active stance in suppressing judicial innovations esteemed to be undesirable.⁴

This, however, has not been true of either English or Australian corporate law. Early legislation did introduce various innovations, such as the introduction of a systematic set of disclosure requirements for firms raising capital⁵ and provisions to minimise hold out behaviour by minorities.⁶ However, most of the key corporate governance principles, which apply to relations between shareholders inter se and between shareholders and officers, derive not from parliamentary fiat but from principles of equity and the decisions of judges. Extraordinarily, those principles frequently anticipate the doctrinal content that, a century later, economists would congratulate interjurisdictional legislative competition for producing.⁷ In turn, Anglo-Australian legislatures have frequently *stifled* some of these doctrinal principles in law reform legislation. For their part, the courts have not infrequently limited enactments when called on to apply reform statutes to cases.⁸ The situation is thus the opposite of the one supposed to prevail in the United States.

This article studies tradition and change in English corporate law, including its application and evolution in Australia. To do this, I describe how English courts reconciled the operational tasks of declaring corporate law with the received constraints on the judicial function in a liberal state. My focus is initially on what I call the ‘classical values’ of corporate law produced in its ‘golden age’. That age began in the middle of the nineteenth century when incorporation was legislatively liberalised. It ended in 1928, when the English legislation was amended to impose substantial restrictions on the private ordering of corporate governance.⁹

To make this argument, I first describe a framework in which we may see the interaction between law, liberalism and facilitation of economic activity. In describing these interactions, we can identify characteristic values or norms. The application of this framework to golden age corporate law identifies four

3 See, eg, R Romano, *The Genius of American Corporate Law*, American Enterprise Institute (1993).

4 See, eg, the amendments discussed in R Romano, “Law as a Product: Some Pieces of the Incorporation Puzzle” (1985) 1 *J L Econ & Org* 225.

5. *Companies Act* 1900, 63 & 64 Vict ch 48; *Companies Act* 1929, 19 & 20 Geo 5 ch 23.

6 *Companies Act* 1929, *ibid*.

7 Compare *General Corporation Law*, Del Code Ann tit 8, s 102(b)(7) (1999) and *Re Brazilian Rubber* [1911] 1 Ch 425.

8 One example is the narrow interpretation given to the oppression provisions introduced by the *Companies Act* 1947 (UK): *Scottish Co-operative Wholesale Society v Meyer* [1959] AC 324; *Re Jermyn Street Turkish Baths Ltd* [1971] 1 WLR 1042.

9 *Companies Act* 1929, 19 & 20 Geo 5 ch 23, first adopted by an Australian parliament in *Companies Act* 1931 (Qld) s 160, with other states following suit over the next two decades.

classical values. These are 'contractibility', 'doctrinal pragmatism', 'adjudicatory passivity', and 'prudentialism'. Contractibility implies that doctrinal principles are susceptible of private ordering by parties to corporate contracts. Doctrinal pragmatism describes a method of judging in which substantive principles are guided by particular instrumental aspirations, albeit within the stable context of doctrinal analysis. Adjudicatory passivity describes how courts favour legal principles that minimise the scope for judicial intervention in contracting relations. Prudentialism involves a judicial preference to conceal innovation, and to reinforce established doctrinal trends and principles against change. I discuss and illustrate these values, and demonstrate why they furthered economic efficiency. On the other hand, I demonstrate why they were not free from tension, quite apart from their fragility to legislative activism. The article initially describes the framework in which I relate liberalism to the economic system; I then describe each of the four values I identify as characteristic of historic English law. I finally examine the demise of these values and what, if anything, has replaced them.

II. LIBERALISM AND THE FACILITATION OF THE ECONOMIC SYSTEM

A. Liberalism in Corporate Law

In corporate law, there has been a decisive shift over time from a corpus in which doctrinal principles derived from judicial declaration, to a body of statutory law.¹⁰ Initially, the restrictions on joint stock companies by the *Bubble Act* provided the stimulus for substantial private ordering of complex long-term relations. In the absence of an available incorporation procedure, the adaptation of other legal forms, such as the partnership and the trust, played an important part in this legal innovation. The innovation obliged courts to take a role in the declaration of corporate law principles. In the absence of statutory law or authoritative precedent, the law declared was influenced by the extant values of the common law.

To understand the values informing this formative period of corporate law, we must understand two things. First, how did the court relate to the economic system (the marketplace), in which complex private ordering was occurring? Secondly, how did the court relate to the legal system, comprising the other arms of government, the constitutional principle that connected them, and their relation to the people?

To take first the court's relation to the economic system, that relation involves a *substantive* and an *institutional* dimension. The substantive dimension involves declaring the legal rules that define the effect of private ordering and market interactions. The institutional dimension manifests the court's attitude towards adjudication in these complex relations. This attitude provides a context or an ethic for the declaration and application of substantive principle. The court's

10 See I Ramsay, "Corporate Law in the Age of Statutes" (1992) 14 *Syd L Rev* 474.

relation to the legal system can also be considered both substantively and institutionally. The substantive dimension consists of the recognition of the liberties, entitlements and obligations that the law confers or imposes on individuals, or recognises individuals as having imposed on themselves. The institutional dimension defines the scope and limits of the behaviour of a court, including its reactions to doctrinal obsolescence and innovation. Thus, these dimensions are an outward manifestation of the politics of the legal system and in particular its inclination towards either Lockean individualism or Hobbesian statism.

The court's relations to the legal and economic systems are not independent phenomena. It is the *intersection* of these particular relations in which we can locate some of English corporate law's most characteristic attributes. Sometimes the values reflect an element of tension between the legal and the economic systems, in which compromise is necessary.

During the formative period of English law, the content given to the court's relations to the legal and economic systems was dominated by liberalism. The second half of the nineteenth century was the high water mark of liberalism, in the classical variety attributed to John Stuart Mill, who wrote his great exposition, *On Liberty* (1859) at this time. Liberal philosophy has direct and powerful implications for the normative issues that I am describing. In so far as the court's relation to the legal system is concerned, liberalism encourages courts to facilitate the freedom of individuals, including the freedom to contract and to associate, unless that freedom deprives others of their own liberties. Liberal approaches will also seek some constraints on the role of the court, like any other arm of government, in order to preserve individual liberty. Thus, curial interactions with private relations are likely to balance restraint and the furtherance of individual liberty.

In so far as the court's relation to the economic system is concerned, classical liberalism is linked to classical economics and thus affirms the link between free, competitive markets and economic prosperity.¹¹ Liberal courts are therefore likely to regard their function as involving the reduction of frictions associated with private interaction - in other words, the reduction of transaction costs. However, we approach a significant complication, since the contracts characteristic of the competitive markets central to classical economics are quite distinct from the relations that comprise corporations. The classical contract is one in which there are sharply defined, dyadic obligations that are performed simultaneously or at least proximately.¹² Corporate contracts however are not dyadic, involve obligations which are not discretely performed, and frequently vest rights in majorities rather than individuals.¹³ Majoritarianism may permit

11 That connection was naturally very great in the late nineteenth century, given the economic impetus of new industrialisation.

12 I Macneil, "Contracts: Adjustments of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law" (1978) 72 *Northwestern UL Rev* 854; O Williamson, *The Economic Institutions of Capitalism*, Free Press (1985).

13 *Ibid*; MJ Whincop, "A Doctrinal and Relational Critique of Shareholders' Special Contracts" (1997) 19 *Syd L Rev* 314.

the ablation of individual liberties and entitlements, even though it may reduce transaction costs by enabling complex relations to adapt to changing circumstances. Thus, at some points, liberalism faces a complex choice between individual liberty and the imprimatur given by the freedom of association and contract to majority rule.

Liberalism is not the only characteristic philosophy of English corporate law. English law has also long been influenced by what might be described as prudentialism or conservatism.¹⁴ Drawing on both Aristotelian and Burkean traditions, conservatism's watchword is caution.¹⁵ It prefers to seek solutions in established practices and traditions rather than in theorisation, based in part upon the limits and flaws of individual judgment and theoretical analysis. As such it is related to the organic rationality school of Austrian economics, and in particular, Friedrich Hayek. Hayek's jurisprudential *oeuvre* is inseparably linked to the idea that the common law, like a market, is a spontaneous equilibrium to which conservative deference is appropriate.¹⁶

Conservatism as a political philosophy seems to matter most to corporate law at the institutional level, in terms of the importance of adherence to precedent and judicial restraint. In this respect, it is not greatly different from the classical liberal preference for smaller government. Hayek certainly considered that the English legal tradition furthered liberty.¹⁷ Yet conservatism's influences are also felt elsewhere. The first, related to precedent, is the conservative preference to banish policy from legal reasoning. One way of doing so which pervades English corporate law is the reliance on metaphysical concepts, which mediate divergent results without exposing instrumental motivations that might explain differences.¹⁸ The second, related to the preference for the status quo, is to accept the outcomes of existing power structures, of which the institutions that embody majority rule are an important example. An equation may be made here between these institutions and the Burkean propensity to defer to higher authoritative orders or classes. The third is the distaste for change, and the inclination to confine reform narrowly to minimise any disjunction with tradition.¹⁹

Although they have commonalities, such as the respect for property rights, conservatism and liberalism are not fully compatible. Conservatives oppose change that liberals may favour. Conservatives more readily endure the deprivation of liberties in a corporation that may deeply trouble a liberal.

14 PS Atiyah and RS Summers, *Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory, and Legal Institutions*, Oxford University Press (1987).

15 J Coniff, "Burke on Political Economy: The Nature and Extent of State Authority" (1987) 49 *Rev Politics* 490.

16 FA Hayek, *The Constitution of Liberty*, University of Chicago Press (1960); *Law, Legislation, and Liberty*, University of Chicago Press (1973).

17 *Ibid*, p 94.

18 An example is the complex inquiries into inter-corporate agency, as a means of circumventing the principle, attributed to *Salomon v Salomon & Co Ltd* [1897] AC 22, that a corporation cannot be the agent of its shareholders: see below, text accompanying note 126 *infra*.

19 For an early example (perhaps as much libertarian as conservative), see *Twycross v Grant* (1877) 2 CPD 469 at 498, per Bramwell LJ (criticising legislation as 'paternal', and adopting a narrow interpretation).

However, there is another tension here, to which I return in Part VI — conservatism can ironically render the status quo vulnerable, first, because the preference for conceptualism over the expression of policy can distort the application of the doctrine. Secondly, where the status quo produces a result in an exceptional case that attracts criticism, the status quo may be more vulnerable to legislative change. The policy that connects the exceptional unusual result to the normal run of cases is unarticulated and therefore cannot function as a defence. By emphasising the instrumental value of doctrine, liberalism may better preserve so much of the status quo that has value.

The confluence of liberalism and conservatism in English law produces four identifiable values in corporate law. Those values, shown in Table 1, correspond to the intersection of the substantive and institutional dimensions of the court's relation to the legal system, and those same dimensions of the court's relation to the economic system. I discuss these values in the following parts.

TABLE 1

The values defining the English courts' relations to the economic and legal systems in corporate law

Courts' relation to the legal system:	Courts' relation to the economic system:	
	Substantive	Institutional
	Contractibility	Adjudicatory passivity
	Doctrinal pragmatism	Prudentialism

We may finally note that neither liberalism nor conservatism need remain the dominant philosophies of the courts. The accommodation between liberalism and conservatism need not be constant either. The demise of corporate law's golden age saw conservatism gain an ascendancy over liberalism. Legislative change is also likely to import values, such as paternalism and communitarianism, which alter these classical values. After discussing the values, I discuss changes in Part VI.

III. CONTRACTIBILITY

A. Contractibility's Link to Liberalism and Conservatism

As Table I shows, contractibility is the value we find in classical corporate law at the intersection of the substantive dimensions of the court's relation to both the legal and economic systems. In this sense, contractibility does not appear to represent an institutional value, either of the legal or economic system. This is of course a simplification since the phenomenon of contracting is socially

constructed, and the contracts that are entered will depend on the institutions that exist to interpret and enforce them.²⁰

A legal rule is contractible if parties may vary or exclude it by contract. A rule that asserts the equality of rights between shares is a contractible rule, since the parties may create different classes of shares and confer different rights on them.²¹ Contractibility is a logical consequence of liberalism, since it resonates with the concept of individual liberty and the freedom to contract, subject only to the curtailment of any external effects that free contracting may have.²² The capacity for parties to define their obligations is linked to welfare-maximising free markets. More generally, contractibility limits the capacity of the state to invade individual liberties, since legal rules are presumptive, rather than pre-emptive.

The connection between conservatism and contractibility is less clear. Conservatives treat property rights as fundamental; a respect for property rights entails a substantial respect for individual liberties to trade rights and obligations. On the other hand, contractibility need not necessarily reinforce the status quo, especially if the status quo is highly inefficient.²³ The tension lies basically between two articles of conservative faith, one Hayekian, the other Burkean. The Hayekian tradition regards those who make and administer law as possessing limited information, which encourages both caution and a form of humility. Limiting individual freedom will bias or restrict the formation of spontaneous orders. The opposing article of Burkean faith lies in the conservative's belief in a "transcendent order or a body of natural law which rules society as well as conscience".²⁴ Freedom to avoid that transcendent order contractually must be limited. Much depends on whether or not corporate law rules are seen as emanating from that order.

B. Contractibility's Link to Economics

Economists regard corporations as a bundle of linked contracts, such as those for the supply of capital, labour, or managerial skills, or for the acquisition of the goods or services produced by the business. In any real world setting, those contracts will be formed under conditions of positive transaction costs. Transaction costs can be conceived as taking two quite different forms.²⁵ First, they comprise the resources that are expended to consummate a bargain, such as the negotiation and drafting of the agreement needed for the exchange contemplated. Second, they represent the social losses generated by strategic behaviour prior and subsequent to the formation of the contract. Strategic

20 R Posner, *Overcoming Law*, Harvard University Press (1995) p 301.

21 *Birch v Cropper* (1889) 14 App Cas 525.

22 These are expected to be uncommon: FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law*, Harvard University Press (1991) pp 23-5.

23 That is, if transaction costs are low, parties will contract around the inefficient status quo. Such frequent contracting may exert pressure on the legal rule.

24 R Kirk, *The Conservative Mind from Burke to Eliot* (6th ed, 1978) p 7.

25 R Cooter, "The Cost of Coase" (1982) 11 *J Legal Stud* 1; A Katz, "The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation" (1990) 89 *Mich L Rev* 215 at 226.

behaviour is designed to increase a party's share of the gains from trade. Because transaction costs are real costs, parties will seek to economise on them. For example, parties will attempt to diminish the transaction costs associated with ex post shirking by an employee or manager, which they may do either by providing incentives to work hard or disincentives to shirk in their contract. The attraction of contractibility as a value of corporate law emanates from the fact that economics regards contractual arrangements as an equilibrium that parties adopt to minimise transaction costs. If particular bargains are not permitted, the law may foreclose means of reducing transaction costs.

Almost all US research applying economics to corporate law is united by its advocacy of contractibility.²⁶ These scholars advocate legal rules taking 'default' rather than mandatory forms. That advocacy is reinforced by the financial economic evidence on the speed and accuracy with which prices of exchange-traded stocks react to information (which would include information about governance).²⁷ That evidence indicates that the individual investor need not be informed about the corporation or its governance to pay a fair or representative price. In the United States, the road to contractibility was paved by interjurisdictional competition between the states. In such an environment, legal rules can be avoided not only through a contrary provision in the charter, which US statutes often explicitly permit, but by changing the state of incorporation provided the states' laws are not substantially uniform.²⁸ As noted in the introduction, there is no similar dynamic at work in English law, nor did competition ever really take route in Australia's federal system. There are interesting differences in the approach to contractibility in English law, compared to US law, as I note in the next section. The different competitive dynamic may be responsible for this effect.

C. Contractibility in English Law

The reliance on the deed of settlement as the basis for organising the relations in unincorporated joint stock companies interpolated into corporate law the willingness of equity to permit private ordering of the obligations of the trustee.²⁹ This principle was applied widely in nineteenth and early twentieth century English corporate law. It even extends to principles that provide prudential protection for shareholders against opportunism or overreaching by

26 Cf JN Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 *Colum L Rev* 1549.

27 See, eg, E Fama, "Efficient Capital Markets II" (1991) 46 *J Fin* 1575.

28 BS Black, "Is Corporate Law Trivial?: A Political and Economic Analysis" (1990) 84 *Northwestern UL Rev* 542 at 552-3.

29 As to the contractibility of the trustee's obligations to avoid conflicts of interest with duty, see *Smith v Green* (1903) 22 NZLR 976; *Re Billington* [1949] QSR 102; *In the Estate of Cummings* [1964] SASR 236; *Will of Jackson* [1964-5] NSWLR 1279; *In re Hyne's Will Trust* [1971] 1 WLR 758; *Ballard Estates v Ballard Estates* (1991) 79 DLR (4th) 142; *Re Thompson's Settlements* [1985] 2 All ER 720; *In re Sykes* [1909] 2 Ch 241. As to the contractibility of the trustee's obligations of care, see *Brumbridge v Brumbridge* (1858) 27 Beav 3; 54 ER 2; *In re Sykes* [1909] 2 Ch 241; *Wyman v Peterson* [1900] AC 271; *Rehden v Wesley* (1861) 29 Beav 213; 54 ER 609; *Wilkins v Hogg* (1861) 31 LJ (Ch) 41; *Pass v Dundas* (1880) 43 LT 665; *Knox v McKinnon* (1888) 13 App Cas 753; *Rae v Meek* (1889) 14 App Cas 558. Delegation restrictions were also contractible: *Austin v Austin* (1906) 3 CLR 516 at 523, 526.

fiduciaries, the obligation to avoid a conflict of interest and duty, and the standard of care.³⁰ Lord Hatherley's comments in respect of the conflict rule are notable:

[The conflict rule], like any other rule of the Court, is open to contract between the parties, for it is not a principle the benefit of which parties cannot waive by express and direct contract for the sake of other advantages which they suppose they derive.³¹

In addition to these principles of corporate governance, we find a similar emphasis on the freedom of contract in the rights and obligations of members in the nineteenth century. Although statute later placed limitations on the obligations to contribute to the capital of the company, the early law treated these obligations as no different from any other contractual obligation. In 1877, Jessel MR said of an article subjecting a member to additional liability that "it is no part of the duty of courts of justice ... to be astute in finding reasons for avoiding men's contracts which are otherwise reasonable".³² Other cases from this period were decided in the same way.³³ Likewise, the law has long taken a generous view of the entitlement of those contributing capital to protect their rights by way of a shareholders' agreement, which is separate from the articles.³⁴ The use of a shareholders' agreement is an integral part of modern financial contracting in venture capital, given the severe incentive and information problems encountered in this context.³⁵

The contractibility of English law differed from the latter day default rules of US law in two senses. The first is the tendency for courts to read variations of legal principles having prudential value, such as fiduciary duties, in a narrow, somewhat literalist fashion.³⁶ Such an approach balances an incentive to state more explicitly the detail of the variation to the legal rule, with the protection to which shareholders would otherwise be entitled. The explicitness incentive may function to increase the amount of available information to markets and investors, and may also enable ex ante separation between those who contemplate transactions that would otherwise be in breach of fiduciary duty and those who do not.³⁷

30 See BR Cheffins, "Law, Economics and Morality: Contracting out of Corporate Law Fiduciary Duties" (1991) 19 *Can Bus LJ* 28; MJ Whincop, "Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate Law" (1997) 21 *MULR* 187.

31 *Imperial Mercantile Credit Association v Coleman* (1871) LR 6 Ch 558 at 570.

32 *McKewan's Case* (1877) 37 LT 201 at 203.

33 *The Lion Mutual Marine Insurance Association Ltd v Tucker* (1883) 12 QBD 176; *Peninsular Co Ltd v Fleming* (1872) 27 LT 93.

34 VR Goldwasser, "Shareholder Agreements - Potent Protection for Minorities in Closely Held Corporations" (1994) 22 *ABLR* 265.

35 WA Sahlman, "The Structure and Governance of Venture-Capital Organizations" (1990) 27 *J Fin Econ* 473.

36 MJ Whincop, note 30 *supra*. As to the US, see JC Coffee, Jr, "The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role" (1989) 89 *Colum L Rev* 1618.

37 The theory of information-forcing defaults is analysed in I Ayres and RH Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 *Yale LJ* 87.

The second difference is that English law has taken an enabling approach to contracting that occurs after the ex ante governance contract is in place.³⁸ For instance, where some course of action is prohibited by the law, the law has taken an accommodating approach to decisions by those with the benefit of the prohibition to waive it, provided the proposal to do so is accompanied by full information and is not coercive.³⁹ Examples include conflicts of interest or the appropriation of business opportunities. This is related to the literalist tendency of English law, as well as the strict formulation of fiduciary duties.⁴⁰ Both principles shift the burden from the court to decide whether the transaction was permissible under the ex ante contract, to the shareholders to decide whether the transaction improves their welfare. Thus, the law encourages contentious governance questions to be negotiated, rather than litigated, which is related to the second value, adjudicatory passivity. This effect is quite obvious in the authorisation or ratification of fiduciary duties, but it also prevails in other contexts in which the law recognises the rights of an individual shareholder or subset of shareholders. An example is the 'personal rights' exception to the rule in *Foss v Harbottle*.⁴¹ By creating individual standing, it requires minority consent to the abridgment of personal rights.⁴²

IV. ADJUDICATORY PASSIVITY

A. Adjudicatory Passivity's Link to Liberalism and Conservatism

Adjudicatory passivity is the value we find in English corporate law at the intersection of the substantive dimension of the court's relation to the economic systems and the institutional dimension of the court's relation to the legal system. Any value we find at this locus must express the court's attitude towards adjudication of corporate relations, interpreted within the context of the liberties, entitlements and obligations that the law recognises corporate participants as having against each other.

What is adjudicatory passivity? It may be most easily understood in comparison to its polar opposite, adjudicatory activism. Activism and passivity, in the sense I use those terms, are distinguishable at several levels. First, to borrow an administrative law analogy, an activist court apprehends its function as involving the review of the merits of decisions reached by governance processes, whereas a passive court is only concerned by the fact that those processes have been properly constituted and exercised.

Secondly, an activist court claims and exercises a significant measure of ex post discretion in formulating its orders. The court views itself as a means by

38 MJ Whincop, "Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law" (1999) 19 *Oxf J Legal Stud* 19.

39 See, eg, *Parker v McKenna* (1874) 10 Ch App 96 at 124; *Miller v Miller* (1995) 16 ACSR 73 at 87.

40 *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 473.

41 (1843) 2 Hare 461; 67 ER 189.

42 See L Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" [1957] *CLJ* 194; [1958] *CLJ* 93.

which society economises on bargaining failure. The court will fill a vacuum, in which parties fail to cut a deal, with a simulated bargain based on its own discretionary balancing of merits.⁴³ A passive court will decide cases according to any rights for which the parties have explicitly contracted, and, in the absence of a contract, a set of default rights and entitlements in which permissions and prohibitions do not depend on the balancing of particular merits.⁴⁴

Thirdly, an activist court is willing to extend its role beyond the particularity characteristic of common law adjudication to embrace a more general policy brief, discharged through constant refinement of legal rules. A passive court is more content with the legal status quo.

Adjudicatory passivity represents a fusion of liberalism and conservatism. It combines liberalism's insistence on laissez-faire and non-interference of government with private relations with the conservative recognition of the impoverished regulatory position of the courts and the states. Adjudicatory passivity is also conservative in the further sense that it often defers to governance processes, recognising their priority in an explicitly hierarchical view of the corporation. I have commented that this deference can be somewhat illiberal, in so far as it constitutes majorities that are capable of taking certain rights away from minorities, although adjudicatory passivity is just as able to justify passive enforcement of individual rights as of majority rights.

B. Adjudicatory Passivity's Link to Economics

The contractarian characterisation of corporations raises a question about how courts can reduce transaction costs in these corporate contracts. Transaction costs cause corporate contracts to be incomplete. Activism and passivity represent the extreme positions courts might take to the filling of these contract gaps. Activist approaches are analogous to the use of tailored defaults, in which a court discriminates between the legal rules it applies to situations based on the characteristics of the situation, and the use of standards, in which ex post discretion is reserved to give effect to some legal norm.⁴⁵ Passivity counsels the use of simpler, generic legal principles and the preference for rules to which content is given ex ante, rather than ex post, "with no judicially imposed ifs, ands, or buts".⁴⁶

Each side enjoys theoretical support. The case for passivity recognises that one of the main reasons contracts are left incomplete is that the terms that would be required to complete them would predicate on information that would be impossible or difficult to verify to a court.⁴⁷ An example might include an

43 See generally R Cooter, note 25 *supra*.

44 This concept of passivity receives a definitive exposition and analysis in A Schwartz, "Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies" (1992) 21 *J Legal Stud* 271.

45 As to tailoring, see I Ayres and R Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 *Yale LJ* 87; I Ayres, "Preliminary Thoughts on the Optimal Tailoring of Contractual Rules" (1993) 3 *S Cal Interdis LJ* 1.

46 JS Johnston, "Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures" (1992) 70 *Wash ULQ* 291 at 294. See generally A Schwartz, note 44 *supra*.

47 A Schwartz, *ibid*.

hypothetical contract in which a director is entitled to pursue a corporate business opportunity where his valuation of the opportunity is greater than the cost to the corporation of foregoing the opportunity. Although such a contract achieves first-best efficiency, courts are likely to be incapable of verifying either the director's valuation or the cost to the corporation. Alan Schwartz argues that many relational contracts are likely to be left incomplete for these reasons, since the inputs to and products of relational contracts will frequently lack ready market proxies. Schwartz argues that the optimal response of courts to contracts left incomplete for these reasons is to enforce express contractual terms and, in their absence, to grant rights unconditionally to one party or the other. In these circumstances, the parties can still achieve first-best efficiency by renegotiating *ex post*, in other words by trading the property rights the law has granted. Schwartz argues this renegotiation is easiest when the parties' threat values — the payoff each earns if an agreement is not reached — are clear, which passive rules are most likely to provide. Other scholars have relied on related arguments in corporate law to favour similar approaches, in particular in members' rights.⁴⁸ English law's use of strict fiduciary rules and its encouragement of *ex post* contracting encourages renegotiation.⁴⁹

The arguments for activism in corporate law are primarily defences of the use of standards. There are two arguments in favour of the use of greater *ex post* discretion. The first is that rules which involve *ex post* discretion make good defaults.⁵⁰ Parties may value *ex post* discretion, even though unverifiable information may cause courts to fail to produce results that are consistently first-best efficient. If parties don't value discretion, rules are quite easy to contract out of in favour of a passive, unconditional allocation. If the parties do value discretionary balancing approaches, they may not be easy to contract into *ex ante* where the default is passive, except through the use of imprecise terms, such as 'reasonableness'. These terms may have no clear meaning unless consistently applied by courts to these sorts of cases.⁵¹ Also, a more fact-discriminating approach to dispute resolution increases the number of allocations for which parties might actually express a preference. For instance, the various approaches taken by Delaware courts to defensive actions in takeovers, such as proportionality review and 'just-say-no',⁵² could each function as options the parties might choose from a menu.⁵³

The second argument for *ex post* discretion takes issue with the claim that contracting is most likely under passive, absolute allocations. Jason Johnston has used a game theoretic model to analyse bargaining under precise rules, precise standards and imprecise standards. The capacity of an uninformed party to

48 JS Johnston, note 46 *supra*; E Rock and M Wachter, "Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in the Close Corporation" (1999) 24 *J Corp L* 913.

49 See text accompanying notes 38-39 *supra*.

50 I Ayres, "Making a Difference: The Contractual Contributions of Easterbrook and Fischel" (1992) 59 *U Chi L Rev* 1391.

51 M Klausner, "Corporations, Corporate Law, and Networks of Contracts" (1995) 81 *Va L Rev* 757.

52 *Paramount Communications Inc v Time Inc* 571 A2d 1140 (Del 1990); *Unocal Corp v Mesa Petroleum Co* 493 A2d 946 (Del 1985).

53 M Klausner, note 51 *supra*.

invoke an imprecise adjudicatory standard may in fact increase the amount of efficient trade, compared to either absolute allocations of rights or precise ex post comparison.⁵⁴ I should note that these latter arguments are hardly an unfettered charter of activism in the sense I describe it in section A. They are arguments only in favour of tailoring and ex post discretion, not a defence of a quasi-legislative brief for the courts.

C. Adjudicatory Passivity in English Law

Activism and passivity are extremes on a continuum; decisions in practice are likely to fall somewhere in between. Since passivity depends upon some default allocation of rights, the court must at some point declare what is involved in that allocation. Nonetheless, English law historically approached the passive end of the continuum.

Directors' duties are a good example. Fiduciary duties to avoid conflicts of interest and duty were traditionally passive. Courts resolved these cases by means of an absolute prohibition, in which the fairness of the transaction was irrelevant,⁵⁵ with the right for a majority of shareholders to ratify or authorise the transaction with full information and without coercion.⁵⁶ This is passive since the court does not purport to verify the fairness of the transaction, but allows the contract to be renegotiated ex post, if the fiduciary rule has not been varied ex ante. Duties of care are similar since, apart from permitting ex ante releases of liability, English law characterised the standard of care in such a way that findings of negligence were difficult in all but genuinely exceptional (verifiable) cases.⁵⁷ The courts did not purport to reconstruct retrospectively the action a reasonable director would take ex post.

The response of English and Australian courts to defence by directors in contests for corporate control also provides an interesting parallel between activist and passive approaches. In general, these cases often invoke the fiduciary principle that a power conferred on the board of directors cannot be exercised for an improper purpose. This principle apparently provides the occasion for greater ex post discretion in the review of director action.⁵⁸ Yet the English courts have often eschewed activism by consistently striking down self-entrenching actions.⁵⁹ The Australian courts have taken a more permissive approach, in which the benefits of the action have often been regarded as a legitimate subject for consideration.⁶⁰ Thus, the English approach is the more passive of the two.

54 JS Johnston, "Bargaining Under Rules Versus Standards" (1995) 11 *J L Econ & Org* 256.

55 *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 473.

56 See text accompanying note 39 *supra*.

57 *Re City Equitable Fire Insurance Corp* [1925] Ch 407.

58 See MJ Whincop, note 30 *supra*.

59 *Punt v Symons & Co Ltd* [1903] 2 Ch 506; *Piercy v S Mills & Co Ltd* [1920] 1 Ch 77; *Hogg v Cramphorn Ltd* [1967] Ch 254; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

60 *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 183; *Darvall v North Sydney Brick and Tile Co Ltd (No. 2)* (1989) 16 NSWLR 260; *Pine Vale Investments Ltd v McDonnell and East Ltd* (1983) 1 ACLC 1294; *Winthrop Investments Ltd v Winns Ltd* (1979) CLC [40-554].

Adjudicatory passivity has a highly significant bearing on the tension between classical liberalism and the majoritarian qualities of corporations. In general, most business, litigious, management and distributional issues lie in the power of the majority and the constituted governance instrumentalities, such as the board. English courts took an approach that did not purport to disturb these decisions. This includes purely internal issues, such as investment or production decisions, as well as most events that generate a cognisable cause of action in law. This result is achieved through the recognition of the corporation as a separate legal entity, in which most causes of action are vested under the rule in *Foss v Harbottle*.⁶¹ Nonetheless, some rights are conferred on individual shareholders.⁶² These protect the minority from being excluded from participation as a shareholder in governance processes (such as the right to vote), expropriation, and other attempts to redefine or circumvent the rights of the minority to share in assets and income. Shareholder protections, however, are not necessarily defined passively as majority rights tend to be. For example, the so-called personal rights and fraud on the minority exceptions to the rule in *Foss v Harbottle*, and rules such as that in *Allen v Gold Reefs*⁶³ that protect the defendant against adverse changes to the articles are complex tests. They are often defined in a manner in which their application can only be determined *ex post*. It may be that this substantive uncertainty and the litigation costs associated with its resolution do in fact decrease the likelihood of bargaining failure, as the game theoretic literature suggests.

V. DOCTRINAL PRAGMATISM

A. Doctrinal Pragmatism's Link to Liberalism and Conservatism

Doctrinal pragmatism is the value we find in English corporate law at the intersection of the institutional dimension of the court's relation to the economic systems and the substantive dimension of the court's relation to the legal system. As such it describes the approach and judicial method that courts use to define the substantive law applicable to corporations and corporate contracts. Thus, we are concerned with issues of change and evolution in the law, but also with the conceptual structure of the law itself. In this respect, liberalism and conservatism will influence the content of the law and the direction of its evolution.

In studying this question, we must ask whether the law is formalistic, or whether it is pragmatic. Formalism is often regarded as a characteristic of English law.⁶⁴ A formalistic approach to the law asserts that law is an exact, logical discipline; the correctness of the conclusions associated with legal reasoning should be apodictic. That view was challenged by fin-de-siècle American thought, particularly by Oliver Wendell Holmes. Holmes, and later the

61 Note 41 *supra*.

62 And of course the shareholders may explicitly contract for others.

63 *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656.

64 Note 14 *supra*; RA Posner, *Law and Legal Theory in England and America*, Oxford University Press (1996).

legal realists, demonstrated that law was not and could not be applied as if it were an exact science.⁶⁵ Holmes demonstrated that legal rules frequently served instrumental purposes. Changes in social circumstances, including economic ones, could be expected over time to exert pressure for change on the legal rule. An approach to legal reasoning that recognises the influence of instrumental factors, and that eschews formalist claims to strict logical derivation, is pragmatic.⁶⁶

Although a judge who makes explicit reference to policy and instrumental considerations might seem to be pragmatic, pragmatism is a matter of substance, not of style or manners. Thus, judges who eschew policy in favour of the application of precedent may be preferred to the uncertainty and likely amateurism of some policy-based adjudication. This claim is related to the logic underlying adjudicatory passivity. Constraints on the judge's 'creativity' have liberal appeal, since the court will only attempt to resolve questions about obligations based on the parties' own acts. It will not intervene to create new obligations in fulfilment of an agenda the parties may not share. Pragmatism should however be manifested in certain specific respects. First, changes in the law should be explicable with reference to instrumental factors. Secondly, judges should limit the extent to which they complicate the law by reference to metaphysical concepts or other concepts of doubtful ontology, unless that itself has some instrumental aim.⁶⁷ By contrast, a formalistic approach is much more likely to rely on these concepts as the analytical units in pseudo-logical discourse. Thirdly, pragmatism suggests that courts confronting new questions may well borrow from existing doctrinal principles, but are likely to give the principle new content. The formalistic alternative is to recognise some concept as distinguishing the new case from the established one, in order to limit the appearance of invention.

These are the features of what I call doctrinal pragmatism. I qualify pragmatism with the adjective 'doctrinal', in order to recognise that the conservative doctrinalism of the English courts can be substantively pragmatic as well as stylistically formalistic.

B. Doctrinal Pragmatism's Link to Economics

Given that contractibility and adjudicatory passivity show efficiency influences, we may further inquire about whether this is also true of doctrinal pragmatism. Efficiency would be detected at two levels. First, legal principles should be consistent with the economic objective of reducing transaction costs. This is not straightforward to examine, since there may not be a single prescription that satisfies this objective. We saw that this was true when we

65 OW Holmes' definitive works are *The Common Law*, Brown Press (1881) and "The Path of Law" (1897) 10 *Harv L Rev* 457. See also BN Cardozo, *The Nature of the Judicial Process*, Yale University Press (1921).

66 On pragmatism, see generally JP Diggins, *The Promise of Pragmatism: Modernism and the Crisis of Knowledge and Authority*, University of Chicago Press (1994). On pragmatism and the law, see R Posner, note 20 *supra*.

67 See text accompanying notes 86-90 *infra*.

examined the debate about the need for tailoring and for ex post discretion in relational contracts. However, some legal principles will clearly be inconsistent, either because they make certain bargains impossible, or because they occasion unnecessary transaction costs.

Secondly, doctrinal pragmatism has something to say about the use of the corporate entity concept in the law. As I have explained above, economists regard the corporation as a nexus of contracts and reject the utility of entity concepts. Doctrinally, this should imply that the corporation concept should not appear in the law, or that if it does, there will be instrumental explanations of the sort Holmes once identified.⁶⁸ If cases are decided in a way which is inconsistent with the existence of a corporation as an autonomous ontological entity, a pragmatist would claim that the entity concept has no significance.

C. Doctrinal Pragmatism in English Law

The appearance of the entity concept in so many areas of English corporate law suggests two alternative possibilities: either that the law is not pragmatic, or that the concept has particular instrumental justifications. In the 'golden age' period of corporate law, the latter is true in the main, although there are several instances where the concept functions unpragmatically.

The entity concept serves varying purposes in corporate law. The first is to reinforce adjudicatory passivity. The second is to function as a transformative device, in the context of the extension of existing doctrinal principles to new contexts. The third is to function as a device for risk allocation. The fourth is to provide scope for ex post discretion.

The entity concept reinforces adjudicatory passivity by vesting various rights and procedural entitlements in the corporation. As mentioned above, the rule in *Foss v Harbottle* does this.⁶⁹ *Foss v Harbottle* explicitly links the capacity of individual shareholders to litigate to the capacity of the majority to ratify particular conduct.⁷⁰ This enhances the capacity of the internal organs and decision-making bodies of the corporation to make governance decisions while also encouraging ex post contracting as a means of addressing disputes in the corporation. So understood, the rule in *Foss v Harbottle* is best appreciated as a rule that delineates the powers of the majority and the minority, rather than a rule which recognises the corporation as an entity in its own right.

The corporation can function as a device that permits the transformation of doctrinal concepts. I said above that a pragmatic approach to doctrine is more likely to permit freer mutations of doctrine to address novel situations and different policy issues. The law on promoters' duties provides a good illustration of the entity concept's place in this evolutionary enterprise.⁷¹ Superficially, promoters' duties seem analogous to directors' duties. However, there is a quite fundamental difference between the two. Directorship raises a paradigm instance

68 OW Holmes, *The Common Law*, note 65 *supra*, ch 1.

69 See text accompanying note 61 *supra*.

70 Note 41 *supra*.

71 This argument is developed in more detail in MJ Whincop, "Promoters, Prospectuses, and Pragmatism: Updating Fiduciary Duties in a Time of Economic Reform" (1998) 24 *Mon L Rev* 454.

of an agency problem in which shareholders are concerned with ensuring competent and loyal discharge of directors after they have been appointed. In economics, this is called a *moral hazard* problem. The principal issue in promoters' duties cases is basically one of disclosure, which arose because of concerns that promoters were on-selling assets to companies at grossly inflated prices. In economics, this is called an *adverse selection* problem. This general concern was eventually fully integrated with the law on fund-raising and mandatory requirements for a formal prospectus. Until that occurred, the law adeptly created a substitute disclosure obligation by the interpolation of the requirements imposed on a fiduciary selling assets to his or her beneficiary - notwithstanding the absence of the moral hazard profile characteristic of most fiduciary situations. Initially, the use of the entity concept created its share of complexities, as the precise obligation of the promoter was not clear. Thus, in earlier cases, such as *Erlanger v The New Sombrero Phosphate Co*,⁷² the House of Lords thought the duty was to provide an independent board. By the time of later cases, however, that principle had changed to an obligation which was based primarily in disclosure to new investors.⁷³ The willingness to allow free mutations in fiduciary principle is pragmatic.

There are other instances of using the entity concept to permit doctrinal mutation. One is its relevance to the enforcement of provisions of the articles. The concept of the corporation and the subsidiary concept of membership were used to define the rights contained within the corporate contracts that members might enforce.⁷⁴ Although it is unquestionably true that these concepts could operate obscurely, there is a trend in some of the earlier cases to limit the enforcement of certain rights, such as to the appointment of office or the enjoyment of certain privileges.⁷⁵ This seems to spring from similar norms to those motivating the promoter cases. In other instances, the membership concept is used negatively to enable the enforcement of certain rights that the law would not permit to be enforced against a member.⁷⁶ Thus, the concept is permeated by instrumental purposes, which transform the simple promissory qualities of classical contracts for use in more complex corporate contexts.

The entity concept has a role in risk allocation. Dealings with a corporation are frequently tripartite, involving an 'external' contractor, the agent or employee of the corporation with whom the contractor deals, and the shareholders who are the principals of the agent or employee. Corporate legal principles must often resolve these problems. The most obvious principles are those on actual and ostensible authority, but others serve similar purposes, and

72 (1878) 3 App Cas 1218.

73 *Re Ambrose Lake Tin and Copper Mining Co; Ex parte Taylor and Moss* (1880) 14 Ch D 390; *Re British Seamless Paper Box Co* (1881) 17 Ch D 467; *Gluckstein v Barnes* [1900] AC 240.

74 RR Drury, "The Relative Nature of a Shareholder's Right to Enforce the Company Contract" [1986] *CLJ* 219; MJ Whincop, "A Relational and Doctrinal Critique of Shareholders' Special Contracts" (1997) 19 *Syd L Rev* 314.

75 *Eley v Positive Government Security Life Assurance Co Ltd* (1876) 1 Ex D 88.

76 *Shalfoon v Cheddar Valley Co-operative Dairy Company Ltd* [1924] NZLR 561.

include the law on pre-incorporation contracts, the entitlements of plaintiffs to lift the corporate veil, and, until its legislative exorcism, the law on ultra vires.

There are several pragmatic aims the law might serve in these cases. First, it should seek to enforce contracts that are not tainted by fraud or any other form of unlawful behaviour. Most contracts fall into this category. However, the law sometimes refused to do this. An obvious instance is the interpolation of ultra vires doctrine, by false analogy to the law on statutory corporations.⁷⁷ A similar example is the impossibility of binding a corporation to a pre-incorporation contract.⁷⁸ The doctrinal issues in this regard are somewhat more complex, because the cases in this area may involve similar problems to those associated with promoters' duties and capital formation, such as attempts to sell assets to the shareholders at an overvalue without disclosure.⁷⁹ The law in the formative period of English corporate law provided a partial solution for these problems by allowing the contractor to enforce the contract against the promoter.⁸⁰ However, in light of the independent requirements under the law on promoters' duties, this effect was redundant. These doctrinal complications create unnecessary transaction costs, and, after the golden age, opportunities for parties to evade ex post contracts that indisputably served their self interest ex ante.⁸¹

Secondly, the law might seek to address problems associated with overreaching or fraud by the agent.⁸² Since the contractor and the shareholders rarely transact directly, the agent is capable of controlling the communications between them. This gives him considerable power to act opportunistically. In these cases, the appropriate objective of the law might be described as making allocations of the risk of fraud to whichever of the contractor or shareholders has the lowest marginal costs of avoiding the unauthorised transaction. This is an objective similar to the historic 'least cost avoider' principle used in the economic analysis of torts.⁸³ The law's success in this regard is somewhat patchy. On the one hand, principles like the indoor management rule, and the imposition of the risk of pre-incorporation contracts on the promoter obtain a balance that intuitively seems accurate. The nature of internal procedures and the status of incorporation are subjects in which shareholders and their representatives have low information costs compared to outsiders. On the other hand, ultra vires clearly violates the objective. As we see below, the more formal use of the entity concept in the later twentieth century is similarly problematic.

A third objective, related to the second, is to address the problem of collusion between any two of the three parties, at the expense of the third. In a recent

77 *Ashbury Railway Carriage and Iron Co v Riche* (1875) LR 7 HL 653.

78 *Kelner v Baxter* (1866) LR 2 CP 174.

79 MJ Whincop, "Of Dragons and Horses: Filling Gaps in Pre-Incorporation Contracts" (1998) 12 *J Contract L* 217.

80 Note 78 *supra*. In Australia, see *Summergreene v Parker* (1950) 80 CLR 304 at 323; *Vickery v Woods* (1952) 85 CLR 336 at 343.

81 See text accompanying notes 126-7 *infra*.

82 MJ Whincop, "Nexuses of Contracts, Corporate Authority Doctrine and Doctrinal Indeterminacy: From Formalism to Law and Economics" (1997) 20 *UNSWLJ* 274.

83 G Calabresi, *The Costs Of Accidents: A Legal And Economic Analysis*, Yale University Press (1970).

working paper, George Cohen has suggested this as an objective of agency law.⁸⁴ Collusion is possible between any two of the three parties, but in corporation cases, it is most likely to occur between the corporation and the agent, because of the likely long-term, 'repeat-playing' relation between the two.⁸⁵ Thus, the corporation might represent to the contractor that the transaction affected by the agent was in fact unauthorised, when the reverse was true. Traditional law on agency and authority did little to solve collusion problems, because the entity concept's role in corporate law often shifted the onus of proving authorisation onto the contractor. On balance, the entity concept had mixed success in the pragmatic allocation of risk. The conservative unwillingness to explicate these issues of risk allocation often resulted in judges elevating the corporation from instrumental fiction to ontological entity with consequent distortions of the results.

The fourth use of the entity concept in the law is the use of the concept of the 'company as a whole'. This appears in the law in two places: in the specification of the content of the duties of directors,⁸⁶ and in the limitation of the circumstances in which a majority might alter the articles.⁸⁷ As far as I can tell, the requirement that directors act bona fide in the interests of the company as a whole only appeared definitively in the twentieth century, although it was prefigured in nineteenth century cases like *Hutton v West Cork Railway Co.*⁸⁸ The use of the company as a whole rubric in alterations to articles by majorities was established by *Allen's Case* in 1900. In both areas, the principle seems to provide judges with discretion to balance particular interests ex post, rather than precommitting the exercise of judicial discretion. Such a balancing process is inconsistent with adjudicatory passivity, but the extent of the violation depends on the sorts of factors that courts consider when exercising the discretion. More relevant to our interest in doctrinal pragmatism is the fact that these sorts of tests, even now, rarely recognise interests inconsistent with those of the shareholders.⁸⁹ The interests of creditors might be relevant if the corporation was in financial distress,⁹⁰ but that creates no metaphysical complications. These principles, like the related requirement that directors act for proper purposes, seem to be invoked in cases of substantial factionalism. That is, they are used when a simpler rule may be equally indeterminate. Thus, the rule is often used in majority-minority fights or contests for control. 'The interests of the

84 GM Cohen, *The Collusion Problem in Agency Law*, University of Virginia School of Law, Legal Studies Working Paper No. 00-2.

85 As to repeat play effects, see note 82 *supra* at 295-6.

86 See, eg, *Re Smith and Fawcett Ltd* [1942] Ch 304 at 306; *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438-9.

87 *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 at 671; *British Equitable Assurance Co v Bailey* [1905] AC 35 at 38.

88 (1883) 23 Ch D 654.

89 See *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 at 291; *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438.

90 *Grove v Flavel* (1986) 4 ACLC 654; *McNamara v Flavel* (1988) 6 ACLC 802; *Jeffree v NCSC* (1989) 7 ACLC 556; *Castrisios v McManus* (1991) 9 ACLC 287; *Sycotex Pty Ltd v Baseler* (1994) 13 ACSR 766; *Winkworth v Edward Baron Development Co Ltd* [1987] 1 All ER 114 at 118.

shareholders' is a difficult concept to apply where, as in many of these cases, the shareholders themselves have divided views on the subject.

Doctrinal pragmatism therefore has some claims to describe traditional English law, and provides a more useful understanding of the many apparent conflicts in the invocation of the entity concept. However, it is clear that even from relatively early times, the unwillingness of English judges to acknowledge explicitly the particular interests and policies at stake, and the conservative temptation to resolve cases formalistically, limited the pragmatic qualities of the doctrine.

VI. PRUDENTIALISM

A. Prudentialism's Link to Liberalism

Prudentialism is the value we find in English corporate law at the intersection of the institutional dimensions of the court's relation to both the economic and legal systems. At this intersection, our focus is not on substantive actors. Prudentialism is a conservative affirmation of the notion that judicial self-restraint and caution provide legitimacy for the courts as an institution within the legal system and the stable property rights required by the market.

The link between prudentialism and liberalism depends on the status quo that prudentialism preserves. The classical liberal virtues of the English courts in the nineteenth century could thus be preserved by prudentialism. Moreover, to the extent that prudentialism remains as the institutional value of courts in corporate law, it may preserve liberalism (or at least a version of liberalism) against legislative abridgments.

B. Prudentialism's Link to Economics

Let me briefly recap some of the points I have made about conservatism in discussing the efficiency claims of prudentialism. Prudentialism is likely to establish clear and relatively absolute property rights. However, there is a tension, as is so often the case with conservative values. On the one hand, courts will prefer not to arbitrate the validity of non-consensual takings of property rights. They will enforce the property right passively because property rights are treated as being of the highest importance and because the information deficiencies of courts preclude identification of efficient takings. On the other hand, the conservative tendency to defer to established centres of authority may have the opposite effect. We saw above that adjudicatory passivity resonates with this deference to authority. Finally, the tendency to prefer precedent to policy in legal reasoning may limit the adaptive capacities of the doctrine.

I have not yet commented on the efficiency of enforcing the status quo strictly compared with selective adaptation of the status quo to reflect demonstrable changes in praxis and society. In particular, should the norms and values that exert important ongoing governance effects in corporations influence the formal doctrine? Much recent work in law and economics has sought to examine how

norms form, their governance effects, and the relationship to formal doctrine.⁹¹ Given the early stage of the scholarship, there is no straightforward position, as yet. This reflects larger debates within economics and amongst conservatives about the conditions required for the development of institutions, and the role of the state therein.⁹² On the one hand, behavioural regularities that are not dysfunctional may provide vital guidance for conservative courts that do not know which of various alternative resolutions is the appropriate one.⁹³ Indeed, this sort of resort to custom, typical of the common law, may frequently explain why efficiency is a persuasive positive theory of law - courts economise on their information deficiencies by following actual practice.⁹⁴ Examples might include having regard to 'best practice' in making determinations as to what constitutes reasonable care for directors.⁹⁵ Conservatives such as Hayek have recognised the important role of law in the formation of socially desirable norms.⁹⁶

On the other hand, many valuable norms, such as those that emphasise cooperation and mutuality in contracts, may only be able to prosper *outside* of the legal system, and may in fact be undermined by active attempts at judicial emulation.⁹⁷ Norms of cooperation can be enforced outside the legal system, either through threatened retaliatory deprivation of future business or cooperation, or by the punishment of other persons who are not parties to the contract but who belong to a common community.⁹⁸ For instance, an entrepreneur may try to withhold information from a venture capitalist in relation to the business. However, the venture capitalist can threaten retaliation by cutting off future finance.⁹⁹ Other financiers may perceive this as a negative comment about the quality of the entrepreneur that is fatal to the entrepreneur's capacity to obtain finance elsewhere.¹⁰⁰ When the current venture capitalist cuts off future finance, the norm of sharing information is enforced by *second-party*

91 L Bernstein, "Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms" (1996) 144 *U Pa L Rev* 1765 ("Merchant Law"); L Bernstein, "Social Norms and Default Rules Analysis" (1993) 3 *S Cal Interdisc LJ* 59; R Cooter, note 1 *supra*; RD Cooter, "The Theory of Market Modernization of Law" (1996) 16 *Int'l Rev L & Econ* 141; RC Ellickson, "Law and Economics Discovers Social Norms" (1998) 27 *J Legal Stud* 537; JS Johnston, "The Statute of Frauds and Business Norms: A Testable Game Theoretic Model" (1996) 144 *U Pa L Rev* 1859.

92 Compare, for example, O Williamson, *The Economic Institutions of Capitalism*, Collier Macmillan (1985); D North, *Institutions, Institutional Change, and Economic Performance*, Cambridge University Press (1990).

93 Conservatives take custom very seriously, seeing in it the essence of spontaneous social governance: AE Galeotti, "Individualism, Social Rules, Tradition: The Case of Friedrich A Hayek" (1987) 15 *Polit Theory* 163.

94 R Cooter, note 1 *supra*.

95 There are some reflections of custom in Justice Rogers' famous analysis of non-executive directors in *AWA Ltd v Daniels* (1992) 7 ACSR 759.

96 S Deakin, "Law Versus Economics? Reflections on the Normative Foundations of Economic Activity" in G Hadfield and M Richardson, *The Second Wave of Law and Economics*, Federation Press (1999).

97 L Bernstein, "Merchant Law", note 91 *supra*.

98 J Johnston, note 91 *supra*.

99 PA Gompers, "Optimal Investment, Monitoring, and the Staging of Venture Capital" (1995) 50 *J Fin* 1461.

100 DG Smith, "Venture Capital Contracting in the Information Age" (1998) 2 *J Small & Emerging Bus L* 133.

means; the refusal of other parties to deal with the entrepreneur is a type of *third-party* enforcement. The reverse situation is also conceivable - the financier may use a threat of finance restriction to facilitate an opportunistic renegotiation of the terms of his investment. The entrepreneur may retaliate by withholding information or by communicating the financier's threat to other persons seeking finance. Although probably not *sufficient* conditions, the existence of these deterrents has an important role in the development of trust and cooperation.¹⁰¹ However, the capacity for the parties to be able to make these forms of threats presupposes a strong degree of passivity in the judicial response. Were courts to claim that the taking of the threatened action violated the cooperative norms of the relation, and this justified enforcement of that norm, the threat of punishment would cease to be credible. If that happened, parties may be unwilling to act cooperatively for fear that courts would give effect to the behaviour. This problem is exacerbated by the difficulties of verification that courts face, since the content of norms may be difficult to verify, as may be the form of conduct that contravenes them.¹⁰² This approach suggests that passively conservative responses may be superior for the evolution of cooperative norms in long-term relations. The final position as to the desirability of emulating customs and norms is therefore ambiguous.

C. Prudentialism in English Law

Prudentialism has long been regarded as a characteristic value of English judging. We have already seen that separating conservatism and pragmatism, or pragmatism from formalism may not always be easy in the face of such reticence, but there can be no doubt that English law is prudential in method, whatever else it may also be. The adjudicatory passivity of traditional English judging also confirms this conclusion.

VII. CHANGE IN CORPORATE LAW VALUES

A. Regulation and Formalism

So far, I have spoken of the values of the formative period of English law without being precise about the period in question. The formative period actually divides into two periods, around *Salomon v Salomon & Co Ltd.*¹⁰³ *Salomon* is a significant authority for two reasons. First, it represents the beginning of the formalisation of the entity concept in English law.¹⁰⁴ As we can see from the earlier authorities, entity concepts obviously predate *Salomon*, yet later authorities regard *Salomon* as the exclusive authority for the proposition that the corporation is a separate legal entity. Secondly, *Salomon* represents a singular

101 OE Williamson, "Calculativeness, Trust, and Economic Organization" (1993) 34 *J L & Econ* 453

102 L Bernstein, "Merchant Law", note 91 *supra*.

103 [1897] AC 22 ("*Salomon*").

104 MJ Whincop, "Overcoming Corporate Law: Instrumentalism, Pragmatism, and the Separate Legal Entity Concept" (1997) 15 *C & SLJ* 414.

instance of statutory interpretation. *Salomon* is an example of the courts' willingness to construe a corporate statute *liberally*, to facilitate the widest use of the incorporation legislation. That liberality may in part be a consequence of the fact that the legislation in question was enabling, rather than prescriptive or prohibitory. That expansion of the legislation's scope arguably prompted the change in corporate legislation in the twentieth century from enabling, to regulatory and prohibitive. *Salomon* forms an interesting contrast to the court's response to later reform legislation. Thus, *Salomon* is peculiar for its simultaneous liberal interpretation and conservative method.

If then we take *Salomon* as beginning the second period of English corporate law's formative period, in which the balance between prudentialism and pragmatism begins to shift, when does that period end? My answer is that it ends in around 1928, when the United Kingdom parliament enacted legislation adopting the recommendations of the Greene Committee.¹⁰⁵ That legislation imposed substantial limitations on the contractibility of director obligations, which had informed English law up until that time. By imposing these limitations, the court's commitment to liberalism was checked by parliament. It is unclear what values guided this legislation. Paternalism is the most likely rationale, although one might also explain the legislation as an instance of regulatory self-seeking. Backlash to lawmakers is arguably reduced if those who suffer loss as a result of a company's insolvency may seek restitution (or retribution).¹⁰⁶ Seventeen years later, the UK parliament enacted further legislation creating a cause of action in relation to oppressive behaviour, which, had it been implemented expansively, might have altered the adjudicatory passivity value. These early legislative innovations later inspired, especially in Australia, a wealth of statutory material designed to intensify the regulation of governance. Corporate law has shifted radically from the nineteenth century, when statutes took a minimalist role in corporate governance; they now exercise a dominant position.

In addition to a change in the statute-common law balance, the role of the executive has become increasingly central.¹⁰⁷ This has been achieved in two ways. First, legislation has entrusted securities commissions with the responsibility for defining the operation of a number of important areas of the law, such as fundraising.¹⁰⁸ This is exercised through policy statements, practice notes, no action letters and so on. Secondly, securities commissions have an important role in the selection of cases for prosecution. A commission can thus determine the nature of conduct these provisions deter. Thirdly, commissions may be granted a range of supervisory, prudential and paternal functions. In Australia, for instance, the commission scrutinises proposals for related party

105 *Companies Act 1929* (UK), s 152; *Report of the (UK) Company Law Amendment Committee (1926)*, Cmnd 2657, ss 46-7.

106 MJ Roe, "Backlash" (1998) 98 *Colum L Rev* 217.

107 DA Kingsford Smith, "Interpreting the Corporations Law — Purpose, Practical Reasoning and the Public Interest" (1999) 21 *Syd L Rev* 161.

108 See now *Australian Securities & Investment Commission v DB Management Pty Ltd; Southcorp Wines Pty Ltd v DB Management Pty Ltd* (2000) 33 ACSR 447.

transactions that require shareholder approval.¹⁰⁹ It may also function as a plaintiff in representative public interest actions.¹¹⁰ A complete picture of corporate law needs to evaluate the values that the regulator seeks to further, and the systemic effects of its action. At this stage, I do not propose to offer this complete picture, as there is a lack of useable empirical evidence on these issues. My analysis at this stage focuses on the interaction between courts and legislature.

Thus, the role of the regulatory state has intensified, with a consequent change from classical liberalism to what we might call progressive liberalism as the guiding value of corporate legislation. However, the courts were reluctant participants in this *gestalt*-shift. In a recent article on the interpretation of corporate statutes, Dimity Kingsford Smith laments the unwillingness of judges to recognise or to further the purposes of these enactments.¹¹¹ She argues that judges frequently resort to what she calls 'private baselines' in resolving cases, meaning the pre-statutory policy of the law. In effect, this is a charge of conservatism - or unnecessary prudentialism. I have mentioned that conservatism has the potential to preserve the values we have observed in standard corporate law. It is therefore interesting to examine whether this has actually occurred.

First, we may note the prudential response that courts gave to legislation purporting to limit contractibility and adjudicatory passivity. I have mentioned the *Companies Acts* 1929 and 1945. The 1929 Act sought to invalidate all provisions of contracts and articles purporting to release or avoid an officer's liability for negligence.¹¹² At the same time, the legislation introduced a mandatory requirement for directors to disclose their interest in any contract to a meeting of the board of directors. What was not clear was whether articles permitting the director to contract with the company violated the first prohibition. By upholding the validity of such articles in *Movitex Ltd v Bulfield*,¹¹³ the English High Court preserved the contractibility of the conflict rule, subject to the disclosure obligation that was commonly included in articles and both listing rules requirements. The 1945 legislation introduced a cause of action for oppression. However, the courts interpreted the concept of oppression very narrowly until the 1980s.¹¹⁴ The legislation was expanded, and there are signs, albeit quite equivocal, that courts are willing to exercise a wider jurisdiction to relieve shareholders against unfairness.¹¹⁵

Some of the cases Kingsford Smith cites as instances of backsliding to private law baselines are interesting, not just because they rely on the traditional *law*, but suggest the importance of the traditional *values*. This is evident in the

109 *Corporations Law*, s 218.

110 *Australian Securities Commission Act* 1989 (Cth), s 50.

111 Note 107 *supra*.

112 This provision endures in *Corporations Law*, s 199A.

113 [1986] BCC 99,403.

114 *Scottish Co-operative Wholesale Society v Meyer* [1959] AC 324; *Re Jermyn Street Turkish Baths Ltd* [1971] 1 WLR 1042.

115 J Hill, "Protecting Minority Shareholders and Reasonable Expectations" (1992) 10 *C & S LJ* 86 (advocating the enforcement of reasonable expectations); I Ramsay, "An Empirical Study of the Use of the Oppression Remedy" (1999) 27 *Aust Bus L Rev* 23.

approach to issues of litigation and standing. For example, a judge's refusal to permit a shareholder to rely on s 1324 of the *Corporations Law*, which appeared to expand the entitlement of shareholders to seek injunctive relief, is essentially a reaffirmation of adjudicatory passivity.¹¹⁶ Even a 'progressive' judgment explicitly recognising the existence of the mysterious 'fifth' exception to the rule in *Foss v Harbottle* is both prudential and pragmatic.¹¹⁷ The pragmatism derives from the judicial notice taken of the fact that dispersion of shareholding has increased over time. This makes the identification of a majority very difficult. The prudentialism arises from the cautious incremental expansion of standing beyond *Foss v Harbottle*, and the limits placed on the scope of the fifth exception. Similar forces are at work in the formulation of substantive director obligations. Resort to the traditional undemanding approach to a director's obligation to monitor and to be informed would enable a court to avoid the grave difficulties of verifying and then balancing the costs and benefits of information acquisition. It is therefore no surprise that the results of cases claiming to break with the obligational laxity of the past have often avoided basing their decisions on these complex substantive comparisons. Findings of liability are either based on overreaching¹¹⁸ or deliberate disregard for procedure,¹¹⁹ or are swept aside at the stage of determining remedies.¹²⁰ Thus, the courts have reacted to the aspirations of the regulatory state with both pragmatism and prudentialism.

Unfortunately, the court's record in fostering the development of judge-made corporate law is less distinguished than its prudential caution in the interpretation of statutes. Since the end of the formative period of the common law, the principle areas of judge-made corporate law have been characterised by increasing aspirations to formalist logic. Several cases from this period show how the separate legal entity concept can distort results in normatively undesirable ways. This is particularly true of the law on the authority of agents and employees. The most cited judgment in this area is Lord Diplock's famous decision in *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd*.¹²¹ There the judge emphasised that he was purporting to restate the law upon a rational basis, it having "developed pragmatically rather than logically", as if that was something to its discredit.¹²² The exposition that follows is a tour de force in formalistic legal reasoning, which nonetheless cannot hide the wide range of discretionary judgments that the judge must make in applying these principles.¹²³ From time to time, the application of this law produces results that fly in the face of the pragmatic aspirations for the reduction of search costs produced by the indoor management rule. The classic example is the result in *Crabtree-Vickers Pty Ltd v Australian Direct Mail Advertising and Addressing*

116 *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 39 NSWLR 128.

117 *Biala Pty Ltd v Mallina Holdings Ltd* (1993) 11 ACSR 785 at 847-8.

118 *State of South Australia v Marcus Clark* (1996) 19 ACSR 606.

119 *Daniels v Anderson* (1995) 16 ACSR 607.

120 *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109.

121 [1964] 2 QB 480.

122 *Ibid* at 502.

123 Note 82 *supra* at 277-80.

Co Pty Ltd,¹²⁴ in which the risk-allocating function of the agency doctrine seems to be forgotten. Instead, the doctrinal concepts seem to be reified as if they were an accurate depiction of decision-making processes in organisations.

Very similar comments can be made in relation to cases of *Salomon's* ilk. One is often surprised by the judicial inclination to abjure the central and often quite simple policy issue in favour of the convoluted metaphysics of entity concepts. For example, to take a textbook case like *Lee v Lee's Air Farming*,¹²⁵ there was only one real question: could the self-employed owner of an incorporated business insure himself under the worker's compensation insurance scheme? The court, however, preferred to base its decision on the ground that a company was an entity separate from its sole beneficial shareholder and governing director, and could therefore enter an employment contract with him. Presumably, however, such an approach opens up a range of complex questions. These include the possibility of undue influence by the person over the company and the profound difficulties in knowing who might authorise or ratify a fiduciary breach from inevitable self-dealing. To take another example, a number of cases have developed principles qualifying *Salomon's* supposed authority that a corporation is not normally the agent of its shareholder.¹²⁶ Those principles demand complex factual judgments about the control of subsidiary companies. Yet, having regard to their facts, the policy basis of many often is quite simple - are there reasons why one would wish to deny compensation for compulsory acquisition of property by a government, when the property and the rents it generates are owned by a corporate group?

Likewise, the separate legal entity concept has cast a shadow over corporate governance. The decisions in corporate law's formative period resonate with the notion that fiduciary duties protect shareholders against overreaching.¹²⁷ This is reinforced by equity's allocation of the entitlement to authorise or ratify a breach of duty in the hands of shareholders. Yet one of the most important judgments of the twentieth century, *Regal (Hastings) Ltd v Gulliver*,¹²⁸ distorted that principle. The facts of that case are well known. An acquisition transaction involved the purchase of the equity of various companies, rather than the purchase of the assets. To make up for an apparent shortage of capital needed to finance the assets, officers of the vendor invested their own money in the asset-holding companies, and reaped substantial profits in the subsequent acquisition. There may be a breach of fiduciary duties on these facts, which would oblige the directors to obtain consent before investing in the shares. However, the court's order permitted a suit to be asserted by the 'corporation' - in effect, by those

124 (1975) 133 CLR 72.

125 [1961] AC 12.

126 For example, *Smith, Stone & Knight v Birmingham Corporation* [1939] 4 All ER 116; *DHN Food Distributors Ltd v Tower Hamlets LBC* [1976] 1 WLR 852; *Hotel Terrigal Pty Ltd v Latec Investments Ltd (No 2)* [1969] 1 NSW 676; *Spreat v Paeson Pty Ltd* (1990) 94 ALR 679.

127 See, for example, *Ex parte Lacey* (1802) 6 Ves Jun 625 at 627; 31 ER 1228, 1229; *Ex parte James* (1803) 8 Ves Jun 337 at 345; 32 ER 385 at 388; *Benson v Heathorn* (1842) 1 Y & C Ch Cas 326 at 342-3; 57 RR 351 at 361-2; *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 473; *Furs Ltd v Tomkies* (1936) 54 CLR 583 at 592.

128 *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 ("*Regal (Hastings)*").

acquiring the assets in an arm's length transaction. Such emphasis on the corporation as an ontological entity not only divorces prudential principles from the persons they are meant to protect, but actually undermines private ordering by encouraging ex post opportunism, in this case by the acquirer.

In Part V, I discussed the problems associated with the early law on pre-incorporation contracts. I noted there that they were ameliorated somewhat by the apparent ratio of *Kelner v Baxter*, which provided obligational certainty by requiring the agent/promoter to perform. Unfortunately, that principle was also lost in the twentieth century. In *Newborne v Sensolid (Great Britain) Ltd*¹²⁹ in England, and in *Black v Smallwood*¹³⁰ in Australia, these contracts were not enforced. Those results flowed directly from the court's willingness to reify the corporation as the true obligor, rather than treating the law as simply a means of allocating the risk of non-performance between those interested in the corporation and the contractor. Had that matter been considered, there could be no question that the contract should have been enforced, given the high information costs of the contractor, compared to the agents and directors, in ascertaining the status of incorporation.

In some of these areas, although not in all, we find a curious phenomenon. What we may call the excesses of formalism have sometimes been corrected by the parliament. Although the legislative solutions may not be global optima, there is no doubt that the reforms made in the areas of corporate authority,¹³¹ ultra vires¹³² and pre-incorporation contracts¹³³ made a substantial improvement on the law that hitherto prevailed. Compare this with my comments above, regarding the prudential assertion of traditional values like adjudicatory passivity and contractibility in the face of 'progressive' regulatory enactments. There, the courts functioned as guardians of traditional values. Yet, in the cases involving the corporate legal entity that I have mentioned, courts have systematically undermined traditional values - doctrinal pragmatism and adjudicatory passivity - in their attempts to formalise the law. In some of these areas, the separate legal entity concept poses questions that demand information of the sort that courts one hundred years ago would never have dreamt of seeking. Examples include questions as to the parties' intention as to whether the promoter should be bound under a pre-incorporation contract,¹³⁴ the nature of the internal governance relations between the members of corporate groups,¹³⁵ and the precise scope and functions performed by agents and governance instrumentalities.¹³⁶ Many of these questions do not even have answers, since they are inquiries that emanate from the abstractions of legal reasoning. Thus, in contrast to the conservative claim that judges should not 'do' policy, because they lack information or

129 [1954] 1 QB 45 ("*Newborne*").

130 (1966) 117 CLR 52.

131 *Corporations Law*, ss 128-9.

132 *Ibid*, s 124.

133 *Ibid*, ss 131-3.

134 *Blackwood v Smallwood*, note 130 *supra*.

135 For example, *Smith, Stone & Knight v Birmingham Corporation*, note 126 *supra*.

136 *Crabtree-Vickers Pty Ltd v Australian Direct Mail Advertising and Addressing Co Pty Ltd* (1975) 133 CLR 72.

expertise, it is often clear that the demands imposed by formalist doctrinalism can be just as great. In these cases, parliament assumes the burden of reintroducing policy into the substance of the doctrine. Yet in some of these cases the parliament is unlikely to take action because the facts are exceptional. *Regal (Hastings)* is an example. The burden of pragmatic adjudication will remain with the courts in these cases, whether or not they choose to shoulder it.

I have painted a curious picture. On the one hand, courts blunt the aspirations of corporate regulation, by elevating more traditional values in conservative statutory interpretation. On the other hand, the courts' relentless pursuit of the formalist enterprise in law has itself undermined its pragmatic and passive aspirations, inducing correction by the parliament, if at all. What this demonstrates is that conservatism can never be an exclusive value of a legal system in equilibrium.¹³⁷ Policy can only be vanquished at the cost of introducing highly complex concepts in order to explain the results appropriately driven by norms of social choice. The uncertainty and inefficiencies that this generates in turn demand legislative correction, with which courts may not wholly cooperate. This vicious circle can only be broken if conservatism is coupled with contractibility, and only then if transaction costs are low. In these circumstances, the capacity to contract enables parties to internalise the welfare gains from avoiding inefficient law.¹³⁸

We therefore have a systemic tension in the modern regulatory state in which courts are both villain and hero; similar comments may be made of the parliament. In many ways, this odd equilibrium may be peculiar to, or at least more likely in, states in which interjurisdictional competition between lawmakers does not exist. Those dissatisfied with either the courts or the parliament will go elsewhere in search of law that maximises the value of the corporation. There is no similar exit in unitary states or non-competing federations, which results in much weaker signals about the dysfunctionality of either enactment or adjudication.

B. Beyond Formalism: The Postmodernity of Corporate Law

In the last section, I demonstrated the uneasy balance between 'progressive' regulatory policy in the legislature and formalism and conservatism in the courts. Although there may undoubtedly be some over-generalisations in that analysis of seventy years of corporate law, the picture is not that outmoded, since it notes various trends in the 1990s. On the other hand, there are some signs in the High Court's decisions in the mid-1990s that the values informing contemporary adjudication may be mutating anew. It might be therefore useful to contrast 'classical' values, 'modern' values, and 'postmodern' values. In using the postmodern appellation, I have no wish to import the philosophical baggage normally associated with it.

137 RA Posner, *The Problems of Jurisprudence*, Harvard University Press (1990) p 444.

138 RH Coase, "The Problem of Social Cost" (1960) 3 *J L & Econ* 1.

No case is more important in this respect than *Gambotto v WCP Ltd.*¹³⁹ That case has been a loadstone for analysis, mostly negative.¹⁴⁰ It is not my current purpose to repeat the substantive criticisms of the case, but to attempt to say something about the method of the case. Is the case a conservative one? The answer must be no. It was, at the time, only the latest in many authorities on expropriation, yet the High Court of Australia clearly intended to declare new law on the subject.

Is the case a liberal one? This is a harder question. The protection of the rights of the individual minority shareholder against appropriation by a majority has strong claims to liberal virtue - perhaps stronger than that of the traditional law. But the liberalism of *Gambotto* is at best intermittent. The court does not accept that the individual right is indefeasible. On the contrary, the shareholders' fate is not determined by contract but by the court itself. As part of that determination, individual rights may be sacrificed for collective welfare.¹⁴¹

The case emphasises neither contractibility nor adjudicatory passivity. The constitution is a contract; *Gambotto* constrains the contract's future adaptations. Neither is the principle a passive one. A pure property rule protecting the right might well be thought passive, since the court need only enforce the right against encroachment. But the court undertakes to judge not only the propriety of the alteration's purpose, but to judge the value of the rights taken from the shareholder - traditional courts would never have assumed these obligations in the past. The case is anything but pragmatic. It sustains the status quo configuration of shareholdings against attack, yet that status quo, involving a majority shareholder holding over 99 per cent of the equity bent on acquiring the remainder of the equity must perforce be unstable.

Once we exhaust these values, is there anything left? Perhaps *Gambotto* is best explained by reference to a completely new set of values that courts administer in corporate law. According to these values, *Gambotto* intensifies the court's role as an institutional constraint on private ordering and governance in organisations. The court assumes a role as an arbiter of both the validity and the effect of changes, rather than protecting rights, enforcing agreements passively, or by emulating exchanges that might occur if transaction costs were higher. The interests of neither majorities nor minorities are the explicit focus of this approach, but there is a special concern with procedure. There is a related approach in the contemporaneous decision, *Bailey v New South Wales Medical Defence Union Ltd.*¹⁴² In that case, the High Court limited the effect of a majority alteration of the articles of a company providing mutual insurance benefits to members. That enabled the estate of a deceased member to claim benefits, even though one would have thought the alteration (for which the

139 (1995) 182 CLR 432 ("*Gambotto*").

140 IM Ramsay (ed), *Gambotto v WCP Ltd: Its Implications for Corporate Regulation*, Centre for Corporate Law & Securities Regulation (1996); H Bird, "A Critique of the Proprietary Nature of Share Rights in Australian Publicly Listed Corporations" (1998) 22 *MULR* 131; P Spender, "Guns And Greenmail: Fear And Loathing After *Gambotto*" (1998) 22 *MULR* 96.

141 Note 139 *supra* at 445-6.

142 (1995) 19 ACSR 521.

member had voted in favour) had clearly excluded those rights. Although there is a similar concern to arbitrate the validity and effect of the change, there is a profound difference from *Gambotto*. That lies in judicial method - the High Court's method is traditional in all respects, inventing no new law, and ploughing no new furrows. Yet a look below the surface shows that the court is pushing doctrinal concepts, such as the shareholder's 'special contract', where they have never gone before.¹⁴³ Despite resonating with the same 'postmodern' norms as *Gambotto*, the case does not free itself of the faults of post-traditional ('modern') formalism. For example, the court must draw lines, probably arbitrary in location, between the rights that members enjoy *qua* members, and other rights. Five years after these cases, we now have *DB Management*.¹⁴⁴ In that case, the High Court upheld the exercise of statutory power by ASIC to allow a successful takeover bidder to acquire the shares in the target that would be issued on the exercise of certain options. The *Corporations Law* did not, at that time, give a special power in this respect. One's initial reaction is to wonder how this case can sit alongside *Gambotto*. However, it can very easily do so, since it emphasises the role of institutions in mediating private ordering. The court is the arbiter in *Gambotto*; ASIC is the arbiter in *DB Management*.

We see related trends in the obligations of directors. Ian Ramsay predicted in 1987 an increasing reliance on procedure as the basis for liability.¹⁴⁵ We see this particularly in the increased emphasis on monitoring and information obligations,¹⁴⁶ and also in the novel reliance on action without authority, which in *R v Byrnes* the High Court was willing to treat as improper use of office under what is now s 182.¹⁴⁷ Like *Gambotto* and *Bailey*, these cases manifest a greater willingness to judicially review executive action. The complexities that arise depart from the premises of adjudicatory passivity. They also appear to be much less prudential than other 'modern' authorities, and are often willing to take their lead from values that underpin corporate statutes. It may be the case that the antagonism between legislature and courts is diminishing. This may be attributable to reduced dissonance in motivating values, as 'accountability' values become more important to judges. It remains to be seen, however, whether these values endure in the increasing importance of economic reform in corporate law.¹⁴⁸ An obvious instance in which conflict may arise is the judicial interpretation of the statutory business judgment rule. It is not inconceivable that courts become convinced of regulatory virtues only after those values outlive their utility in legislative reform.

143 MJ Whincop, note 13 *supra*.

144 Note 108 *supra*.

145 IM Ramsay, "Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance" (1987) 5 *C&SLJ* 129.

146 MJ Whincop, "A Theoretical and Policy Critique of the Modern Reformulation of Directors' Duties of Care" (1996) 6 *Aust J Corp L* 72.

147 (1995) 183 CLR 501.

148 *Corporate Law Economic Reform Act 1999* (Cth).

VIII. CONCLUSION

In writing this article, I have been conscious of a gap in Anglo-Australian corporate law scholarship. There has been a neglect of the normative and the value-based aspects of English corporate law's evolution. United States scholarship suffers no similar hiatus. It knows where it came from, and has reasonably strong theories of the influence of political and other historical phenomena.¹⁴⁹ Perhaps the conservatism of the English mind discourages attention to origins and causes of doctrine, and encourages one to perceive a body of doctrine as coherent and unified. I am not satisfied with those claims, or with a narrative of corporate law that claims the constancy of values, and treats changes to the law as incremental adjustments to better achieve those values.

My starting point is this - how is it that the *past* of English law is alike the *present* of US law? We know that US law reached that end as a result of interjurisdictional competition, but that cannot be much of an explanation for English law. The answer lies not in legislative competition but in a legislative vacuum, deriving from the substantial restrictions on access to incorporation, and the consequent derived demand for judge-declared law that facilitated private ordering and relational contracting. The law that judges declared was shaped by prevailing political values, and by their own adjudicatory limitations. Substantively, that inclined them towards the enforcement of contracts and the application of rules in a passive manner, eschewing the finer balancing that might be possible if information was verifiable at low cost. Systemically, the courts regarded their role as a limited one, in which they were not policy engineers, but instead engaged in the cautious, incremental adaptation of legal rules to an expanding domain of corporations.

Ultimately, it was the tension between caution and incremental adaptation that contributed to the undoing of this enterprise. Law's aspiration to scientific status in an age of scientific progress led to formalism. Formalism concealed the discretionary and political elements of adjudication. Conceptualism invited impossible or dysfunctional inquiries. Political forces encouraged the demise of contractibility, increased prohibitory and mandatory regulation, and a decline in the passivity of adjudication. Judges proved less than completely loyal partners in this regulatory enterprise since their conservative instincts were not well mated to progressive liberalism. On the other hand, judicial formalism sometimes waxed to a point where pragmatism was placed in total eclipse, so that legislative intervention was required to fix the flaws introduced by corporate law's modern values. Finally, I have drawn attention to some evidence that values may yet be changing again. Courts seem to regard their role and the role of other institutions in corporate governance processes as a more central one, arbitrating on its procedure and evaluating changes to it. Meanwhile, legislatures on the other hand are rediscovering the importance of efficiency as an objective of law reform, as the competitive forces of global capital markets are brought to

149 MJ Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Princeton University Press (1994).

bear on what has been seen in the past as domestic regulation.¹⁵⁰ That role reversal may prove a new form of tension in the system. On the other hand, courts will always try to resolve cases on the narrowest grounds available to them, just as parliaments still prefer economic rhetoric to economic action. Maybe the two will get on better than ever.

Most corporate law research in this country falls into two overlapping categories: descriptive (either doctrinal or empirical), and critical (including interdisciplinary perspectives). I hope this article helps to bring these two streams a little closer together. Critical analysis is needed to understand not just doctrinal or empirical phenomena but the system that produces them, and the values that guide the system. Informed debate about the values actually served by corporate regulation, now and in the past, is a prerequisite for both strands of research. Normativity has neglected its positive premises for too long.

150 R Romano, "Empowering Investors: A Market Approach to Securities Regulation" (1998) 107 *Yale LJ* 2359.