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Agency Problems and Legal Strategies

HENRY HANSMANN and REINIER KRAAKMAN

2.1 THREE AGENCY PROBLEMS

As we explained in the preceding Chapter,¹ corporate law performs two general functions: first, it establishes the structure of the corporate form as well as ancillary housekeeping rules necessary to support this structure; and, second, it attempts to control conflicts of interest among corporate constituencies, including those between corporate ‘insiders,’ such as controlling shareholders and top managers, and ‘outsiders,’ such as minority shareholders or creditors. These conflicts all have the character of what economists refer to as ‘agency problems’ or ‘principal-agent’ problems. For readers unfamiliar with the jargon of economists, an ‘agency problem’—in the most general sense of the term—arises whenever the welfare of one party, termed the ‘principal,’ depends upon actions taken by another party, termed the ‘agent.’ The problem lies in motivating the agent to act in the principal’s interest rather than simply in the agent’s own interest. Viewed in these broad terms, agency problems arise in a broad range of contexts that go well beyond those that would formally be classified as agency relationships by lawyers.

In particular, almost any contractual relationship, in which one party (the ‘agent’) promises performance to another (the ‘principal’), is potentially subject to an agency problem. The core of the difficulty is that, because the agent commonly has better information than does the principal about the relevant facts, the principal cannot costlessly assure himself that the agent’s performance is precisely what was promised. As a consequence, the agent has an incentive to act opportunistically,² skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent’s performance to the principal will be reduced, either directly or because, to assure the quality of the agent’s performance, the principal must engage in costly monitoring of the agent. The greater the

¹ *Supra* 1.1.

² We use the term ‘opportunism’ here, following the usage of Oliver Williamson, to refer to self-interested behavior that involves some element of deception, misrepresentation, or bad faith. See Oliver Williamson, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47–49 (1985).

complexity of the tasks undertaken by the agent, and the greater the discretion the agent must be given, the larger these ‘agency costs’ are likely to be.³

As we noted in Chapter 1, three generic agency problems arise in business firms. The first involves the conflict between the firm’s owners and its hired managers. Here the owners are the principals and the managers are the agents. The problem lies in assuring that the managers are responsive to the owner’s interests rather than simply to the managers’ own personal interests. The second agency problem involves the conflict between, on the one hand, owners who possess the majority or controlling interest in the firm and, on the other hand, the minority or noncontrolling owners. Here the noncontrolling owners are the principals and the controlling owners are the agents, and the difficulty lies in assuring that the former are not expropriated by the latter. The third agency problem involves the conflict between the firm itself (including, particularly, its owners) and the other parties with whom the firm contracts, such as creditors, employees, and customers. Here the difficulty lies in assuring that the firm, as agent, does not behave opportunistically toward these various other principals—such as by expropriating creditors, exploiting workers, or misleading consumers.

Law can play an important role in reducing agency costs. Obvious examples are rules and procedures that enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents. Paradoxically, in protecting principals against exploitation by their agents, the law can benefit agents as much as—or even more than—it benefits the principals. The reason is that a principal will be willing to offer greater compensation to an agent when the principal is assured of performance that is honest and of high quality. To take a conspicuous example in the corporate context, rules of law that protect creditors from opportunistic behavior on the part of corporations should reduce the interest rate that corporations must pay for credit, thus benefiting corporations as well as creditors. Likewise, legal constraints on the ability of controlling shareholders to expropriate minority shareholders should reduce the cost of outside equity capital for corporations. And rules of law that inhibit insider trading by corporate managers should increase the compensation that shareholders are willing to offer the managers. In general, reducing agency costs is in the interests of all parties to a transaction, principals and agents alike.

It follows that the normative goal of advancing aggregate social welfare, as discussed in Chapter 1,⁴ is generally equivalent to searching for optimal solutions to the corporation’s agency problems, in the sense of finding solutions that maximize the aggregate welfare of the parties involved—that is, of both principals and agents taken together.

³ See, e.g., Steven Ross, *The Economic Theory of Agency: The Principal’s Problem*, 63 *AMERICAN ECONOMIC REVIEW* 134 (1973); John W. Pratt and Richard J. Zeckhauser (eds.), *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* (1984); Paul Milgrom and John Roberts, *ECONOMICS, ORGANIZATION AND MANAGEMENT* (1992).

⁴ *Supra* 1.4.

2.2 LEGAL STRATEGIES FOR REDUCING AGENCY COSTS

In addressing agency problems, the law turns repeatedly to a basic set of legal strategies. By ‘legal strategy,’ we mean a generic method of deploying substantive law to mitigate the vulnerability of principals to the opportunism of their agents. These strategies can be divided into two subsets, which we term, respectively, ‘regulatory strategies’ and ‘governance strategies.’ Regulatory strategies are prescriptive; they dictate substantive terms that govern either the content of the agent-principal relationship, or the formation or dissolution of that relationship. By contrast, governance strategies build on the elements of hierarchy and dependency that commonly characterize agency relationships; they attempt to protect principals indirectly, either by enhancing their power or by molding the incentives of their agents.

Table 2-1 sets out ten strategies—four regulatory strategies and six governance strategies—that, taken together, span the law’s principal methods of dealing with agency problems. These strategies are not limited to the corporate context. They can be deployed to protect nearly *any* vulnerable principal-agent relationship. Our focus here, however, will naturally be on the ways that these strategies are deployed in corporate law.

2.2.1 Regulatory strategies

Consider first the regulatory strategies on the left hand side of Table 2-1.

2.2.1.1 Rules and standards

The most familiar pair of regulatory strategies constrains agents by commanding them not to make decisions, or undertake transactions, that would harm the interests of their principals. Lawmakers can frame such constraints as *rules*, which require or prohibit specific behaviors, or as general *standards*, which leave the precise determination of compliance to adjudicators after the fact.

Both rules and standards attempt to regulate the substance of agency relationships directly. Rules, which prescribe behaviors *ex ante*,⁵ are commonly used in

Table 2-1: Strategies for Protecting Principals

	Regulatory Strategies		Governance Strategies		
	Agent Constraints	Affiliation Terms	Appointment Rights	Decision Rights	Agent Incentives
EX ANTE	RULES	ENTRY	SELECTION	INITIATION	TRUSTEESHIP
EX POST	STANDARDS	EXIT	REMOVAL	VETO	REWARD

⁵ For the canonical comparison of the merits of rules and standards as regulatory techniques, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE LAW REVIEW 557 (1992).

the corporate context to protect a corporation's creditors and public investors. Thus corporation statutes universally include creditor protection rules such as dividend restrictions, minimum capitalization requirements, or capital maintenance requirements.⁶ Similarly, capital market authorities frequently promulgate detailed rules to govern tender offers and proxy voting.⁷

By contrast, few jurisdictions rely on the rules strategy as a principal device for regulating complex, intra-corporate relations, such as, for example, self-dealing transactions initiated by controlling shareholders. Such matters are, presumably, too complex to regulate with a matrix of prohibitions and exemptions, which threaten to codify loopholes and create pointless rigidities. Rather than rule-based regulation, then, intra-corporate topics such as insider self-dealing tend to be governed by open standards that leave discretion for adjudicators to determine *ex post* whether violations have occurred.⁸ Standards are also used to protect creditors and public investors, but the paradigmatic examples of standards-based regulation relate to the company's internal affairs, as when the law requires directors to act in 'good faith' or mandates that self-dealing transactions must be 'entirely fair.'⁹

The importance of both rules and standards depends in large measure on the vigor with which they are enforced. In principle, well-drafted rules can be mechanically enforced. Standards, however, inevitably require courts (or other adjudicators) to become deeply involved in evaluating and sometimes molding corporate decisions *ex post*. In this sense, standards lie between rules (which simply require a decision maker to determine compliance) and another strategy that we will address below—the trusteeship strategy, which requires a neutral decision maker to exercise his or her own unconstrained best judgment in making a corporate decision.¹⁰

2.2.1.2 *Setting the terms of entry and exit*

A second set of regulatory strategies open to the law is to dictate the terms on which principals *affiliate* with agents rather than—as with rules and standards—the terms on which the principal-agent relationship develops internally. The law can dictate *terms of entry* by, for example, requiring agents to disclose information about the likely quality of their performance before contracting with principals.¹¹ Alternatively, the law can prescribe *exit opportunities* for principals, such as awarding to a shareholder the right to sell her stock, or awarding to a creditor the right to call a loan.

The entry strategy is particularly important in screening out opportunistic agents in the public capital markets.¹² Outside investors know little about public

⁶ See *infra* 4.2.2. ⁷ See, e.g., *infra* 7.3.3 (mandatory bid) and 8.4.1 (listing requirements).

⁸ See *infra* 5.1.5 and 5.2.3. ⁹ See, e.g., *infra* 4.2.3.1 managerial liability vis-à-vis creditor.

¹⁰ Rules, too, may be seen as akin to the trusteeship strategy if the legislator is taken to be the neutral decision maker. The difference, of course, is that the legislator decides generically, while the trustee (and the adjudicator) decides case-by-case.

¹¹ See *infra* 4.2.1 and 8.2. ¹² See *infra* 8.2.

companies unless they are told. Thus it is widely accepted that public investors require some form of systematic disclosure to obtain an adequate supply of information. Legal rules mandating such disclosure provide an example of an entry strategy because stocks cannot be sold unless the requisite information is supplied, generally by the corporation itself. A similar but more extreme form of the entry strategy is a requirement that the purchasers of certain securities be ‘qualified investors’ who are wealthy or financially sophisticated.

The exit strategy, which is also pervasive in corporate law, allows principals to escape opportunistic agents *ex post*. Broadly speaking, there are two kinds of exit rights. The first is *the right to withdraw* the value of one’s investment. The best example of such a right in corporate law is the technique, employed in some jurisdictions, of awarding an appraisal right to shareholders who dissent from certain major transactions such as mergers.¹³ As we discuss in Chapter 6,¹⁴ appraisal permits shareholders who object to a significant transaction to claim the value that their shares had *prior to* the disputed transaction—thus avoiding a prospective loss if, in their view, the firm has made a value-reducing decision.

The second type of exit right is *the right of transfer*—the right to sell shares in the market—which is of obvious importance to public shareholders. (Recall that transferability is a core characteristic of the corporate form.) Standing alone, a transfer right provides less protection than a withdrawal right, since an informed transferee steps into the shoes of the transferor, and will therefore offer a price that impounds the expected future loss of value from insider mismanagement or opportunism. But the transfer right permits the replacement of the current ‘agent’—the management team in a widely held company—by a new one that may be more effective in exercising control. Thus, unimpeded transfer rights allow hostile takeovers in which the disaggregated shareholders of a mismanaged company can sell their shares to a single active shareholder with a strong financial interest in efficient management. Such a transfer of control rights, or even the threat of it, can be a highly effective device for disciplining management.¹⁵ Moreover, transfer rights are a prerequisite for stock markets, which also empower disaggregated shareholders by providing a continuous assessment of managerial performance (among other things) in the form of share prices.

¹³ The withdrawal right is a dominant governance device for the regulation of some non-corporate forms of enterprise such as the American partnership at will, which can be dissolved at any time by any partner. Business corporations sometimes grant similar withdrawal rights to their shareholders through special charter provisions. The most conspicuous example is provided by investment companies, such as open-ended mutual funds in the U.S., which are frequently formed as business corporations under the general corporation statutes. The universal default regime in corporate law, however, provides for a much more limited set of withdrawal rights for shareholders, and in some jurisdictions none at all.

¹⁴ *Infra* 6.2.2.1.

¹⁵ Viewed this way, of course, legal rules that enhance transferability serve not just as an instance of the exit strategy but, simultaneously, as an instance of the entry strategy and incentive strategy as well. The same legal device can serve multiple protective functions. See also *infra* 7.1.2.4.

2.2.2 Governance strategies

Thus far we have addressed the set of regulatory strategies that might be extended for the protection of vulnerable parties in any class of contractual relationships. We now turn to the six strategies that depend on the hierarchical elements of the principal-agent relationship.

2.2.2.1 Selection and removal

Given the central role of delegated management in the corporate form, it is no surprise that *appointment rights*—the power to *select* or *remove* directors (or other managers)—are key strategies for controlling the enterprise. Indeed, these strategies are at the very core of corporate governance. As we will discuss in Chapter 3, moreover, the power to appoint directors is a core strategy not only for addressing the agency problems of shareholders in relation to managers, but also, in some jurisdictions, for addressing agency problems of minority shareholders in relation to controlling shareholders, and of employees in relationship to the shareholder class as a whole.

2.2.2.2 Initiation and ratification

A second pair of governance strategies expands the power of principals to intervene in the firm's management. These are *decision rights*, which grant principals the power to *initiate* or *ratify* management decisions. Again, it is no surprise that this set of decision rights strategies is much less prominent in corporate law than are appointment rights strategies. This disparity is a logical consequence of the fact that the corporate form is designed as a vehicle for the delegation of managerial power and authority to the board of directors. Only the largest and most fundamental corporate decisions (such as mergers and charter amendments) require the ratification of shareholders *ex post* under existing corporation statutes, and no jurisdiction to our knowledge requires shareholders to initiate managerial decisions.¹⁶

2.2.2.3 Trusteeship and reward

Finally, a last pair of governance strategies alters the incentives of agents rather than expanding the powers of principals. These are *incentive strategies*. The first incentive strategy is the *reward strategy*, which—as the name implies—rewards agents for successfully advancing the interests of their principals. Broadly speaking, there are two principal reward mechanisms in corporate law. The more common form of reward is a *sharing rule* that motivates loyalty by tying the agent's monetary returns directly to those of the principal. A conspicuous example is the protection that minority shareholders enjoy from the equal treatment norm, which requires a strictly pro rata distribution of dividends.¹⁷ As a consequence of this rule, controlling shareholders—here the 'agents'—have an incentive to

¹⁶ See *infra* 3.1.2.1.¹⁷ See *infra* 6.4.2.

maximize the returns of the firm's minority shareholders—here the 'principals'—at least to the extent that corporate returns are paid out as dividends.

The reward mechanism that is less commonly the focus of corporate law is the *pay-for-performance regime*, in which an agent, although not sharing in his principal's returns, is nonetheless paid for successfully advancing her interests. Even though no jurisdiction *imposes* such a scheme on shareholders, legal rules often facilitate or discourage high-powered incentives of this sort.¹⁸ American law, for example, has long embraced incentive compensation devices such as stock option plans, while more skeptical jurisdictions continue to place obstacles in the path of option compensation plans.

The second incentive strategy—the *trusteeship strategy*—works on a quite different principle. It seeks to eliminate conflicts of interest *ex ante* to ensure that 'bad' behavior by an agent will not be rewarded. This strategy assumes that, in the absence of strongly focused—or 'high-powered'—monetary incentives to behave opportunistically, agents will respond to the 'low-powered' incentives of conscience, pride, and reputation,¹⁹ and are thus more likely to manage in the interests of their principals. Agents serving as trustees may be *internal* to the corporation, as when disinterested directors must approve a self-dealing transaction by a controlling shareholder, or they may be *external*, as when the law requires an investment banker, a state official, or a court to approve corporate action.

2.2.3 *Ex post* and *ex ante* strategies

The bottom row in Table 2-1 arranges our ten legal strategies into five pairs, each with an '*ex ante*' and an '*ex post*' strategy. This presentation merely highlights the fact that half of the strategies take full effect *before* an agent acts, while the other half respond—at least potentially—to the quality of the agent's action *ex post*. In the case of the regulatory strategies, for example, rules specify what the agent may or may not do *ex ante*, while standards specify the general norm against which an agent's actions will be judged *ex post*. Thus, a rule might prohibit a class of self-dealing transactions outright, while a standard might mandate that these transactions will be judged against a norm of fairness *ex post*.²⁰ Similarly, in the case of setting the terms of entry and exit, an entry

¹⁸ See *infra* 5.1.

¹⁹ We use the terms 'high-powered incentives' and 'low-powered incentives' as they are conventionally used in the economics literature, to refer to the distinction between economic incentives on the one hand and ethical or moral incentives on the other. Economic incentives are high-powered in the sense that they are concrete and sharply focused. See, e.g., Williamson, *supra* note 1, 137–41; Bengt Holmstrom and Paul Milgrom, *The Firm as an Incentive System*, 84 AMERICAN ECONOMIC REVIEW 972 (1994). By referring to moral norms as 'low-powered' incentives we do not mean to imply that they are generally less important in governing human behavior than are monetary incentives. Surely, for most individuals in most circumstances, the opposite is true, and civilization would not have gotten very far if this were not the case.

²⁰ Compare *infra* 5.1.4 (*ex ante* prohibitions) and 5.1.5, 5.2.3 (*ex post* standards).

strategy such as mandatory disclosure specifies what must be done *before* an agent can deal with a principal, while an exit device such as appraisal rights permits the principal to respond after the quality of the agent's action is revealed.²¹

The six governance strategies also fall into *ex ante* and *ex post* pairs. If principals can appoint their agents *ex ante*, they can screen for loyalty; if principals can remove their agents *ex post*, they can punish disloyalty. Similarly, shareholders might have the power to initiate a major corporate transaction such as a merger, or—as is ordinarily the case—they might be restricted to ratifying a motion to merge offered by the board of directors.²² Finally, trusteeship is an *ex ante* strategy in the sense that it neutralizes an agent's adverse interests prior to her appointment by the principal, while most reward strategies are *ex post* in the sense that their payouts are contingent on uncertain future outcomes, and thus remain less than fully specified until after the agent acts.

We do not wish, however, to overemphasize the clarity or analytic power of this categorization of legal strategies into *ex ante* and *ex post* types. One could well argue, for example, that the reward strategy should not be considered an *ex post* strategy but rather an *ex ante* strategy because, like the trusteeship strategy, it establishes in advance the terms on which the agent will be compensated. Likewise, one could argue that appointment rights cannot easily be broken into *ex ante* and *ex post* types, since an election of directors might involve, simultaneously, the selection of new directors and the removal of old ones. We offer the *ex post/ex ante* distinction only as a classification heuristic that is helpful for purposes of exposition.

Indeed, it is in the same heuristic spirit that we offer our categorization of legal strategies in general. The ten strategies arrayed in Table 2-1 clearly overlap, and any given legal rule might well be classified as an instance of two or more of those strategies. Our purpose here is simply to emphasize the various ways in which law can be used as an instrument, not to offer a new formalistic schema that displaces rather than aids functional understanding.

2.3 LEGAL STRATEGIES IN CORPORATE CONTEXT

The legal strategies just described can in principle be deployed to deal with the agency problems presented by any type of organization. Our interest here, however, is in the distinctive ways that those strategies are deployed in the context of business corporations.

The law does not apply legal strategies in the abstract but only in specific regulatory contexts. For purposes of exposition and analysis, we have grouped those contexts into six basic categories of corporate decisions and transactions.

²¹ Compare, e.g., *infra* 4.2.1, 5.1.1, 5.2.1, 8.2 (mandatory disclosure), and 6.2.2.1 (appraisal).

²² See *infra* 6.2.1.1.

Each of the six chapters that follow focuses on one of those categories. The boundaries of these categories are necessarily arbitrary and overlapping. Nevertheless, each category has a degree of functional unity, and the typical deployment of legal strategies in each is moderately distinct.

Chapter 3 examines the legal strategies at play in the regulation of ordinary business transactions and decisions. Not surprisingly, governance strategies predominate in this context. Chapter 4 turns to corporate debt relationships and the problem of creditor protection—a context in which regulatory strategies are common. Chapter 5 examines the legal regulation of related party (or self-dealing) transactions; Chapter 6 investigates the corporate law treatment of ‘significant’ transactions, such as mergers and major sales of assets; and Chapter 7 assesses the legal treatment of control transactions such as sales of control blocks and hostile takeovers. As the discussion below will demonstrate, jurisdictions adopt a fluid mix of regulatory and governance strategies in all of the last three transactional contexts. Finally, Chapter 8 turns to investor protection and the regulation of issuers on the public market, where regulatory strategies predominate much as they do in the context of creditor protection.

While we do not claim that these six transactional and decisional categories exhaust all of corporate law, they cover most of what is conventionally understood to be corporate law, and nearly all of the interesting and controversial issues that the subject presents today.

Within each of our six substantive chapters, our analysis proceeds functionally. We first describe the problems associated with the class of transactions in question. We then analyze the primary legal strategies—from among those outlined above—that are available to corporate law for dealing with those problems. In all but one chapter, our analytic discussion is organized by agency problems and legal strategies. In Chapter 6, however, the analytic discussion is organized by categories of transactions. Finally, to the extent that there are significant differences across jurisdictions in the legal strategies employed to regulate a given class of corporate decisions, we attempt to assess the origins of these differences. In particular, we ask to what extent these differences can be understood as functional adaptations to differences in institutions, such as trading markets and financial intermediaries, and how far they appear to be historical, cultural, or political artifacts without a direct functional basis.

2.4 THE ROLE OF LAW

We have been speaking here of ‘legal’ strategies. The various strategies arrayed in Table 2-1 do not, however, necessarily require law for their implementation. We observed in Chapter 1 that, of the five defining characteristics of the corporate form, only one—legal personality—clearly requires special rules of law.²³ The

²³ *Supra* 1.2.1.

other characteristics could, in principle, be adopted by contract—for example, through appropriate provisions in the articles of association agreed to by the firm’s owners. The same is true of the various legal strategies we have just surveyed. If, for instance, a corporate board with a majority of outside directors is an important means of mitigating the agency problem between controlling and minority shareholders, this implementation of the trusteeship strategy could be undertaken by individual corporations on their own by including in share contracts a commitment to a board with that composition.

We need to ask, then, whether and why the various strategies described here should be embodied in law. In addressing this question, it is important to distinguish between legal rules that are merely default rules, in the sense that they govern only if the parties do not explicitly provide for something different, and rules of law that are mandatory, leaving parties no option but to conform to them.

Much of corporate law consists of default rules. To this extent, corporate law simply offers a standard form contract that the parties can adopt, at their option, in whole or in part. A familiar advantage of such a legally provided standard form is that it simplifies contracting among the parties involved, requiring that they specify only those elements of their relationship that deviate from the standard terms. In serving this function, default rules of corporate law will generally serve best if they reflect the terms that the parties themselves would most commonly choose. Default rules can also, however, serve a protective or information-revealing function. A rule that serves this function may not be the one that well-informed parties would generally choose, but rather a ‘penalty default’ that burdens the party most likely to have private information relevant to the transaction. The purpose of such a rule is to force parties to reveal their private information—in order to avoid the default outcome—and consequently induce explicit contracting between the parties that will lead to an outcome superior to that which would otherwise be expected.²⁴ A rule permitting veil-piercing in undercapitalized firms,²⁵ for example, can be seen as a penalty default that creates an incentive for firms with low net capital to disclose that fact when contracting with potential creditors, so that the creditors will be estopped from piercing.²⁶

There are also important rules of corporate law that are mandatory. Large German corporations, for example, have no alternative but to give half of their supervisory board seats to representatives of their employees, and publicly traded U.S. corporations have no alternative but to provide regular detailed financial disclosure in a closely prescribed format.²⁷ The rationale for manda-

²⁴ See Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE LAW JOURNAL* 87 (1989).

²⁵ See *infra* 4.2.3.3 (discussing veil-piercing).

²⁶ Ian Ayres, *Making A Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 *UNIVERSITY OF CHICAGO LAW REVIEW* 1391, 1397 (1992).

²⁷ See *infra* 3.3.1 (codetermination) and 4.2.1.2 and 8.2 (disclosure).

tory terms of these types is, often, that some parties might otherwise be exploited because they are not well informed, or that the interests of third parties might be affected, or that collective action problems (such as the notorious ‘prisoners’ dilemma’) might otherwise lead to contractual provisions that are inefficient or unfair.

Mandatory rules need not just serve a prescriptive function, however. In some circumstances, they can serve an enabling function similar to that served by default rules. More particularly, mandatory rules can facilitate freedom of contract by helping corporate actors to signal the terms they offer and to bond themselves to those terms. The law accomplishes this by creating corporate forms that are to some degree inflexible (i.e., are subject to mandatory rules), but then permitting choice among different corporate forms. There are two principal variants to this approach.

First, a given jurisdiction can provide for a menu of different standard form legal entities from which parties may choose in structuring an organization. In some jurisdictions, for example, a firm with the five basic attributes of the business corporation can be formed, alternatively, as a publicly traded corporation, a closely held corporation, a limited liability company, a limited liability partnership, or a business trust—with each form subject to a separate statutory regime. Each of these forms commonly exhibits some rigidity, by virtue of mandatory rules. Those rules, however, often vary from one form to another. The result is to enhance an entrepreneur’s ability to signal, via her choice of form, the terms that the firm offers to other contracting parties, and to make credible the entrepreneur’s commitment not to change those terms. Thus, paradoxically, greater rigidity within any particular form may actually enhance overall freedom of contract in structuring private enterprise, so long as there is a sufficiently broad range of alternative forms to choose from.

Second, even with respect to a particular type of legal entity, such as the publicly traded business corporation, entrepreneurs or managers may be permitted to choose among different jurisdictions’ laws. In the United States, for example, the prevailing choice of law rule permits a business corporation to be incorporated under the law of any of the 50 individual states, regardless of where the firm’s principal place of business, or other assets and activities, are located. Where, as in the U.S., such choice is available at low cost, a given jurisdiction’s corporation statute simply serves as an item on a menu of alternative standard forms available to the parties involved. As in the case where there is intra-jurisdictional choice of alternative forms, mandatory rules in any given jurisdiction’s corporation law may serve not to constrain choice of form but actually to enhance it, by making it easier for firms to signal, and to bond themselves to, their choice among alternative attributes.

