Introduction: Corporate Legal Ideas

A Corporate Law's Pre-History

Corporate law is theoretically rich but historically poor. There is a "pre-history"[1] of corporate law that is prior to the discipline's historical knowledge, horizon and imagination; a pre-history of legal concepts and doctrinal structures upon which contemporary corporate law is built, but which is either unknown to the discipline or represented by only a small number of historical standard bearers. If, as Holmes counselled, "in order to know what [the law] is, we must know what it has been",[2] then our understanding of corporate law today is deficient as the discipline possesses only fragments of knowledge about its pre-history.

The discipline does not, however, accept Holmes's proposition; it has evidenced no desire to uncover this pre-history. Modern corporate law's functionalism renders such an inquiry surplus to requirements: corporate law provides functional solutions to the governance and agency problems generated by the corporate form; necessarily, the origins of these rules lie in legal innovations and adaptations designed to address those functional problems. It follows that tracing the doctrinal origins of these legal rules may be of interest, but at best it can only add a little colour to what is self-evident about law's adaption to these functional imperatives. Academic energy is better spent elsewhere.

This book is animated by Holmes's proposition and sidesteps the above disciplinary advice. It explores the pre-histories of US and UK

[1] See David Ibbetson, *A Historical Introduction to the Law of Obligations* (Oxford University Press: 1999) at 1 using the term "pre-history" in relation to the law of obligations; John Armour, "Review of 'An Economic and Jurisprudential Genealogy of Corporate Law'" (2002) *Cambridge Law Journal* 467, identifying a "pre-history" "gap" in his review of Michael Whincop's book.

[2] Oliver Wendell Holmes, *The Common Law* (Little, Brown & Co.: 1881) 1.

corporate fiduciary law[3] – the duties the law imposes on directors, and shows how understanding those duties in historical perspective drives a re-evaluation of the nature, quality and production processes of contemporary corporate law in both jurisdictions. The book presents these pre-histories through a close doctrinal study; a study designed to identify the original moral and policy drivers of corporate fiduciary law's foundational ideas and concepts, and to carefully trace the influence and path of those ideas and concepts through the adaptations and adjustments of the eighteenth-, nineteenth- and twentieth-century case law. The first objective of the book then is to provide both a legal etymology of corporate fiduciary law – an account of the origins of the concepts and ideas that provide the raw materials of modern corporate fiduciary law, such as rationality review and fairness review, gross negligence and skills-adjusted ordinary care – and a historical legal genealogy or topography – the excavation of a map of the path of these ideas from their origins through to today. This exploration is organised in the book into four separate parts. Part I explores the duties that apply to a director's exercise of corporate power, her business judgment; Part II considers the directorial duty of care; Part III explores the law applicable to directorial self-dealing; and Part IV considers the law applicable to corporate opportunities, which the book calls "connected assets law".

In excavating these historical legal maps, the book's second objective is to explain why these US and UK legal paths were taken and why alternative available paths were not seen, or were foreclosed. It is the juxtaposition of the UK and US pre-histories which enables this exploration. This juxtaposition provides a natural legal experiment through which we can control for the real drivers of the paths taken and of jurisdictional divergence. This is because although today the fiduciary duties which corporate law imposes on the directors of US[4] and UK companies are very different, both jurisdictions started from the same place. In both jurisdictions, in order to fashion directors' duties, nineteenth-century courts borrowed from the same eighteenth- and nineteenth-century English, non-corporate legal sources. And in several instances, for

[3] Note that, for simplicity's sake, the book adopts the US use of the term "fiduciary duties" to include the directorial duty of care, which in the United Kingdom is not understood to be a fiduciary duty.

[4] Although there is no such entity as a US corporation – there are only corporations incorporated in US states – we will use the terms "US company" and "US corporate law" as useful ways of referring to corporate law in the United States and corporations incorporated in a US state.

a period in the mid-nineteenth century, the leading cases in the United States and the United Kingdom were English eighteenth- and nineteenth-century corporate cases, fashioned from English non-corporate legal borrowings.

This shared heritage is both difficult to believe, and to see, when one considers the leading corporate law jurisdiction in the United States, the state of Delaware, and contrasts its modern corporate fiduciary laws with the law applied today in the United Kingdom. Consider first Delaware law's regulation of business judgments. Today, Delaware law is well known for its business judgment rule, which provides that if the directors comply with both their duty of care in the process of making a decision and their duty of loyalty – which requires that they act in good faith and that there be no direct conflict – then the decision will only be subject to rationality review. That is, if there is a rational reason to support the decision, courts will not inquire further. In the United Kingdom, a director's business judgment is subject to the requirement to act in good faith to promote the success of the company in the interests of its shareholders, which generates both rationality review of decisions and, in some instances, more demanding and intrusive review. In the UK, neither care nor loyalty is understood as a precondition to a separate business review standard. If we turn to those duties of care and loyalty, the differences appear starker. The decision-making process is subject to a gross negligence standard in Delaware, breach of which is in some cases said to require proof of reckless indifference or deliberate disregard to the interests of shareholders. Care in relation to monitoring requires merely a good faith effort to monitor and a good faith effort to put in place systems and controls to enable monitoring. The UK, in contrast, applies a version of an average-director reasonableness standard to both process and monitoring, and the nomenclature of gross negligence has long been rejected. In relation to direct conflicts of interest, Delaware law today applies fairness review to self-dealing transactions, whereas the UK common law provides for the voidability of self-dealing transactions in the absence of shareholder approval, and eschews any inquiry into transactional fairness. Delaware's corporate opportunity rule is flexible and pro-director and pays regard, inter alia, to whether the company has a property-like "expectancy" in the opportunity, to the company's area of business, and to the company's financial capacity to acquire the opportunity. Whereas the modern UK anti-director position has no regard to corporate expectancies, rejects line-of-business restrictions and excludes evidence of financial capacity. Attention to the detail of some of these

rules smoothes some of their first-blush hard edges, bringing similarity as well as difference into view. Nevertheless, in several areas of corporate fiduciary law these first impressions do not deceive.

These considerable differences intuitively lead us to view these modern legal rules as being connected to a shared legal history in only the most perfunctory and superficial way – in the way that one might say that American and British cultures are connected as they are formed through the syntax and structures of a shared language. This is not correct. Modern US corporate fiduciary law is deeply rooted in legal principles first formed in, and borrowed from, the United Kingdom. In Part I, we see that in both jurisdictions contemporary regulation of business judgment is the product of an eighteenth- and early nineteenth-century common law approach to the exercise of delegated power in both public and private law contexts. In Part II, we see that the modern care standard in both the US and the United Kingdom is the product of eighteenth-century English legal ideas about the care that could be expected of those paid or unpaid to undertake a bailment of goods; bailment law ideas that diverged in the United States and the United Kingdom prior to corporate legal adoption. In Part III, we see that the UK's self-dealing rule is based on trust law's prohibition of trustee-trust self-dealing, and that the US's fairness standard is a product both of the exploration of the remedial implications of that same standard, as well as broader borrowing from the English fiduciary law's regulation of fiduciary-beneficiary influence. In Part IV, we see that today's corporate opportunities rules in the United States are the partial product of eighteenth- and early nineteenth-century case law on whether a trustee could take a lease, or buy the reversion, in property subject to a lease held on trust; legal rules which, although the product of early English fiduciary law, struggled to gain traction in UK company law.

B A History of Legal Ideas

The book charts these pre-histories with the assistance of four guiding legal ideas. These ideas are distilled from the exploration of each of the areas of fiduciary law covered in Parts I–IV of the book. The book's submission is that each of these legal ideas is pivotal to understanding why corporate law in the US and the UK has taken the paths the book describes. These ideas are the nuclei of corporate fiduciary law's formation and divergence. Of course, in the complex process of legal formation and change the book describes, it is very difficult, perhaps foolhardy, to

attribute primary status to one particular idea. The point in elevating these ideas is not to flatten the complex processes of legal development the book describes; nor is the point to argue that corporate fiduciary rules are the deductive product of these ideas. The point is simply to foreground ideas that have been foundational to corporate fiduciary law's development and divergence.

In Part I the guiding idea is "the idea of honesty in the exercise of delegated authority". Modern business judgment regulation in both the US and the UK is a direct product of a basic moral idea, recognised in early eighteenth-century fiduciary law, that you cannot expect more of a delegatee than that she exercise the delegated authority in what she honestly thinks furthers the purpose of the delegation; an idea that is the direct ancestor of the business judgment rule and rationality review. In Part II we see that the care standards that flow into modern corporate law were the product of moral ideas adopted by the common law about the relationship between care and reward, and care and undertaking. How much care, for example, could one expect from a "friendly act for his friend"?[5] More precisely, the book shows that early care concepts and standards were the product of a tension between, on the one hand, the care one could expect from bailees who were rewarded or unrewarded for their bailment service, and, on the other hand, the care one could expect from someone who gave an undertaking to act on another person's behalf. In Part II, we see how the differential weighting of these two different moral ideas in the US and the UK accounts in significant part for the different corporate care standards we find today. In Part III, we look not to a moral idea to explain the divergence of US and UK self-dealing law, but to the "idea of the corporation". Here we see that starkly different ideas about the nature of the corporation in the United Kingdom and the United States generated starkly divergent paths of self-dealing law, both of which, however, are rooted in, and consistent with, nineteenth-century non-corporate English fiduciary law. Finally, in Part IV the book shows that the paths of US and UK corporate opportunities law, which the book labels *connected assets law*, are in large part the product of divergent nineteenth-century ideas about both the meaning of the term "property" and about the creation of property rights. More specifically, the dominance in the United States (and its absence in the UK) within and outside of the law of a Lockean justification for property rights: that property is not merely a label for a bundle of exclusionary rights which are otherwise grounded –

[5] *Coggs* v. *Barnard* (1703) LD Raym. 909, 194.

for example to prevent fraud or in relations of confidence – but rather property is created by labour, work and effort; is prior to and recognised by law; property as right. It was this guiding idea in the United States that fertilised a nascent legal rule about connected assets borrowed from early nineteenth-century English fiduciary law to generate the modern corporate opportunities doctrine; a rule that although originated in the UK withered in the UK without the fertilisation provided by this property idea.

C Divergence and Theories of Corporate Legal Change in the United States

The spirit of Oliver Wendell Holmes will never tire of reminding us that the life of law is not logic but experience.[6] To account for legal divergence in jurisdictions which had shared common law starting points, we naturally look to experiential/extra-legal explanations, such as variation in the extra-legal interest group landscape; jurisdictional differences in consensus policy preferences; or jurisdictional variation in judicial receptivity to such pressure and policies. Indeed, the divergence of modern US and UK corporate law correlates extremely well with mainstream "experiential" corporate legal theories and approaches to US legal history, which are outlined below. For example, a theory about how American corporate legal federalism results in pro-managerial rules in areas of the law such as self-dealing law or connected assets law fits perfectly with both the modern pro-director fiduciary rules we find in the United States and the pro-shareholder rules in the United Kingdom, which are not subject to the pressures arising from state competition for incorporations.

The problem with this and other such extra-legal theories of corporate law change is that they have not been disciplined by the control of doctrinal corporate legal history. Without a comprehensive understanding of the historical trajectory of modern corporate fiduciary law, we do not know whether substantive legal change has occurred at all – or in which of the divergent jurisdictions it has occurred – which requires or could benefit from an extra-legal change explanation. Nor, in the absence of an understanding of this historical trajectory can we understand how such extra-lawmaking pressures interacted with prior legal norms to produce an output that is an amalgam of both. Offering a theory of legal production and change without an understanding of the law's

[6] Supra note 2, at 1.

historical precursors is like trying to write a recipe after the cake has been baked, when you are aware of the existence of flour but have never heard of eggs; inevitably in the recipe flour will take precedence over the unknown ingredient. And inevitably, unaware of its pre-history, corporate law's theories of rule production and change overweight the role of extra-legal factors and underweight law's internal constraint, including the legal path dependence imposed by the common law's earliest elections. The corporate doctrinal history provided by this book both disciplines contemporary corporate law's extra-legal claims and provides clearer sight of the extra-legal factors that have and have not moulded the path of corporate fiduciary law.

This doctrinal genealogy also foregrounds a complementary, but more prosaic, account of legal change; an account that is self-evident to those schooled in the common law method, but one which is often pushed from the limelight by experiential theories. Here we see the path of the common law as the product of judicial mis-readings, re-presentations and mis-representations; slight entropic adjustments in legal positions that disturb the prior order of legal things; the common law equivalent of the butterfly effect.[7] Courts unschooled in, or hostile to paying attention to, the existing legal tradition redirect the path of law with small adjustments – often unintentionally and unnoticed both by reader and author – in the statement of the legal position; small adjustments that, sometimes with a time delay, generate significant legal change. Although this prosaic account of change is exposed to the charge of the modern legal leprosy of legal formalism, we need to be cognisant of this effect, alongside other possible drivers of legal change, in order to understand the twists and turns in the path of law, and to assess its legitimacy and authority. This is law by "telephone" or "Chinese Whispers"; contingent, quasi-random legal products that once identified should garner little systemic loyalty.

We see several examples of this effect in both US and UK corporate fiduciary law, although it is more pronounced in the Delaware courts, where, as we discuss below, the effect of being a winner in the race for incorporations accentuates the disconnection from legal tradition, providing freer rein to re-present. For example, in Part I of the book we show how the re- and mis-representation of the business judgment rule in the famous case of *Aronson* v. *Lewis*[8] in 1984 generates several new and incoherent legal logics; and in the United Kingdom we show how

[7] James Gleick, *Chaos: Making a New Science* (Viking Press: 1987).
[8] 473 A.2d 805 (1984).

modern confusion about the relationship between the duty of care and the quality of the business judgment is rooted in the use of reasonableness terms in non-care standards designed to articulate the idea that the courts have no jurisdiction to interfere with a business judgment in the absence of extreme error. In Part IV we see how the slight shift in the United Kingdom's no conflict rule resulting from the leading connected assets case of *Boardman* v. *Phipps*[9] – from a conflict of interest and duty to a conflict of interests – drives substantive change in UK connected assets law as well as the new idea of prescriptive directorial duties.

1 *Realist Legal History and the Search for Experience*

A dominant idea about judging in nineteenth-century American law is that US judges operated with very limited regard to precedential constraint, and that judicial practices and institutional arrangements supported this approach to judging. For proponents of this idea of American legal history, judges were "all realists then".[10] Through this lens, judges did not commence the judicial operation from within the rules and principles found within prior cases, building out to the facts presented to them in court, rather they "beg[a]n with a vague anticipation of a conclusion and . . . and then . . . look[ed] around for principles and data that w[ould] substantiate it".[11]

For this account of legal change, US law in the nineteenth century was not a closed, or even relatively autonomous,[12] system that imposed constraint on judicial discretion and outcomes; rather law was an open system, and the laws were readily remade by judges in the image of prevailing social norms, economic needs, policy concerns, interest group pressure and ideological preferences. Of course, the common law has always been "in part an exercise in interpreting the needs and feelings of the wider community",[13] but in the strongest version of this

[9] [1967] 2 A.C. 46.
[10] Paraphrasing Joseph Singer who in 1988 argued that "to a great extent we are all realists now" – Joseph Singer, "Legal Realism Now" (1988) 76 *California Law Review* 468, 503.
[11] John Dewey, "Logical Method and Law" (1924) 10 *Cornell Law Quarterly* 560, 567.
[12] Duncan Kennedy, "Towards an Historical Understanding of Legal Consciousness: The Case of Classical Legal Thought in America, 1850–1940" (1980) 3 *Research in Law and Sociology* 3, 4, referring to "legal consciousness as an entity with a measure of autonomy . . . yet that autonomy is no more than relative".
[13] Michael Lobban, "The Politics of English Law in the 19th Century" in Joshua Getzler and Paul Brand (eds) *Judges and Judging in the History of the Common Law and Civil Law* (Cambridge University Press: 2012) 102, 111.

understanding of nineteenth-century American legal practice, the logic of the law was merely a deposable façade for judicial legislation fashioned by experience.

Several nineteenth-century institutional factors support this idea of US judicial practice – factors that were not present in other common law countries such as the United Kingdom, where such instrumentalist accounts of legal history have struggled to gain a foothold.[14] Of importance in this regard was the fact that many US judges were lay judges with no legal training.[15] Furthermore, by the 1840s and 1850s many judges began to be directly elected, and such judges may, as a result, have had a much stronger sense of the political legitimacy of their democratic role to "reflect the values of the people".[16] Such an outlook would also have been supported in late eighteenth- and earlier nineteenth-century decisions by the lack of available law reports,[17] as well as by the fact that the abolition of separate courts of equity and common law in many US jurisdictions meant that judges were less likely to have specialised legal knowledge, particularly in relation to equity.[18] James Kent, on taking the position of chancellor in New York's Chancery Court, famously observed that: "I took the court as if it had been a new institution. I had nothing to guide me . . . [and] almost always found principles suited to my views of the case".[19]

A significant body of academic and judicial authority can be marshalled in support of this account of American legal history. These accounts vary according to (1) the extent to which they understand law as an open system; (2) their selection of their dominant experiential

[14] See Michael Lobban, "The Politics of English Law in the Nineteenth Century" in Joshua Getzler and Paul Brand (eds) *Judges and Judging in the History of the Common Law and the Civil Law: From Antiquity to Modern Times* (Cambridge University Press: 2012) at 106–112; Michael Lobban, "Legal Theory and Judge Made Law in England" (2011) 40 *Quaderni Fiorentini* 554.

[15] Peter Karsten, *Heart versus Head: Judge-Made Law in Nineteenth Century America* (University of North Carolina Press: 1997) (location 644 Kindle Edition).

[16] Ibid. (location 6787 Kindle edition) citing Robert Cover, *Justice Accused: Antislavery and the Judicial Process* (Yale University Press: 1975) 178. See also Lawrence M. Friedman, *A History of American Law* (2nd edn, Simon & Schuster: 1985), 371–391.

[17] See supra note 15 at location 644.

[18] Note that in some jurisdictions, such as Pennsylvania, there was never a separation of law and equity. In others, like New York, separate courts began to be abolished by the mid-nineteenth century. See Kellen Funk, "Equity without Chancery: The Fusion of Law and Equity in the Field Code of Civil Procedure, New York 1846–76" (2015) 36 *The Journal of Legal History* 152, and Joseph H. Beale, "Equity in America" (1921–1923) 1 *Cambridge Law Journal* 21, 25.

[19] *Supra* note 15 at location 758.

driver; and (3) the extent to which they view nineteenth-century laws as having been remade in this image of these concerns; that is, the extent of legal continuity and the extent of legal change. The most influential realist school of legal history is the Wisconsin tradition of legal history associated with the great American legal historians James Willard Hurst[20] and Lawrence Friedman.[21] The Wisconsin tradition offers a self-consciously instrumentalist approach to legal history that views law "as *not* totally (or even mostly) autonomous"[22] and, "in American society at least", as "a tool, an implement, which concrete interest groups and individuals manipulated for whatever ends they had in mind".[23] For this school of thought "law moves with its times and is eternally new".[24] The Wisconsin tradition focuses, in particular, on the ways in which common law rules were adjusted to respond to the instrumental needs of commerce and the marketplace. Peter Karsten, summarising the views of this tradition, observed:

> According to the author of the leading textbook on American legal history the better antebellum jurists, such as Lemuel Shaw, the Chief Justice of the Massachusetts Supreme Court of Judicature (1830–60) and John Bannister Gibson (1827–53), "could write for pages without citing a shred of authority". Moreover, "they did not choose to base their decisions on precedent alone; law had to be chiselled out of basic principle". Far from being checked by hide-bound English precedents, jurists of the Golden Age of American Law were willing and able to create new rules from time to time consistent with needs of a new and burgeoning America.[25]

For Friedman, the author of the leading textbook to whom Karsten refers in the above quotation, nineteenth-century US judges decided cases on an "expedient economic basis". Concluding his analysis of the Law of Sales, for example, Friedman observes that it is

> another example of the principle that nothing – neither small specks of technicality nor large stains of legal logic and jargon – was allowed to interfere in the nineteenth century with what judges or the dominant

[20] For example, James W. Hurst, *Law and the Conditions of Freedom in the Nineteenth Century United States* (University of Wisconsin Press: 1956).
[21] Lawrence M. Friedman, *A History of American Law* (2nd edn, Simon & Schuster: 1985).
[22] Lawrence M. Friedman, "Losing One's Head: Judges and the Law in 19th Century American Legal History" (1999) 24 *Law and Social Inquiry* 253, 277 (emphasis in original).
[23] Laurence M. Friedman, "Opening the Time Capsule: A Progress Report on Studies of Courts Over Time" (1990) 24 *Law and Society Review* 229, 230.
[24] Friedman, supra note 21 at 18. [25] *Supra* note 15 at location 640.