

## ON THE LINKAGE BETWEEN THE FUNDAMENTAL PROBLEM IN CORPORATE LAW AND STANDARD CONTRACTS LAW

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### Abstract

The claim argued in this paper is that common law, as presently applied to public corporations (i.e., Corporate Law and Securities Law), is characterized by a broad consumer outlook that subsumes standard contracts law. The “consumerist” attributes of shareholders in public corporations rely on the widely accepted theoretical analysis of corporate law that focuses on the separation of ownership and control (the “agency problem”), which was developed in the wake of the growing might of mega-corporations. Respectively, standard contracts law, including its consumerist elements, designed to deal with contractual failures arising from the nature of the bylaws of a public corporation, as a contract whose contents are not negotiable by the parties invited to adhere to it, and from the inferior economic and informational standing of share buyers in the capital market. As such, standard contracts law serves as an additional, justified and consistent legal tool for contending with the agency problem, whence the opening for its application to public corporations.

**Keywords:** corporate law, public corporations, agency problem, common law

### Introduction

The vast economic and social growth experienced by many corporations during the twentieth century has, in turn, recast the shareholders’ right of ownership in them in a new and weakened mold. Growth has provided the justification for the coextensive application of standard contracts law to corporate law and, in particular, to the laws regulating corporations whose securities are widely distributed and traded by the public (hereinafter – public corporations).

On the transformation of the classic proprietary right in the wake of industrial development regarding the ownership of shares in public companies, see M. J. Horwitz, *The Transformation of American Law 1870-1960, The Crisis of Legal Orthodoxy* (Oxford University Press, 1992) 166. The application of standard contracts law to the bylaws of a cooperative corporation was recognized for the first time in Israel in 1997 by the Israeli Supreme Court with an expanded seven-judge panel which ruled, respectively, that it should be exposed to wide legal scrutiny (Civil Appeal 1795/93, 1831/93 *Egged Members’*

*Pension Fund Ltd. v. Jacob* Judgments 51 (5) 433). In this case, consumer doctrines were applied to a cooperative corporation engaged in transportation, where the members are also its workers. It was specifically with respect to this cooperative corporation, which was even cited in American academic literature as an example of a corporation owned by its workers because of their shared homogeneous interest (H. Hansmann, *When Does Worker Ownership Work? ESOPs Law Firms, Codetermination and Economic Democracy*, 99 *Yale L.J.* 1749, 1762), that the application of standard contracts law was first recognized in Israel with regard to bylaws. Recognition rested on the “nature of the relations between the cooperative corporation and its members,” which was deemed by Israeli Supreme Court Justice Englard as an alienated employer/employee relationship. Since alienation between owners and managers is a built-in feature, and perhaps even a sharper one, in a public corporation where shares are widely distributed and impersonally purchased by trading in

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the Stock Exchange, one cannot rule out the application of the Egged verdict to this latter type of corporation as well. Justice England, who wrote the majority opinion in the Egged case, is opposed to extending the application of standard contracts law to public corporations. Nevertheless, and in view of the arguments stated in this paper, it would seem that his reasoning applies even more cogently to public corporations where, due to the separation of ownership and control, relations between shareholders and management are extremely alienated and inherently subject to the one-sided determination and modification of the bylaws.

I will argue below that common law, as presently applied to public corporations, is characterized by a broad consumer outlook that subsumes standard contracts law. This view relies on the widely accepted theoretical analysis of corporate law that focuses on the separation of ownership and control, which was developed in the wake of the growing might of mega-corporations. This analysis assumes that corporate constituencies, and corporate shareholders in particular, are inferior contractual parties due to inherent problems of coordination, asymmetric information, and rational passivity, and lack of incentives to monitor corporate managers. From this perspective, it seems possible to identify a harmonious conception linking contractual, consumer, and corporate doctrines; this substantive viewpoint calls for an innovative “consumerist” approach, which acknowledges that applying traditional proprietary and contractual classifications to dispersed shareholders in public corporations is anachronistic.

The present paper is concerned with a descriptive analysis of the law, but also does not ignore the debate as to whether mandatory intervention is desirable in contract law in general and in corporate law in particular<sup>1</sup>. My view, however, is that the present theoretical starting point of public corporate law, as well as of common law, deals with flaws usually regulated by consumer law. Consumer law tends to assume that one party holds an advantage that imposes an obligation of concern for the interests of the “inferior” party, which tends to rely on this protection. Thus, presumably, a consistent perception stressing substance over form will support an expansion of the standard contract to include public corporations. In these corporations, the “consumerist” attributes of the shareholder are more distinctive, and

come to the fore in the alienation prevalent between shareholders and their representatives, and in the shareholders’ inferiority in terms of expertise, information, incentives and bargaining ability. This expansion is consistent, on the one hand, with the position of diversified shareholders acquiring their shares, including the respective contractual obligations, in an impersonal market such as the capital market. On the other hand, it is also consistent with the philosophical foundation underlying standard contracts law, entailing an advantage to the formulating/selling party who may abuse it, and with the practical inability of the buyer to participate in setting the terms of the contract. Such an interaction – although taking place between the shareholder and “his/her” corporation—is an obvious category in which the freedom of contract is questionable in a manner resembling other categories of standard contracts, which are most common in transactions among giant organizations and their other constituencies in the modern economy.

#### **Concerning the fundamental problem in corporate law and the consumerist nature of the shareholder**

The separation of ownership and control in corporations became a significant element in the United States in the late nineteenth century, with the growth of the railroad and the telegraph. These developments, which led to the “Second Industrial Revolution,” were marked by the growing power of giant corporations and the advancement of the capital market<sup>2</sup>. Berle & Means reviewed these events in their celebrated 1932 volume<sup>3</sup>, which focused corporate analysis on a view of shareholders as passive and lacking influence and control over what is done to their assets, both due to the difficulty and unwieldiness inherent in the collective management of

<sup>1</sup> For an analysis that advocates a generally enabling view of public corporation law, see F. H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporate Law* (Harvard, 1991). For an economical perspective that identifies market failures in some specific corporate law issues see: L. A. Bebchuk *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments* 102 *Harv. L. Rev.* (1989) 1820 and L. A. Bebchuk *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law* 105 *Harv. L. Rev.* (1992) 1435.

<sup>2</sup> Regarding the side-effects of this development in the railroad sector, see A. D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Harvard, 1977) 87: “Ownership and management soon separated. The capital required to build a railroad was far more than that required to purchase a plantation, a textile mill, or even a fleet of ships. Therefore, a single entrepreneur, family or small group of associates were rarely able to own a railroad. Nor could the many stockholders or their representatives manage it. They required special skills and training which could only be commanded by a full-time salaried manager. Only in the raising and allocating of capital, in the setting of financial policies and in the selection of top managers did the owners or their representatives have a real say in railroad management.”

<sup>3</sup> A. A. Berle & G. C. Means, *The Modern Corporation and Private Property* B (1991, originally published in 1932). Regarding an economic model for this phenomenon, see the well-known article by Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *J. of Financial Economics* (October 1976) 305.

dynamic businesses and to the system of personal incentives. Perspectives shifted from the classic proprietary approach, which combines the right of owners to cash flow with their right to control over their assets, to the inevitable split between these two components of the classic proprietary right and to a loss of control as far as the proprietary rights of passive shareholders in public corporations are concerned<sup>4</sup>. In the spirit of this paper's topic, one might say that the attitude toward shareholders in public corporations highly resembles a perception of them as consumers giving their capital to the corporation's officers who, in turn, provide management services and a return on their investments. Since the right of typical shareholders to influence corporate moves is a function of their grip on voting powers, and since their holding rates are mostly negligible, the actual influence and control of shareholders over developments in "their" corporation, including their power to determine and modify the bylaws, is nominal and largely ceremonial.

Some have claimed that the term "control" suits all corporate laws and also substantiates them<sup>5</sup>. A corporation that, at least at present, is by definition a body never fully owned by a single individual, inevitably raises the question of the separation between ownership and control, and with it a potential for distortion in the decisions of the controlling representative. The separation between ownership and control (also known as the "agency problem") has produced a large body of legal and economic literature. This literature has stressed the conflicts stemming from the incentives to the controlling shareholders (the "agents") to profit for themselves at the expense of the passive "owners" (the "principals"), who are excluded from control. Since the agents controlling the decision-making mechanism of the corporation and its assets do not have total ownership, they do not bear the full cost of their negligent or distributive decisions. At best, then, these agents lack an optimal economic incentive to act for the maximization of the company's profits. The acts of a controlling agent, besides the influence and control s/he exerts over the assets of others, and particularly in a large and wealthy company employing a sizeable staff as well as creating and resorting to many social resources, have overall social influence. The agency problem is further aggravated when accompanied by the "passive" shareholders' informative and professional inferiority, rational indifference, and lack of bargaining and controlling powers—a win-win formula for the agents. This structured situation, in

which one party holds power and control over another, explains and justifies legal intervention to protect "passive" shareholders from their agents. It is in this spirit that one can understand and justify the various doctrines scattered throughout corporate law and securities law, most of them aiming to cope with and minimize the agency problem.

A general consensus prevails concerning the conflicts inherent in the separation of ownership and control in public corporations. In contrast, a debate is still ongoing concerning the necessary—if any—level of effective intervention by the law in this economic domain, which is perhaps more suited than others to the "Darwinistic" restraint of market forces and to independent individual choice<sup>6</sup>. Nonetheless, it would appear that at present, beside the permissive rhetoric invoked in the domain of corporate law, some spheres are essentially regulated by securities law. In these areas, common law widens the scope of mandatory and even criminal intervention in public corporations, emphasizing investors' protection from injury and maintaining trust in public corporations. The federal and partly criminal nature of the Securities Law in the United States, and the manifest interventionist approach evidenced by the Israeli Supreme Court concerning norms of conduct in public corporations, could be explained through the socio-economic importance ascribed by the court to the business activities of public corporations, the importance of the capital market, and the direct and indirect exposure of the public as a whole to the risks and prospects created by these corporations (e.g., as shareholders, workers, pension fund savers, clients, suppliers, etc.). Public corporations are thus subject to a quasi-public set of norms, in addition to the private one, which is also consistent with effective and constraining intervention in the form of standard contracts law as well<sup>7</sup>.

<sup>6</sup> See supra note 2.

<sup>7</sup> This quasi-public characterization makes public corporations typical candidates for the permeation of norms from public law. This is the rationale to sec. 239(d) of the new 1999 Israeli Companies Law – a law that replaced the old and anachronistic corporate code which was based on an old English code – which obliges publicly held corporations to nominate, among its outside directors, at least one man (if all other directors are women) or at least one woman (if all other directors are men) and sec. 11(a) to the same law that states that "the purpose of a company shall be to operate in accordance with business considerations in realizing its profits, and within the scope of such considerations, the interests of its creditors, its employees and the public; may *inter alia* be taken into account..." (For an English translation of the new 1999 Israeli Companies Law see the following weblink:

<http://www.justice.gov.il/NR/rdonlyres/75391714-5731-4BAA-822F-7F0BCB9AC344/0/CompaniesLaw57591999.pdf>). In general, it seems reasonable to theorize that the quasi-public orientation of modern corporate law (especially as it relates to publicly-traded corporations) is also supportive of the

<sup>4</sup> See Horwitz, supra note 1.

<sup>5</sup> This claim targets Dworkin's "super" judge Hercules, who deals with a "theory" that best fits and justifies most of the formal argument, and "must construct a scheme of abstract and concrete principles that provide a coherent justification for all common law precedents and.... constitutional and statutory provisions as well" (R. Dworkin, *Hard Cases*, 88 Harv. L. Rev. (1975) 1057, 1094).

The Securities Law applies also to corporations in which the agency problem is particularly acute, namely, public corporations (and also in certain cases of private corporations with a material affiliation to public corporations). This law substantiates the position of common law, which regards investors in public corporations as inferior contractual parties in need of protection. As presently construed and applied, the Securities Law may be considered, for all intents and purposes, a specific consumer law; it does not, however, negate the basic and coextensive application of general consumer laws such as standard contract law. Rather, given that the Securities Law has much in common with the conception underlying standard contracts law, and is also concerned with inherently contractual transactions, there is no reason in law, logic or legal policy to preclude application of general consumer and contract law when the specific law fails to provide full solutions.

Let us consider the status of a shareholder who purchases shares in the Stock Exchange, and the legal relationships established between the shareholder and the public corporation. This is a contractual relationship in which the buyer of the share, even if not pushing a shopping cart, is a consumer with a right of claim against the supplier (the issuing company and its controlling shareholders and officers, who are supposed to provide management services and a return on his/her investment). Upon purchasing the share on the Stock Exchange, the shareholder becomes a party to the bylaws, i.e., to the contract, although s/he never had an opportunity to negotiate in that regard<sup>8</sup>. S/he shares this contract with several hundreds or even thousands of others.

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concept that view corporations as a social entity, and not only as a capitalistic one (see, e.g., W. T. Allen *Our Schizophrenic Conception of the Business Corporation* 14 *Cardozo L. Rev.* (1992) 261). This concept is particularly relevant in the State of Israel, that experienced a significant constitutional reform during the last 10 years with the enactment of two fundamental laws in 1992 that deal with Human Rights (Basic Law: Human Dignity and Liberty and Basic Law: Freedom of Occupation). These rules triggered the application of constitutional and social norms as part of the private law as well (mainly contract and corporate law) through the contractual "Good Faith" and "Public Policy" doctrines. From another perspective, one might think that the social statements embedded in the new Israeli companies law and the more general public-private law synthesis are closely connected to the views of the current prominent Israeli Supreme Court Chief Justice, Aaron Barak, who was the chair of the committee that drafted the new 1999 Israeli Companies Law and in the same time, serves as the leading Justice who entrenched the "social" and constitutional reform in the Israeli private law.

<sup>8</sup> Note that it may be necessary to draw a distinction between the different markets in which the share is traded: the primary market, in which the issuing company stands in direct contractual privity toward the buyer of the security, versus the secondary market, in which securities selling and buying transactions are carried out among the in-

Indeed, the Securities Law includes distinctive elements of consumer legislation, chief among them the replacement of the rule "caveat emptor" with the rule "caveat venditor," through the augmented duties of disclosure, itself a clear indication of a consumerist philosophy. The philosophy of mandatory disclosure, the "caveat venditor" approach, and the endorsement of the class action mechanism, constitute the foundation of the Securities Law that applies to the contractual-cum-corporate relationship typical of investors in public corporations. In this connection, it is worth citing the following statement by Chief Justice Shamgar, former Chief Justice of the Israeli Supreme Court, in Civil Action 5320/90, *Baranovitz v. The SEC*:

"This development [of the principle of mandatory disclosure at the basis of the Securities Law – E.B.] stemmed from the need to balance the trend of growth toward mega-corporations and the problems attending on the distribution of spread ownership of shares and the split between ownership and control within the company.... The development of the modern economy has made it necessary for corporations to raise capital by selling securities to the public. The sale of securities to the public differs from an ordinary sales transaction in that, generally, it involves no personal meeting between buyer and seller. Furthermore, unlike the object of an ordinary sale, securities comprise a special type of commodity, being certificates whose real value (i.e. the value of the company against which they represent a claim) is not immediately apparent (as opposed, for instance, to a currency bill), while the information concerning this said value is in the company's possession and accessible to its managers and controlling shareholders.... The securities laws, therefore, has replaced the well-known fundamental selling rule of 'caveat emptor' with a philosophy of full disclosure by the selling company"<sup>9</sup>.

Further on, Chief Justice Shamgar stresses the connection between disclosure and supplying appropriate information to investors, deterring the "seller" from manipulative behavior:

"In essence, it is customary to regard disclosure as operating on two levels: the first— supplying investors with an adequate information base so as to enable rational decision-making concerning their investments; the second—detering wielders of

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vestors themselves, without the issuing company being a direct party to the transaction and its consideration. In the present context, it is enough to note that the transaction in the secondary market may be regarded as one of assignment of a right, placing the assignee in direct privity vis-à-vis the issuing company. The institutions of the issuing company, which are influenced by its representatives, formulated the same "standard" bylaws. This suffices to sustain the cause of action under standard contracts law, even for someone who purchased his or her share in the secondary market.

<sup>9</sup> Emphasis added. Civil Appeal 5320/90, *Baranovitz v. The SEC*, Judgments 46(2) 818, 830.

power in public companies from fraud and manipulative behavior, enabling close watch over their activities<sup>10</sup>.

This rhetoric is also used to justify “conventional” consumer legislation, on the grounds that there is no gainsaying the present need for a standard contracts law to balance the inequality between supplier and buyer in terms of skills, information, and bargaining ability<sup>11</sup>. In sum, the claim argued in this paper is that, given the separation between ownership and control, the bylaws of a public corporation definitely conform with the formal as well as the substantive characterization of standard contracts law, whereby, “the consumer remained ‘free’ in theory but his choice was often restricted to ‘taking it’ or ‘leaving it.’ Thus, although nobody could compel a passenger to travel by train, if he wanted to do so he had to do so on the terms and conditions imposed by the railway companies. He could not negotiate his own terms...[T]here was often no opportunity, and hence no real freedom, to negotiate one’s own terms. The terms were imposed by one party, and the other had no choice but to accept them or go without. From the very nature of the case, these terms were liable to be far more favourable to the organization supplying the goods or services in question than to the individual receiving them. The organization had every advantage over the individual. It usually had the advantage of large resources, of the best legal advice and draftsmanship, of being able to litigate, if it came to that, without having to worry unduly about the cost, and, of course, of knowing that the individual, squirm as he might, could not really do without its services”<sup>12</sup>.

Like the common law standard of reasonableness that enables the court to scrutinize the reasonableness of the standard contract, the Israeli Standard Contracts Law includes a legal source investing the court with the power to annul or change any condition in a standard contract involves undue disadvantage to “customers” or unfair disadvantage to “supplier”<sup>13</sup>. The same discretion should apply to corpo-

rate bylaws. Weighty reasons do indeed counsel restraint in resorting to the cancellation remedy in regard to a company, which is a contractual knot involving many “innocent” third parties. On these grounds, however, one should not deny *a priori* the relevance of using standard contracts law in appropriate cases, since the law is merely a formal tool. Once the Standard Contracts Law was enacted to preclude “discrimination” resulting from one party exploiting its advantage to dictate the terms of the contract to an inferior party, what is the source of the court’s authority to rule out discrimination? Once legislators have conveyed their intention to preclude situations in which a party wielding power will use it to exploit another, there is no clear justification for preventing the application of another law insofar as it regulates—even if generally—the same issue and rests on the same rationale. In a paraphrase of the well-known saying—we don’t care if the cat is black or white, only that it catches mice.

### Concluding notes

Standard contracts law, including its exacting consumerist elements, is a general contract law suitable for application in the realm of public corporate law that views diverse shareholders, who are the company’s owners, as passive consumers of management and return services. This perception of shareholders is embodied in the agency problem, has been identified by the law, and is presently the main object of regulation in common law. Obviously, the existence of a direct and specific system of corporate and securities laws does not negate the parallel and general application of other systems of laws, insofar as they are intended and able to provide support in coping with the agency problem. Given contemporary trends in corporate law, securities law, contract law, the laws of good faith, and consumer legislation, as well as the growing jurisprudential trend to put substance before form, the theoretical application of standard contracts law to the bylaws of a public corporation appears to be self-evident. Yet this application does not imply disregard of the judicial restraint stemming from an additional set of considerations applied to corporate bylaws, such as special contracts involving third parties that were not meant to be covered by standard contracts law. Hence, any decision concerning the cancellation of a stipulation in a corporation’s bylaws, even if it clearly discriminates against the parties, will include considerations that take into account the reliance of innocent third parties who could be adversely affected by such a cancellation.

Alternatively, the court is not only empowered to cancel an unreasonable stipulation but can also “modify” a discriminatory stipulation in a standard contract; hence, it may intervene to balance the contents of the stipulation so that it eliminates discrimination against shareholders but also takes into account innocent third parties or parties to whom the law was not intended to apply (such as founders who

<sup>10</sup> *Ibid.*, 831. Compare: L. Brandeis *Other People’s Money and How the Bankers Use It* (1914) ch. 5 (“Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman”).

<sup>11</sup> It is also important to note a prevalent trend in Israel, toward expanding the duties of disclosure in the consumer sphere, even without recourse to specific consumer legislation but through direct reliance on the principle of good faith in the precontractual stage (section 12(a) of the Israeli Contracts (General Part) Law 1973, which prescribes that: “In negotiating a contract, a person shall act in customary manner and in good faith”). Evidently, this is most clearly seen in cases of contractual involvement of mega-corporations, considering their power, the public trust placed in them, and their vast socio-economic importance.

<sup>12</sup> P. S. Atiyah *An Introduction to the Law of Contract* (Oxford University Press, Fifth Edition, 1995) at p. 16.

<sup>13</sup> Section 3 of the Israeli Standard Contracts Law, 1982.

participated in the formulation of the bylaws). In any event, given the standing of common law and in pursuit of consistency, one cannot negate the practical and legal application of standard contracts law to public corporations as an additional tool for minimizing the agency problem, both preventively and consequentially.

Contemporary law attempts to contend with issues deriving from the agency problem in public corporations through various doctrines in different branches of corporate and securities law. A person drafting a standardized mass contract, acts as the representative of the contracting parties, who do not actually negotiate with him, nor do the controlling persons in a public corporation, who have *de jure* and *de facto* responsibility for modifying the company's bylaws. Standard contracts law is designed to deal with contractual failures arising from the nature of the bylaws of a public corporation, as a contract whose contents are not negotiable by the parties invited to adhere to it, and from the inferior economic and informational standing of share buyers in the

capital market. As such, standard contracts law integrates with the spirit of the current corporate law reform in the US and the Sarbanes-Oxley Act of 2002 (enacted in response to the big corporate crisis experienced by Enron, WorldCom, Tyco International, Adelphia Communication and others), and serves as an additional, justified and consistent legal tool for contending with the agency problem, whence the opening for its application to public corporations.

This reform – mainly calling for more disclosure - was said to be “Arguably the most far-reaching corporate reform legislation since the Securities and Exchange Acts of 1933 and 1934, the [Sarbanes-Oxley] Act was designed to increase the transparency, integrity, and accountability of public companies and, in turn, to combat the kind of corporate deceit that had given rise to the scandals and financial breakdowns” – The Good, The Bad, And Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems With Legislating Good Behavior 116 Harv. L. Rev. (2003) 2123.