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## What Matters in Design of Corporate Law

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## Abstract

For the corporate business model to be successful, it is important to align the interests of those who control and finance the firm. Corporate law has here an important task to fulfill. It offers a legal framework that can facilitate for parties to conclude mutually preferable agreements at low transaction costs. The purpose of the paper is to show how to design corporate law to fulfill this task. A two-dimension model that simultaneously considers both regulation intensity and the level of default of the corporate law is presented. Earlier literature treats these dimensions separately. By adding a transaction cost perspective to our model, we assess different regulatory techniques and examine how legislation can help corporations by offering a standard contract that lowers transaction costs of contracting. This can be achieved through a legislation that covers most contingencies and take the heterogeneity of firms into consideration. Furthermore, default rules or standards of opt-out character should be combined with other regulatory techniques with lower transaction costs such as opt-in alternatives and menus.

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## 1. Introduction

Corporate law matters for economic efficiency and growth (Cooter and Schäfer, 2012). Consequently, the design of corporate law is important. We present a two-dimension model that makes it possible to analyze and characterize corporate law with respect to the level of regulation intensity and the level of default. This model works as an analytic tool that can guide lawmakers in the choice between regulatory techniques such as the choice between rules or standards and between mandatory or default regulation.<sup>1</sup>The model thereby visualizes alternative regulatory techniques and allows for comparison of different legal solutions. It also serves as an analytic tool for policy changes as it eases the understanding of how transaction costs affect the effectiveness of the different techniques and how regulatory techniques can be used to match the needs of different types of corporations, e.g. public corporations, closely held businesses and family firms. (To our knowledge this has not been done before.) We believe that legal research fulfills an important role in addressing these issues and encourage more research on conceptual, empirical and/or comparative aspects of regulatory design, which result in conclusions that can assist lawmakers in the choice of regulatory techniques.

In the analysis, the concept transaction costs will be used. This is a concept that has to be clarified in order to have any analytical meaning. We use it for the costs of social productive interaction. Referring to Adam Smith people with differing competencies and access to resources must interact in order for nations to be wealthy. Social productive interaction promotes economic growth and welfare. We define social productive interaction as transactions. There are barriers of different kinds that have to be overcome in order for welfare increasing transactions to take place. These barriers can be considered as costs of transactions. Sometimes the costs are considered as insurmountable and potentially welfare-increasing transactions do not take place. To overly simplify the concept, there are costs of contacting, contracting and controlling (three c:s) associate with arranging for productive interactions (See e.g. Coase 1937). Acquiring information about transaction partners, bargaining about contract terms (determining the conditions for the productive interaction), policing, and enforcing (controlling) agreements are costly activities in all transactions.

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<sup>1</sup> In this paper, we define regulation as a binding standard set by a public regulator for intentional intervention of economic activities of private actors(Koop and Lodge 2015), with special attention to which extent the regulation gives room for private contractual agreements.

Policing and enforcing are associated with the extent to which transaction partners trust each other.

Law has an important function to fulfill in order for welfare increasing transactions to take place. In Cooter and Schäfer (2012) property law, contract law and corporate law are listed as the most important legal drivers of welfare and economic growth. The design of corporate law matters for how well corporations succeed to make the interests of entrepreneurs and investors converge. It also matters for how attractive it is to start a corporation in the first place. In order for corporate law to be attractive one has to consider transaction costs of contract solutions that align interests and are adaptable to different and changing circumstances. Especially through the life cycle of a firm, from startup to a large publicly listed company, the preferences and need for control, ownership and protection of stakeholders are likely to differ. We will take a closer look into how the design of corporate law can lower the costs for accomplishing this (i.e. aligning interests and being adaptable to different and changing circumstances).

In the literature, at least two main topics on the design can be identified. The first is how detailed corporate issues should be regulated in legal statutes and to what extent it instead should be left for the parties to regulate by contract. Within this topic, questions such as the usage of rules versus standards and non-regulation are discussed. We call this dimension of corporate law design the level of regulation intensity. The second main topic found in the literature is what we call the level of default, i.e. whether legal rules should be mandatory or non-mandatory and the usage of different default techniques such as opt-in and opt-out regulation. What is new in this paper is that these two dimensions are combined and integrated in one model of corporate law design. Earlier literature treats the dimensions separately.

Ehrlich and Posner (1974) analyze rule making. They claim that it is fruitful to apply a specificity-generality continuum, in contrast to a “dichotomy between ‘rules’ and ‘standards’”. We will apply a similar analysis to rule making, but in combination with a consideration to the default character of a legal norm. Hence, in the analysis of level of default we envision, just like Ehrlich and Posner (1974) did, a continuum, instead of a dichotomy, between default and mandatory rules.

The two-dimension approach works as a tool to analyze and characterize corporate law and to make statements to which extent corporate law design suits the purposes of different groups of corporations, e.g. listed versus unlisted firm, family firms versus non-family firms, closely held versus public corporations, startups versus older firms, firms of different sizes etc. The model can be applied on corporate law in general, but also on specific sections of corporate law, such as the regulation on capital requirements, the transferability of shares or the regulation on directors' liability. Hence, the model is also valuable for comparative studies where solutions in different states are compared, not only based on their legal content, but also in the regulatory techniques used.

We find that literature supports a corporate law design with high level of both default and regulation intensity. To fulfil this, the legislator should be ambitious in designing corporate law as a standard contract to fit the needs of the vast majority of corporations. In most states, such firms are closely held. To succeed in the accurate level of defaults the legislator cannot only equip the law with opt-out regulation. Such rules are in many cases associated with too high transaction costs for the parties to effectively derogate from them. For different economic and psychological reasons, parties tend to stick with opt-out rules even if they are suboptimal. Instead, the legislator should aim to lower the costs of contracting by also using opt-ins and menus. In addition, the legislator must acknowledge costs of so-called altering rules and aim to lower also such costs, especially by highlighting and not hiding the default character of legal norms.

The paper will be organized in sections as follows: After this introduction follows a presentation of the double trust problem, the corporation as a nexus for contracts and the corporate law as a standard contract. In section three, we present our two-dimension model discussing the default and regulation intensity aspects of corporate law and how economic efficiency/growth and transaction costs are affected hereby. A special section is thereafter devoted to a Swedish case where we illustrate how the model can be applied and enrich an analysis of corporate regulation. Summary, comments and discussion ends the paper.

## **2. Law, transaction costs and the corporation**

### **2.1 The trust problem**

In the introduction, we mentioned that law has an important function to reduce differences in incentives of entrepreneurs and investors to help overcoming trust problems and lowering transaction costs in the economy. People in contractual relations often have conflicting incentives and people are from time to time opportunistic. In order to take advantage of the benefits of specialization it is necessary to harmonize incentives. Laws and contractual safeguards serves as bridges that harmonize divergent incentives. Asymmetric information and bounded rationality are at the roots of the problem. Use of safeguards are unique in every transaction but the law is a public good in form of a social infrastructure that can be at low or no cost used by everyone. It serves as economizing on transaction costs. How low the transaction costs are will depend on how the law is formulated.

Cooter and Schäfer (2012) show with a broad painted brush how law in form of property rights law, contract law and company law can overcome these problems. They focus on financing of innovation and promotion of economic development and welfare around the world. We use a similar framework but goes beyond their work by looking more in detail how transaction costs can be reduced in corporate law to help parties to trust each other. Williamson's assumptions that people are opportunistic, bounded rational and have incomplete information are used (see Williamson 1985 etc.).<sup>2</sup> These are factors that give rise to high transaction costs.

The corporate law can provide solutions to trust problems in the relations between the financiers and the corporate firm as well as with other contracting partners. The extent to which the law solve such problems matters for the attractiveness to become an entrepreneur, start a business, to obtain financing and the growth of the firms. In other words, it matters for economic growth (as described by Cooter and Schäfer). In a corporation with dispersed ownership, the minority needs safeguards so they can trust dominant owners. Owners in turn need to trust the executive management and, as suggested by the law, a board can serve as safeguard for trust in the relationship between management and shareholders. However, the means to overcome trust problems between shareholders and between shareholders and management differ for different

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<sup>2</sup> Bounded rationality means that capacity of human beings to formulate and solve complex problems is limited. By opportunism is meant that human beings cannot always be relied upon to candidly reveal all information pertinent to a transaction. From time to time people will try to take advantage of such information asymmetries to exploit a situation to their own advantage at the expense of the other contracting party

firms. Small firms differ from large firms, listed from unlisted firms, family firms from non-family firms.

## 2.2 Nexus for contracts

Armour, et al. (2009) consider the legal personality be the most important characteristic of the corporate form of business. By being a legal person the assets of the corporation are shielded from the owner's personal creditors. This is utterly important for the firm's contracting partners as it makes it easier for them to estimate how likely it is that their claims on the firm will be honored.

Jensen and Meckling (1976) depict the firm as a nexus of contracts. Inspired by Armour, et al. (2009) we change it to a nexus *for* contracts.<sup>3</sup> Our focus is on firms that have adopted the corporate form of business. As a corporation is a legal entity, it can, just like a physical person, enter into binding agreements (contracts) with other physical and legal persons. From this perspective, the corporate form of firm can be seen as a "nexus *for* contracts" that coordinates financial investors, suppliers of intermediate goods, services and labor as well as customers in the production of goods and services. In other words, the firm is a central contracting party in a web of contractual relations.

To view of the corporation as a nexus for contracts helps to understand that the role of the legislation, besides to grant the firm legal personality etc., is to assist and ease the contractual relations between different interests in the contractual web. Corporate law regulates some of these relations, others by e.g. securities regulation (relations to investors), sales law and consumer law (sale contracts with the firm either as a buyer or a seller), labor law (employment contracts) and tort law (legal claims for non-contractual damages). In this study, the relations between owners and managers and among shareholders are in focus.

The seminal article by Jensen and Meckling (1976) gave rise to a new field of research called agency theory. It depicts a principal-agent relationship between shareholders and management in corporations where there is a division between shares ownership and management control (i.e. a separation of ownership and control). The shareholders are considered as principals

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<sup>3</sup> Their motivation is that the corporation is "the common counterparty in numerous contracts with suppliers, employees, and customers, coordinating the actions of these multiple persons through exercise of its contractual rights" (Armour et al.2009, p.6)

whose welfare is dependent on the actions of the management. Their approach is of a positive nature with refutable propositions (Jensen 1983). The transaction cost approach shares some commonalities with agency theory. The nexus concept is used in transaction cost economics as well as in agency theory (see Williamson 1988). The behavioral assumptions of bounded rationality and opportunism (self-interest seeking with guile) that makes contracts incomplete are also shared with agency theory. What characterizes transaction cost economics according to Williamson (1988), in contrast to other theories like agency theory, is a focus on transaction dependency and how to handle the resulting interdependencies through safeguards of different kinds. The focus is on ex post governance. In other words, how to reduce the costs of future disturbances in the relations between the firm and its contractual partners is emphasized. In line with transaction cost economics, we discuss how the corporate law can help the firm with contractual solutions that reduce future contractual problems. By doing that, the transaction costs of the firms are reduced.

According to Enriques, et al. (2009) there are primarily three agency problems to be addressed. These are between shareholder, the board and the executive management, between majority and minority shareholder and between shareholders and creditors. We pay special attention to the relationship between shareholder, board of directors and executive management and the relation amongst shareholders with majority voting power and shareholders with small non-controlling ownership (protection of the minority). Shareholders are often considered to be the owners of the firm (especially in closely held companies). Their contractual relations with the firm are characterized by a claim on the residual that remains when all the other contractual obligations of the firm have been met. (They are residual claimants.) The size of the residual is dependent on the management of the firm's resources. Consequently, shareholders have an interest and a legally recognized right to control how the firm is managed. Sometimes there is a separation of ownership and control in the sense that owners and managers are different persons. In these cases, the board has an important role to play as an agent who controls the management on behalf of shareholders. However, in most cases owners and directors and/or executive managers are the same persons. In these corporations, the division into two decision-taking organs, the general meeting and the board of directors, is usually non-prevailing. Instead, the owner-managers act as one active decision-taking organ.

### **2.3 Corporate law as a standard contract and hypothetical bargaining**

Within the context of the corporation as a nexus for contracts, we concentrate on the contractual relations between the firm and its shareholders. Shleifer and Vishny (1997) regard this as the core of the corporate governance perspective. These contractual relationships are regulated by corporate legislation, supplemented by the articles of association and, in some cases, a shareholder agreement. Different contractual parties contribute resources to the firm and have contractual claims on the legal person. How well the firm succeeds in the transactions with these parties determines firm performance. As first pointed out by Coase (1937), transactions are not costless. Entering into contracts is associated with transaction costs. To be witty, these transaction costs can be described as three magic C's; i.e. contact, contract and control costs. Contact costs represent all costs associate with localizing and obtaining information about prospective contract partners and the terms these partners offer/demand. Contract costs are the costs of negotiating and concluding a contract with someone. Control costs are the costs of monitoring and policing the contract. One task of the lawmaker is to increase economic efficiency by legal rules that lower transaction costs in the economy (cf. Coase 1960).

In case transaction costs were zero, corporate law could more or less be reduced to a registration of a corporation as a legal person, allowing it to enter into contracts with other parties (Enriques, et al. 2009, p. 19). It would then be left to the shareholders and the legal person to enter into, negotiate and enforce contracts for the birth and survival of the company. But transaction costs are not zero. Contracting is costly (Buchanan and Tullock 1965) and can in some cases be so costly that transactions are not taking place. High transaction costs also makes contracts incomplete.

One purpose of corporate law is hereby to lower transaction costs by providing a ready-made standard contract (See e.g. Bebchuk 1989). The task of the legislator is to formulate a standard contract close to what informed rational persons would have chosen if they had anticipated future contingencies and actively negotiated without paying attention to transaction costs (See e.g. Cheffins 1997, Easterbrook and Fischel 1989, Gordon 1989). Such contract will be attractive to firms since transaction costs will be saved. The method to find the rules of such a standard contract is often referred to as the "Hypothetical Bargaining Model" (Ayres and Gertner 1989).

Describing corporate law as a standard contract facilitates the understanding that this contract is inherently incomplete. Not even the legislator can foresee all possible circumstances and

events that could affect the relation between parties. In addition, the lawmaker will neither be able to construct a standard contract that suits firms of all sizes nor all phases of their life cycles. In order to compensate for this, the standard contract should, as the starting point, be of a default character (Easterbrook and Fischel 1986). Parties must be allowed to derogate from the legal standard when they find it necessary. The default character of the rules is therefore important and in the next section we will further discuss how the lawmaker can decrease transaction costs by means of different regulatory techniques.

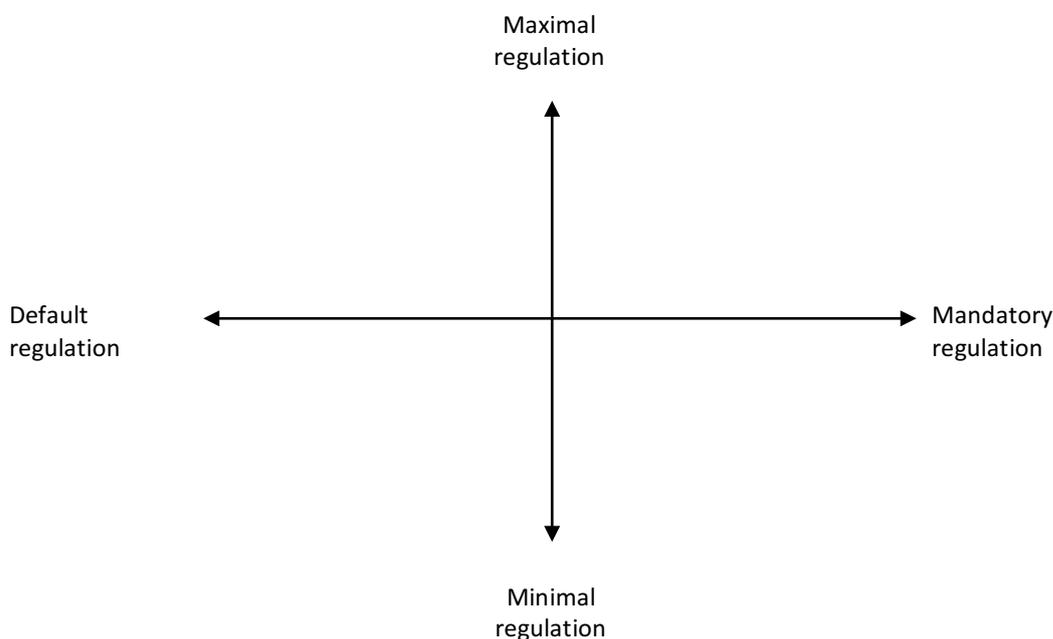
### **3. A model of corporate law design**

#### **3.1 Introducing the model**

The legislator has essentially two toolboxes at its disposal to influence transaction costs in the contractual web of the corporation and guide the firm towards a cost efficient framework. By cost efficient framework is here meant a legal framework that lowers transaction costs in the firm's contractual relations among shareholders (present and future) and between shareholders and the board of directors and/or the executive management. The two toolboxes are the level of regulation intensity chosen in corporate law and the level of default characterizing the rules. Figure 1 illustrates these two aspects (or toolboxes) by movements along the vertical and horizontal axes. By placing regulatory techniques in the model with respect to their level of regulation intensity and level of default, differences between them are highlighted. In addition, through a transaction cost analysis of the techniques they can be better understood and compared with each other.

This model can be used to analyze regulatory techniques on all levels, e.g. legal norms to apply on an individual basis (micro level), a set of rules (mid-level) or a legal field such as corporate law (macro level). The model should even be possible to use in a comparative legal study, where the regulatory techniques of different states are compared. In section 4, we will by a national example illustrate how the model can be applied to a set of legal norms.

**Figure 1 - The default and regulation intensity aspects of corporate law**



### **3.2 The vertical axis – level of regulation intensity:**

Several aspects, such as culture and legal tradition, affect how intense and detailed regulation is. Of course one can question the need of legal rules altogether. In such a case, the legislator either ignores the area, is unaware of it or has come to the conclusion that the market will regulate itself and hence no state interference is necessary. In the latter situation, deregulation, in the meaning abolishing legal rules, could be an alternative. However, in the area of corporate law some regulation is inevitable (since it at least must establish the legal personality). From a legislative perspective the law has to deal with gaps in explicit contracts (Easterbrook and Fischel, 1989, p 1433). Two legal regulatory techniques to fill out gaps are through rules and standard. We will discuss the transaction cost implications of these two legal techniques.

Crucial assumptions of human beings in transaction cost analysis, as developed by Williamson (1975 and 1986), are that people are bounded rational and opportunistically take advantage of asymmetric information. Bounded rationality and opportunism makes explicit contracts between parties more or less incomplete due to high transaction costs. Contingent claims

contracts envisioned by Arrow and Debreu (1954) that cover all future possible events will be impossible. The pairing of bounded rationality with complexity and uncertainty of the future makes it costly to deal with contingencies in contracts. In regulation a distinction can be made between rules and standards. A rule differs from a standard by being specific in the description of what is permitted/prohibited while a standard is of a more general character with a high degree of vagueness of what is unlawful. As shown by Ehrlich and Posner (1974) there exist a continuum between what can be considered as rules and standards in terms of specificity and generality. We are inspired by their approach but instead consider a continuum of degree of regulation based on the use of rules and standards.

Before explaining our continuum of degree of regulation as depicted in Figure 1 in more detail, it is fruitful to point out the major difference of specificity of rules and standards in terms of transaction costs implications. A rule is transaction cost saving in the sense that it reduces uncertainty of legal consequences. But standards cannot be replaced with rules on a one-to-one basis. Several rules are needed for each standard that is replaced. So the reduction of uncertainty eventually comes at the expense of complexity of having to keep track of a lot of rules. As described by Williamson (1975 and 1986), complexity as well as uncertainty increases transaction costs. There is in other words a trade-off. Another factor to pay attention to is the high cost of promulgation of rules. This is a fixed cost that favors rules for frequent situations as the regulation cost per situation decreases as frequency increases.

The vertical axis of the model in Figure 1 illustrates the level of regulatory intensity. As will be explained in more detail there is non-linear relationship between regulatory intensity and transaction costs. At the bottom we find regulation that corresponds to a minimum number of legal standards, which only regulate the utterly basic rules for corporations to function as legal persons. On the other end of the scale, at the top, we find a regulation that correspond to a comprehensive and complex set of both legal rules and standards which are meant to cover as many situations as possible. A preconceived conclusion would be that a complex, all covering, piece of legislation, would be more costly to comply with, than a minimalistic regulation. A large number of rules, covering many types of contingencies, indeed makes it costly for the shareholders, directors and managers to be informed of the legal framework. However, even though the complexity affects transaction costs, this preconceived conclusion is only partly true. As can be seen in this section, several scholars argue for a corporate law in the higher portion of the scale. We have identified two main streams of the legal literature about regulation intensity. The first stream is instrumental for explaining transaction cost consequences of

movement along the vertical axis while the second offer a more normative theoretical explanation why regulation intensity rather high up on the intensity scale is desirable.

### **Movement along the vertical axis**

In the first stream of literature the regulatory techniques of rules versus standards are discussed. A rule differs from a standard in being clear-cut in the description of what is permitted/prohibited. Since the content of a rule is given *ex ante*, before an act takes place, rules in general generate lower transaction costs for the parties compared with standards. The predictability of a rule can even have the cost saving effect that parties settle before going to court (Ehrlich and Posner 1974). Because of the relatively low cost of compliance, it is argued that situations, which are frequent for the corporations, should preferably be regulated by rules. In contrast, a standard is more vague in describing what conduct is permissible and instead the interpretation is made *ex post* by the adjudicator, e.g. court (Kaplow 1992). This makes the application of a standard harder to predict and sometimes it is necessary to hire expensive legal expertise or to prepare for many different outcomes. Legal uncertainty is always associated with high costs. However, as the number of precedents accumulates the content might become clearer as each precedent supplements the standard with a case-based rule. Furthermore, a legal standard can be more flexible for changes in society and result in an application of the law that is better tailored for the individual parties (Cheffins 1997). This also makes a standard more suitable for regulating non-day-to-day situations (Kaplow 1992).

One of the main downsides of using rules is the risk that they do not cover all aspects of the regulated situation, leaving gaps in the legislation, which can be used to circumvent the purpose of the rule. These gaps are e.g. overlooked or, for the legislator, unknown scenarios. In addition, some areas are too complex for all aspects to be covered in one clear-cut rule. The alternative, for the legislator, is to elaborate the rule into a set of detailed rules, covering all identified angles of the situation, or to sum up all variables in a catch-all standard (Cheffins 1997). For a transaction cost analysis, this means that sometimes an accurate cost comparison must be made between on the one hand a standard, and on the other a set of legal rules. Hence, in general there is not a one-to-one relationship between standards and rules.

The literature on rules and standards, with focus on corporate law, can be summarized in the following way. In general, compliance with rules add on less transaction costs for contracting parties than standards. But a legislative act made up by only rules and no standards results in a detailed non-perspicuous regulation, putting it on top of the scale of the vertical axis of

regulatory intensity. For that reason, a maximum regulation with rules that cover all contingencies represent high transaction costs for the firm. However, inevitably some questions must be regulated by standards. Therefore, corporate law always consists of a mix between rules and standards. On the other end of the vertical scale, a piece of legislation heavily based on standards might be easier to overview, but more costly to apply and comply with. When moving from maximum regulation, replacing rules with standards, transaction costs decreases as it eases the overview of the law. (i.e. as the degree of complexity decreases) However, the decrease in transaction costs only continues up to a point, where the savings in transaction costs represented by fewer rules is equal to higher transaction cost for compliance and lack of predictability represented by more standards or regulatory gaps (i.e. up to the point where the increase of the uncertainty of what to do to avoid legal consequences associated with standards and gaps is equal to the decrease of the degree of complexity of having fewer rules). Beyond that point the higher transaction cost of standards and legal uncertainty dominates. In conclusion, the literature on rules versus standards leave us with a middle course represented by the upper part of the vertical scale in our model as preferred outcome. Hence there is no linear relationship between regulation intensity and transaction costs.

Let us also from a point of clarification look at what happens with transaction costs if we move in the opposite direction from low regulation to high detailed regulation. Detailed regulation is then associated with a substitution of rules for standards. More rules is in the figure associated with more regulation. As standards are replaced with more detailed rules uncertainty is diminished at the expense of more complexity for the individual in form of more rules to keep track of. As remembered both uncertainty and complexity give rise to higher transaction costs because of the bounded rationality of the human being. Therefore a tradeoff between complexity and uncertainty is reached before the maximal regulation point is reached. This point is likely to be situated at a point where there are more of rules and standards ie above the horizontal line. Above the tradeoff point transaction costs rises when standards are replaced by rules.

### **Preferred position – a normative argument**

In the second stream of literature involving regulatory techniques, which affect the desired intensity of regulation (preferred position on the vertical axis from a transaction cost perspective), we find the theory of majoritarian defaults. According to this theory, regulation should, in line with the hypothetical bargaining model, correspond to what rational parties would have contracted for if they have had perfect information, and did not face significant

transaction costs and could be fully confident that the agreement reached would be performed as agreed.

When applying the model normatively, with no specific individuals to take into consideration, the model must always include some generalization. It is then up to the legislator to decide on how detailed the regulation should be, by Charny (1991, p 1821) referred to as level of idealization. Should the law correspond to what parties to this transaction type would most likely have chosen, taking into consideration that parties in general don't regulate issues that are considered non-important or unlikely to occur? Or, should the law cover all possible scenarios? For the purpose of lowering transaction costs, the law should also cover situations that are rare and hard to predict and therefore often are left out or forgotten by actual parties. In the view of the hypothetical bargaining model, the legislator is in a better position than the average parties to formulate contract-covering contingences. The legislator has the advantages of a higher degree of rationality and more information that follows from specialization. People engaged in the lawmaking process have advanced law education and get information and aptitudes from their daily work. They are in a better situation to come up with the best rule for a certain transaction type, i.e. a high degree of idealization (Charny 1991). Literature therefore support an including, covering corporate law, which regulate both frequent and rare situations. Therefore, in accordance with the theory on majoritarian defaults, literatures support an inclusive corporate law representing the higher end of the vertical scale.

### **3.3 Horizontal axis - level of default:**

Let us now consider the horizontal axis aiming to illustrate the level of default in the design of corporate law as a continuum between default and mandatory rules. In this section, we add a transaction cost analysis on default rules and show how these costs affect the level of default. In theory, the parties can derogate from a default rules. However, depending on how much effort is needed to replace the legal rule or standard with contract terms, a default rule can be close to the mandatory endpoint because of high transaction costs. It is especially cumbersome if a corporate law does not follow the hypothetical bargain model. The combination with high transaction costs to derogate from defaults will make most firms choose to stay with suboptimal rules. Before entering into this discussion, let us explore the endpoints of the axis and some arguments for the need of both mandatory and default corporate regulation.

The left hand endpoint of the horizontal axis in Figure 1 corresponds to non-mandatory rules or standards, also referred to as a gap-filling or default regulation (see e.g. Ayres 1993). The right hand endpoint of the axis corresponds to a mandatory regulation. The parties cannot derogate from such rules or standards, not even by a unanimous decision by the firm's shareholders. Taking into account the enabling role of corporate law, providing the parties with a standard contract, the law should correspond to the hypothetical bargaining model. If not, legal rules that do not fit the need of the parties will be costly to comply with. This is utterly important if the regulation is mandatory (cf. Bebchuk 1989). In economic theory given that not even the legislator can foresee all possible circumstances, this argument is used to support a non-mandatory regime. A reason for default regulation is, as mentioned in section 2.3, that nobody, not even the best lawmaker, will be able to construct a standard contract that suits all firms, e.g. listed versus unlisted firm, family firms versus non-family firms, closed versus open corporations, startups versus older firms, firms of different sizes etc. Hence, a standard contract is bound to be a suboptimal for at least some proportions of the firms in the economy. For example, transferable shares and separation of ownership and control are characteristics of large listed firms, but not of small and medium sized family firms. If the standard contract, provided by corporate law, essentially meet the needs of large firms it is crucial for the rules to be of default character letting other firms agree on more suitable contract clauses (Hansmann 2006).

### **Why mandatory rules**

It must however be recognized that not all corporate rules or standards can be defaults. In particular, legal rules that aim to protect a certain interest are argued to be mandatory, in order to avoid circumvention of the law. This especially applies to third-party interests. Yet, it is equally important to recognize that even though some rules at first glance may appear as mandatory, they can still legally be circumvented. In fact, Romano (1989) argues that not even mandatory rules are truly mandatory, since the owners can decide to incorporate in another state, which regulates the question differently. Leaving state competition at side, rules that are inevitable for the corporation to function as a legal person are truly mandatory, e.g. rules that state that the corporation have legal rights and obligations. No agreement among the shareholders, or with stakeholders, can change this fact.

However, in corporate law most mandatory rules have the character of protecting rules. A protecting rule can normally be derogated from by the consent of the protectee. In the same way, as in all private law disputes, the protectee can also choose not to file a lawsuit against the

violator of the protecting right and by this impliedly consent to the infringement. Under normal circumstances this regulatory technique of protecting rules/standards will ensure accurate protection, at least as long as the protectee has reasonable opportunity to exercise his or her right. Given this characteristic of protecting rules, labeling them as mandatory is not always appropriate. In closely held firms, unanimous consent by all shareholders is both feasible and likely to happen. Therefore, shareholders' protection in these situations is better understood as default rules. In contrast, in corporations with dispersed ownership unanimous consent might be impossible to achieve and therefore shareholders' protection rules, although default in theory, are in practice mandatory.

The need of protection in this form of mandatory rules arises when one of the parties is not capable to protect its own interests, i.e. when transaction costs are too high to make contractual solutions between parties possible. This is often referred to as market failure or contracting failure (cf. Klausner 1995, p. 769 and Armour, et al. 2009 p. 22). We can, as delineated by Cooter & Ulen (2008, p. 226-31), distinguish three kinds of situations where high transaction costs motivate mandatory regulation. First, there can be external costs in form of negative spillovers to a third party, i.e. someone not part of contract. Due to contract, contract and/or control costs, this third party cannot influence the contract to internalize the externalities. (For a further discussion of this see e.g. Easterbrook and Fischel 1989) In corporate law, externalities are the typical argument for mandatory protection of creditors and future shareholders. A second reason for mandatory regulation is when parties face unequal bargaining power (Baldwin, et al. 2012). The source of such inequality is often asymmetric information, opening the door for opportunistic behavior by one party (see e.g. discussion in Williamson 1985). In contract theory, Ayres and Gertner (1999) are using this argument to argue for so called minoritarian or penalty defaults. The third reason for mandatory regulation is in situations of monopoly. However, this might also be seen as an example of an unequal bargaining power situation. To Cooter & Ulen's list we can also add the situation then one party in the contractual relationship in fact constitute a group of individuals, who together only with difficulty can coordinate their decisions in order to exercise their legal rights. This is the case where a trade-off has to be made between decision costs and Pareto sanctioned decisions (see Buchanan and Tullock 1965 and Charny 1991).

## **The transaction cost perspective on default rules**

Moving on to a transaction cost perspective on default rules, our argument is that such costs affect the level of default. We discuss the following transaction cost aspects:

- Costs associated with the opt-out technique
- The status quo–effect
- Transaction costs of altering rules

A traditional default regulation uses the opt-out technique. Parties to a contract can derogate from an opt-out rule by including another rule in their agreement. From a corporate law perspective, this contract could either be the articles of association, or a (unanimous) formal or informal agreement by the shareholders. In some cases, the contract could be a formal decision taken by the board of directors. For parties who wish to use the flexibility of the law and adjust their contract accordingly, the regulatory technique of opt-out will give rise to (at least) the following costs: The parties must be familiar with the law and the fact that the rules are defaults. Sometimes this necessitates taking counseling from a legal advisor. The parties then need to investigate alternative solutions to the regulated situation, negotiate and agree on the solution they believe fit their relationship best. The decision can be followed by formal requirements such as documentation and registration. Finally, there are costs associated with controlling and enforcing agreements.

As an example: suppose the law states free transferability of share as the default rule. Parties to a closely held business seek advice from a legal consultant on whether a right of first refusal, a post-sale purchase right or a ban of transfers is recommended in their situation, given the ownership structure and family situation of the owners. The parties agree on a combined solution, which is included partly in the articles of associations, partly in a shareholder agreement. However, future contingencies can complicate the contractual situation. If two years later, one of the owners enters into marriage, it gives the shareholders reason to reevaluate and rewrite some parts of the agreement. Or when an owner passes away, the remaining owners will enforce the transfer restriction chosen in the contract.

Irrespective of how natural the measures taken in this example seem for any entrepreneur or consultants, one must observe that each step to include contingencies adds on more costs on the contracting parties. High transaction costs always carry a risk that rational parties will choose to

not consider contingencies and will be stuck with suboptimal regulation instead of contracting for a tailored solution. One reason for such a rational inactivity can be that the parties believe that a situation is unlikely to occur and therefore not worth negotiating around (Eisenberg 1989, Korobkin 1997). But, in the rare event that the contractual regulation is needed, the decision of non-activity can be very costly. In conclusion, due to high transaction costs, opt-out as a regulatory technique must be placed in away from the left hand endpoint of the horizontal axis, and closer to the center of the scale.

There is also a status quo effect to consider in the explanation why a parties sticks with default rules even if it does not seem optimal (Korobkin 1997, Korobkin 1998). This kind of effect has been found in experimental tests of the Coase theorem. It has been found that “people sometimes demand much more to give up something that they have than they would be willing to acquire it” (Cooter and Ulen 2012, p 91). This is called the endowment effect. The status quo effect is quite similar. This too has to be taken into account when placing the opt-out technique along the horizontal axis.

If a legislator truly aims for a default character of the corporate legislation, it must also consider other regulatory techniques than opt-out. One alternative is to use opt-in regulation as it adds less on transaction costs for the parties then opt-out. By opt-ins, we understand legal rules or standards that are not automatically applicable to the contract, but dependent on an active choice by the parties. A distinction should to be made between opt-in rules that the firm is free to adopt and the case when the opt-ins represent the only deviations permitted from the main principle. In the latter situation, the opt-in is rather part of a mandatory regime than a non-compulsory alternative.

The cost lowering effect of an opt-in technique is first of all that it clearly indicates that the legal question is within a non-mandatory field of the law. Second, it directly states an alternative to the default rule, which helps the parties in their search for suitable alternatives. However, opt-in rules do not only save costs for the firm by supplying ready-made alternative contracts, there is also a network effect to consider (cf. Klausner 1995). The fact that the legislator has approved the formulation of an alternative contract clause is likely to have as a consequence that the clause will be frequently used and thus be subject to benefits of standardization. Just like a telephone become more attractive and valuable the more telephones there exist, a contract clause also becomes more attractive the more frequently it is used. Among other things, the

interpretation, information, price, and accessibility to legal services are facilitated by the benefits of network externalities. This lowers the cost of contracting and enforcement.

Opt-ins can also be combined into sets of rules, often referred to as menus (Ayres 2006). The advantage of such a regulatory system is that the opt-in-solutions can be tailored for different groups of firms, e.g. corporations with sole ownership, family firms, closely held businesses and listed corporations with dispersed ownership (i.e. when there is a separation between ownership and control). This helps the law to function as a standard contract corresponding to the hypothetical bargaining model for not just one main type of corporate businesses, but several. But simplification is desired in menus in order to facilitate the choice of best rules. Too many choices will affect the legislation in regulation intensity, putting it on the cost intense higher end of the vertical axis in our model. A menu of a limited number of opt-in rules that fit most types of corporations in the economy can substantially lower transaction costs. For this to be feasible, the menus do not have to cover full charters that regulate all aspects of corporate law. Rather, opt-ins in form of menus can preferable be used to some determinate part of the legislation, such as the transferability of share or the decision-taking organs of the firm. If the legislator succeeds in this endeavor, the regulatory technique of menus can be placed far to the left of the horizontal axis in Figure 2.

Our final transaction cost aspect of the level of default is based on Ayres (2012) theory of so-called altering rules. Altering rules are understood as legal conditions for displacing a default rule or standard, no matter if it comes in form of opt-out or opt-in rules. One example of such condition found in corporate law concerns the amendment of the articles of association. Such an amendment required several actions. A decision must be taken by the general meeting of shareholders, postulating numerous formal requirements to be fulfilled, including documentation and registration of the decision. If the parties fail to fulfill these requirements, the derogation from the default rule will not be legally binding. By acknowledging altering rules, another type of transaction costs is identified, which affect the level of default in corporate design. In order to lower contracting costs, attention must also be paid to how altering rules can be eased or abolished. In conclusion, for the purpose of our model on corporate law design, a regulatory technique with high costs of using the altering rules must be placed further to the right hand endpoint on the horizontal axis than the exact same technique with less cost intense altering rules. This conclusion applies regardless if the technique is based on rules or standards, on opt-out, opt-in or menus or if it corresponds to the hypothetical bargaining model or not.

### 3.4 Model summary

Regulatory techniques have different effects on the transaction cost of complying parties, i.e. between shareholders, directors and executive managers in a corporation. To illustrate the differences between regulatory techniques we use a model showing the level of regulation intensity and level of default. When the two dimensions, represented by the vertical and the horizontal axis of our model, are combined, it is possible to draw general conclusions on preferable techniques from a transaction cost perspective.

Starting with the vertical axis in Figure 1, we integrate two streams of. Both support a regulatory technique that corresponds to a high level of regulation intensity. First, according to the literature on rules versus standards, clear-cut rules are associated with greater predictability and therefore lower compliance costs. Hence, rules should be used to regulate frequent situations for the firm, while standards, being more flexible for changes in society, should be used only for mainly regulating non-day-to-day situations. Second, in line with the literature on majoritarian defaults, the theory supports legislation to also cover situations, which are hard to predict and therefore often are left out or forgotten by actual parties. Together, these two lines compose the vital elements for corporate law to function as a standard contract. In conclusion, theory support regulatory techniques with are to be placed on the upper end on the vertical axis. However, not on top, as such an all-inclusive piece of legislation would be too costly to overview and comply with.

For the legislation to fulfill the function as a standard contract, the legislator must take into consideration the heterogenic needs of firms. Hence, the legal framework can't fit the needs of all corporations. This is one important reason why the rules, as a starting point, should be of default character. Looking at the horizontal axis of our model, a transaction cost analysis favors a level of default to the left of the center of the scale. To achieve this level of default, the legislator cannot only rely on opt-out techniques, as it is followed by high transaction costs making the parties reluctant to derogate from the legal norms. Instead, the legislator should combine opt-out-regulation with opt-in alternatives and menus. In the mission of lowering the parties' transaction costs, the legislator must also acknowledge the cost of applying altering rules.

#### 4. The Swedish case

In this section, we illustrate the usage of the two-dimension model by applying it to a specific case. The full-length analysis of this case can be found in Almlöf (2014, chapter 9). The case deals with the regulation of organization and decision-taking organs in Swedish corporate law when applied to closely held businesses. Hence, the analysis is of a set of legal norms, which regulate some corporate governance issues within corporate law.

Swedish corporate law uses a one-size-fit-all regulatory technique. This means that there is only one corporate company form, the aktiebolag. The Corporate Act (Aktiebolagslag 2005:551) therefore includes rules that both fit the needs of public listed firms and small one-person corporations. Some rules only apply to public corporations, but most rules are applicable to all. The one-size-fits-all approach leads to a numerous amount of legal norms, putting it in the northeast quadrant in Figure 2. If the analysis is limited to chapter 7 and 8 of the act, regulating the general meeting, the board of directors and the CEO, the number of provisions are 130, composed by close to 10 000 words. In the area of organization and decision-taking organs, few legal questions are regulated by standards. Instead, the act consists of mostly rules, including many details of e.g. notice for meetings, meeting proceedings or adjournment. Hence, the legislator regulate most anticipated scenarios.

Based on these observations, it is possible to conclude the Swedish Corporation Act is following a hypothetical bargaining model with high level of idealization, also including situations that are rare and hard to predict and therefore often are left out or forgotten by actual parties. However, it is not possible to conclude that the law corresponds to majoritarian defaults, as it regulates firms of all sizes and organizational needs in one and the same act. As the act must fit corporations with dispersed ownership, the needs of closely held businesses are overlooked. This is unsatisfactory, since only around 1500 of all registered Aktiebolag are public corporations, and merely one third of them listed on a stock exchange. This amounts to 0,3% of all registered corporations. The result is that the law as a standard contract is suboptimal for most firms.

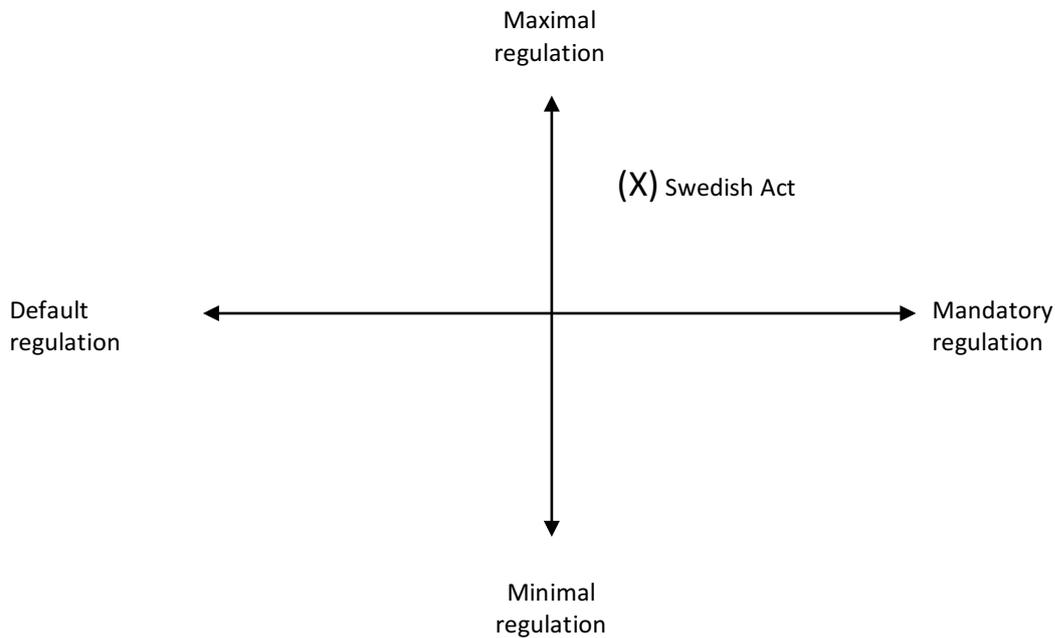
As the legislator recognizes this mismatch, the majority of the rules on organization and decision-taking organs are defaults. The opt-out regulation technique is almost exclusively used for this purpose, i.e. no opt-in alternatives or menus can be found. The default rules can be derogated from by a resolution by the shareholders in one of two alternatives ways. The first alternative is by a formal decision to amend the articles of association taken by the general

meeting of shareholders. By this decision, the contract clause included in the articles will have affect for all current and future shareholders. The act expressly regulates when this is possible. The second alternative is a decision to depart from the default rule taken by unanimous assent among the shareholders. Such decision will only have effect in the specific situation to which the assent applies, as it cannot have effect for future shareholders. The act only stipulates a few scenarios when this opt-out alternative is possible, leaving all other situations un-codified.

As indicated in this paper, the regulatory technique of opt-out is often associated with high transaction costs, bringing the technique close to the right of the center of the horizontal axis of the model. The opt-out rules in Swedish corporate law has high costs of altering rules as the agreement by the shareholders must fulfill formal requirements for the decision to count as a derogation from the legal norm. Even more cumbersome, the law is silent on when the second alternative, derogation though unanimous assent, is possible. In order to fully understand the scope of the principle of unanimous assent, one must perform an advanced legal analysis searching for the underlying purpose of the legal norm. Hence, legal expertise is required for the parties to take advantage of the flexibility of the law.

The above stated leads to the conclusion that, due to high transaction costs, the default regime of the Swedish Corporate Act is partly illusive. The flexibility of the law is hampered by the opt-out regulatory technique, high costs of altering rules and the veiled principle of unanimous assent. When placing the Swedish Corporate law in our two-dimensional model it will appear in the higher end of the vertical axis, representing high regulation intensity due to high degree of complexity, and slightly to the right on the horizontal axis, representing a regulation with low level of default. This however, does not correspond to the intent of the legislator, who is aware of the fact that the law design fails to meet the needs of closely held businesses (i.e. deviates from the theory of majoritarian defaults) but argues that this is compensated by the level of default (Preparatory works Prop. 2004/05:85, p. 199-203).

**Figure 2 Default and regulation intensity aspects of the Swedish case**



Therefore, we argue that in future legal reforms the traditional opt-out regulations technique should be supplemented, and sometime replaced, by other techniques. The Swedish legislator should strive for default rules that truly correspond with the hypothetical bargaining model. This means that the model firm should be closely held with few owners. The majoritarian defaults could be supplemented by tailored opt-in solutions for e.g. one-owner firms, closely held firms with separation between ownership and control and companies with a spread ownership. An alternative would be to have separate corporate laws for corporations with dispersed ownership and closely held businesses. We also argue for a codification of the principle of unanimous assent to visualize the veiled non-mandatory part of the legislation and a clarification of the scope of the principle. This will lower the transaction costs and thereby strengthen the level of default in the corporate law.

## **5. Concluding remarks**

In this paper we present a two-dimension model on corporate law design. Both dimensions are found in earlier literature on the regulation of corporations, yet until now they have not been combined and integrated into one model. This model functions as an analytic tool that helps us to understand and evaluate different regulatory techniques based on their level of regulation

intensity and the level of default. We also illustrate how the model can be used as an analytic tool for suggestions of policy changes based on a transaction cost analysis of a chosen set of legal norms.

We argue that one purpose of corporate law is to decrease the transaction costs for parties by offering attractive contract solutions that are adaptable to different and changing circumstances. The legislator can through the corporate law assist the firm in their search of a contractual solution that align the interests of shareholders in firms that have different ownership structures and plans for future ownership changes. By reducing transaction costs, the legislator makes sure that the corporate form continues to be attractive.

With help of our two-dimension model we have shown that is not enough to have default rules that give firms freedom to design their own rules that regulate relationships between shareholders. Equally, a low degree of regulation leaves firms in the blank of how to handle conflicts. The legislation can help firms by offering a standard contract that lower transaction cost of contracting and take the heterogeneity of firms into consideration. To succeed in this endeavor, the legislator should combine default rules and standards of opt-out character with opt-in alternatives and menus. Regarding the choice between rules or standards as regulatory techniques, we find that rules should be used to regulate frequent situations while standards should preferably regulate seldom-occurring contingencies.

Finally, we encourage more research on conceptual, empirical and/or comparative aspects of regulatory design. Such studies should among other things aim for conclusions, which can assist national lawmakers in the choice of regulatory techniques. However, there is a risk that the knowledge and conclusions stay in academia and never come to use. Yet, lawmakers should be interested in analyses of efficiency in rulemaking. We believe that there is a leap here to be overcome by researchers who are interested in having their regulatory theories tested in their national field of legal expertise.

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