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The Legal Structure of the Firm

Jean-Philippe Robé

Abstract

The notions of "firm" and "corporation" are very often confused in the literature on the theory of the firm. In this paper, the two notions are sharply distinguished: the corporation is a legal entity entitled to operate in the legal system and in particular to own assets, to enter into contracts and to incur liabilities. It is used to legally structure firms for numerous reasons, including the need to locate property rights key for the operation of the firm in the ownership of separate, "fictitious", legal persons. This avoids ex post-contracting bargaining by parties which otherwise would hold residual control rights over key assets used in the firm's operations. The assets partitioning effect of corporate legal personality has also several economizing properties reviewed in the article. The firm is the economic activity developed as a consequence of the cluster of contracts connecting the corporation owning these assets to various holders of resources required in the firm's operations. Numerous consequences deriving from this sharp distinction between corporation and firm are explained in this article, including the need to extend the circle of the beneficiaries of the firm management's fiduciary duties.

KEYWORDS: firm, corporation, assets partitioning, property rights, cluster of contracts

JEL Classification Codes: K22, M20

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Introduction

1. The dominant theory of the firm is built around the notions of agency, property rights and contracts. The common view is that the shareholders are the owners of the firm and that the managers, as their agents, must manage the firm in their interest. That's the micro, private, part of the analysis. The prevailing theory is also part of a broader, macro, societal view. Firms are assumed to be operating within perfect legal and political environments internalizing all externalities within the firms' production prices. All interests affected by the firm's activities (other than those of the shareholders') are assumed to be adequately protected by contracts and laws. Maximizing the shareholders' interests in the management of the firm is then presented as the only form of management to be socially beneficial. For some, this dominant theory of the firm is so established that it implies we have reached "*the end of history for corporate law*".[1]

In the history of corporate law, this now widely shared view and the corporate governance principles deriving from it did not always have the upper hand. In a famous debate which took place in the 1930's, E. Merrick Dodd and Adolf A. Berle debated "*for whom are corporate manager trustees?*"[2] Dodd pressed for the "social responsibility" of the firm (and its managers) while Berle advocated managers should pursue the shareholders' interests only. Twenty years later, Berle clearly acknowledged that Dodd was the winner in the debate.[3] Subsequent developments in the theory of the firm, however, have led to the misconception that the shareholders own the firm and that the managers -as the owners' "agents"- must manage the firm in the sole interest of their "principals", the shareholders.

2. This conclusion is based on a number of errors in the legal analysis of what a firm is:

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[1] Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 Georgetown L. J. 439 (2001).

[2] Merrick E. Dodd, *For Whom are Corporate Managers Trustees?* 44 Harv. L. Rev. 1145 (1932) responding to Adolf A. Berle, *Corporate Powers as Powers in Trust,* 44 Harv. L. Rev. 1049 (1931) who replied in Adolf A. Berle, *For Whom Corporate Managers are Trustees: a Note,* 45 Harv. L. Rev. 1365 (1932).

[3] *See* Adolf A. Berle, Power without Property: A New Development in American Political Economy 107-110 (1959). In Adolf A. Berle, Jr., The 20th Century Capitalist Revolution 169 (1954), Berle wrote "Twenty years ago, the writer had a controversy with the late professor E. Merrick Dodd, of Harvard Law School, the writer holding that corporate powers were powers in trust for shareholders while professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention".

(1) To start with, shareholders do not own *firms* and nor do they own *corporations*: they own *shares* issued by corporations. The shareholders enjoy the privileges of the owner towards what they own: the shares. They don't and can't have these privileges towards the corporation having issued the shares. They own neither corporations nor firms; no one does.[4]
(2) The assets managed by the managers of the firm are not owned by the shareholders: they are owned by a separate juridical entity, the *corporation* (or typically a group of corporations for larger firms). The partitioning of the real assets and liabilities deriving from the interposition of the corporation's juridical personality between the assets and the shareholders has very significant consequences: the shareholders' assets are isolated from the corporation's misfortunes by limited liability; equally, the corporation's assets are isolated from the shareholders by its strong form of legal personality. In the normal course of business, the bundles of assets and liabilities owned by the shareholders, on the one hand, and by the corporation, on the other, are totally separate thanks to the corporation's autonomous existence as a legal person.
(3) The firm and the corporation are very often confused in the literature on the theory of the firm. The two words are often used as synonyms. They correspond, however, to totally different concepts: a corporation is a legal instrument, with a separate legal personality, which is used to legally structure the firm; a firm is an organized economic activity, corporations being used to legally structure most firms of some significance.
(4) The corporation cannot be disregarded in the analysis as a mere "legal fiction" as is usually the case: the fact that firms *do not* have juridical personality and are legally structured around corporations, which *do* have juridical personality, has very significant consequences in a society in which (a) contracts can only exist between legal persons and (b) property rights, rules, regulations, liabilities and so on are allocated or apply to legal persons. It is essential for all social scientists having an interest in the firm, including economists, to differentiate the two concepts. The confusion between the two is at the origin of countless mistakes, some of which have very serious consequences. This article will show some of the most significant ones.
(5) In their role as managers of the corporation's assets, the officers are the agents of the assets' owner -the corporation itself. They are appointed by

[4] *See also* Yuri Biondi, "Accounting and the economic nature of the firm as an entity", in Yuri Biondi, Arnaldo Canziani & Thierry Kirat (eds.), The Firm as an Entity – Implications for economics, accounting and the law, Routledge (2007), pp. 237-265, at 248.

the board of directors but neither directors nor officers are the shareholders' agents because the shareholders own neither the firm nor the assets controlled by the managers via the firm's corporate structure.
(6) The managers, who themselves are not owners of the firm, or of the corporation or (as managers) of the shares, exercise power in the management of the firm because of their corporate positions. They are not automatic machines concluding and enforcing perfect contracts in a perfectly regulated world in which effective norms lead to the internalization of all externalities within the costs of all firms' production. They make unilateral decisions thanks to the property rights controlled by the firm's corporate structure. These decisions are having effects towards the firm's constituents and its environment.
(7) Being in charge of making decisions due to their corporate offices and not as owners, the managers have fiduciary duties towards those subject to the consequences of their unilateral actions. Shareholders are understood by all as being among the beneficiaries of these fiduciary duties. Because the corporate managers, as a consequence of the authority they get under corporate law, manage the firm -the organization built via contracts transferring control over resources to the corporations used to legally structure the firm- the managers' fiduciary duties extend beyond those they have towards shareholders. The law is still in its infancy in its acknowledgement of this fact; probably because of the widespread confusion between the notions of firm and corporation and the ill-founded agency theory.
(8) A precise analysis of the legal structure of the firm leads to a differentiation between corporate governance and firm governance. When making the confusion between the two, one confuses very different sets of issues. The analysis of the legal structure of the firm leads to an abandonment of both the "shareholder supremacy" and the "stakeholder" models of corporate governance. The first model is simply false as it is based on an agency theory which has no room in real life firms: managers are *not* the shareholders' agents; and the second one is insufficiently rooted in the reality of the firms' legal structure and of their environment and, as a consequence, the concept of "stake" is insufficiently precise to be operational.
(9) It is the concept of *fiduciary duty* and not the concept of *agency* which has to be further researched and extended to broaden our understanding of the firm and the adequacy of its governance (or lack thereof) to society's needs.

The prevailing and mistaken theory of the firm, grounded on an inappropriate neglect for its legal structure, leads today to a system of exercise of economic power in which the consequences of legal and political failures are being enhanced. The outcome of the Berle and Dodd debate[5] should therefore not be discarded on ideological grounds.[6] It must be revisited taking into account the reality of the firm's legal structure and of the global legal and political environments in which large firms operate.

3. In the first part of this article, I will distinguish firms and corporations. Simply put, the corporation is recognized by the legal system as being a juridical person having rights and liabilities; the firm is an economic organization which is not a juridical person and is structured using several legal institutions. Large firms, in particular, are organized using corporations which allow them to operate in the legal system and the economy and to structure their economic activity.

In the second part of the article, I will use an example, starting with two entrepreneurs having a brilliant idea, needing financing, succeeding at developing a product, meeting success in its marketing and building a large organization to the point that it becomes a multinational enterprise. We will follow their venture in 11 episodes which will allow us to address the numerous economic consequences of using corporations to structure firms. At the end of the process, we will hit the issues raised by the governance of large firms, which will be addressed in the third part of the article.

1. Firms and Corporations

1.1 Many Theories and A Widespread Confusion Between Firm and Corporation

4. The theory of the firm has evolved from almost nothing to an abundance of riches. Whereas in the neo-classical economic analysis the firm is a "black box", a

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[5] *See supra* note 2.

[6] For Hansmann & Kraakman, "The triumph of the shareholder oriented model of the corporation over its principal competitors is now assured. ... the ideological and competitive attraction of the standard model will become indisputable, even among legal academics. And as the goal of shareholder primacy becomes second nature to politicians, convergence in most aspects of the law and practice of corporate governance is sure to follow." *Supra* note 1, at 468. "Moreover, the new activist shareholder-oriented institutions are today acting increasingly on an international scale. As a consequence, their influence now reaches well beyond their home jurisdictions. We now have not only a common ideology supporting shareholder-oriented corporate law, but also an organized interest group to press that ideology"; *id*. at 453.

"production function", a mere "point" in the market, numerous alternative analyses have been developed.[7] Among them are the nexus of contract approach,[8] the property rights analysis of the firm,[9] the firm as a team,[10] the firm as a nexus of firm specific investments,[11] the firm as a collection of assets[12]; and so forth.

There are of course numerous valuable insights in all these contributions. But there is a widespread confusion between the concept of "corporation" and the concept of "firm" which negatively affects many of the conclusions reached. The two words are often used interchangeably, "company" or "enterprise" being also sometimes used as synonyms. The consequences of this linguistic and conceptual confusion are quite extraordinary. If this paper succeeds at explaining the differences between the concepts and why it is fundamental to make the distinction between the two, most of the literature on the theory of the firm has to be revisited to put the right words –and concepts– at the right place. I contend that many shortcomings in the analyses (some of which I will show in this article) can be avoided by the simple effort of being disciplined in the use of the words "firm" and "corporation".

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[7] *See generally* Louis Putterman & Randall S. Kroszner, The Economic Nature of the firm – A Reader (1996), who remark in their introduction that "where once an interest in what goes on inside 'the black box' of the firm had a faint scent of disloyalty to the enterprise of economics, such an interest in now part of the frontier of economic research"; at 31.

[8] For Fama, "The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs"; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980) at 290; for Fama & Jensen "an organization is the nexus of contracts, written and unwritten, among owners of factors of production and customers"; Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, J. L. & Econ. 301, 302 (1983). *See also* Harold Demsetz, *The Theory of the Firm Revisited*, J. of L. Econ. & Org. 141 (1988). As noted by Zingales, one of the major shortcomings of this approach is that it is unable to explain why firms merge at all. If the firm is simply a collection of contracts, the results achieved through a merger could be more simply obtained by writing a contract combining the two separate firms. *See* Luigi Zingales, *In Search of New Foundations*, J. of Fin. 1623, 1637 (2000).

[9] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, J. Fin'l Econ. 305 (1976).

[10] *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 Am. Econ. Rev. 777 (1972).

[11] *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, Virginia L. Rev. Vol. 85, No. 2 (1999).

[12] *See* Sanford Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, J. of Pol. Econ. 691 (1986) (they "define a firm to consist of those assets that it owns and over which it has control"; *see* at 693) and Oliver D. Hart & John Moore, *Property rights and the Nature of the firm*, J. of Pol. Econ. 1119 (1990).

1.2 Law Matters

5. Let's start with the firm. It would seem to make sense to consider that what we all designate in a loose sense as "Microsoft", "IBM" or "Toyota" are all "firms". At this stage of the analysis, we only need to have a broad understanding of these firms as being "what-it-is-that-they-are" which translates in the real world into the production and distribution of softwares, computers and cars respectively.

Because we live in a world in which ownership and binding obligations are defined by law, the builders and managers of these firms structure them using legal instruments: contracts, property rights and corporations. Note immediately that firms are structured *using* corporations; they are **not** corporations. And note also that the concepts of contract, corporation and property rights referred to in the theory of the firm are legal concepts in the first place, not economic ones. Authors writing about the firm may have their own views as to what property rights,[13] contracts[14] or corporations[15] are or should be. And many have resisted making their analysis using these concepts in their legal meaning.[16] The fact is, however, that because firms are developed in a world in which the terms of all economic exchanges obtain their binding effect via law, the builders of real life

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[13] Barzel, for example, warns in the introduction of his essay that "The intellectual content of "property rights"... seems to lie within the jurisdiction of the legal profession. Consistent with their imperialistic tendencies, however, economists have also attempted to appropriate it." Yoram Barzel, Economic Analysis of Property Rights xi (1989). See also Daniel H. Cole & Peter Z. Grossman, *The Meaning of Property Rights: Law versus Economics?* 78 *Land Economics* 317-330 (2002) demonstrating that economists' definitions of property rights do not reflect legal reality, which is fine only as long as transacting is costless. In coherence with the "Coase Theorem" (see Ronald H. Coase, *The Problem of Social Costs*, 3 Journal of Law and Economics 1-44 (1960)), however, in a world of positive transaction costs, the meaning of property rights is important. And a realistic analysis of the transactions costs effectively involved actually requires using the expression in its legal meaning.

[14] *See generally* Scott Baker, *Incomplete Contracts in a Complete Contract World*, paper presented at the Law and Economics of Intellectual Property Workshop of the University of Michigan Law School on April 6, 2006.

[15] For most economists, a public corporation consists only or principally of a set of contracts. The relationships among participants in the modern public corporation, however, are not primarily the product of actual contracts; *see* Robert C. Clark, *Agency Costs versus Fiduciary Duties*, in Principals and Agents: the Structure of Business 55, 60 & 62 (John W. Pratt & Richard J. Zeckhauser eds. 1985). But this view is widespread and even Margaret Blair writes that "the articles of incorporation and the by-laws, taken together, can be regarded as the basic architecture for a complex contract among the corporation, its management and board and its shareholders"; in Margaret M. Blair, Ownership and Control – Rethinking Corporate Governance for the Twenty-First Century 23 (1995).

[16] *See supra* note 11.

firms are bound to take into account the legal characteristics of property rights, contracts or corporations to structure firms. For them, law matters.[17]

6. Why has the need to distinguish between the corporation and the firm been so neglected? The reasons are complex and their explanation would require at least a full article dedicated just to this topic. To start with, the theory of the firm is relatively recent and is still "incomplete and unclear".[18] Economists' interest in "real-world applicability of theory" is also (relatively) recent.[19] The relevance of law has not been unnoticed, but without much effect.[20] Professional and academic specialization of course played a key role. In all fairness, also, economists were not helped by the lack of discipline among lawyers in their own

[17] Coase adequately remarked that "until quite recently most economists seem to have been unaware of this relationship between the economic and legal systems except in the most general way." Ronald H. Coase, *1991 Nobel Lecture – The Institutional Structure of Production*, in The Nature of the Firm – Origins, Evolution, and Development 227, 233 (Oliver E. Williamson and Sidney G. Winter eds. 1993). See also Geoffrey M Hodgson, *The Legal Nature of the Firm and the Myth of the Firm-Market Hybrid*, Int. J. of the Economics of Business, Vol. 9, n°1, pp. 37-60 (2002), at 47 who appropriately remarked that "the onus is on those challenging the importance of the law to provide concepts and criteria to discern the 'true' reality 'behind the legal forms". "The following challenge is posed to those that wish to dispense with a legally-oriented definition of the firm: please provide us with a good reason for doing so." Id. at 55.

[18] Demsetz, *supra* note 8, at 141. Although the remark is 20 years old, it is still true today. Demsetz also remarks that "From the birth of modern economics in 1776 to 1970, a span of almost 200 years, only two works seem to have been written about the theory of the firm that have altered the perspectives of the profession – Knight's "Risk, Uncertainty and Profit" (1921) and Coase's "The Nature of the Firm" (1937)"; *id*.

[19] Cheung remarks that the "surging interest in [Coase' 1937 paper on the Nature of the Firm] during the past decade is one measure of the change in view among economists about the importance of the real-world applicability of theory which Coase and others have helped to promote". *See* Steven N. S. Cheung, *The Contractual Nature of the Firm*, J. of L. & Econ. 1, 23 (1983). He also reminds that "Knight and Hayek ... shared an early interest in Coase's subject matter. But came the Keynesian revolution, and whatever observations economists did not understand found refuge in various "imperfections""; *id*. at 21. Coase made it clear that: "when economists find that they are unable to analyze what is happening in the real world, they invent an imaginary world which they are capable of handling". See Ronald H. Coase, *The Nature of the Firm - Meaning*, in The Nature of the Firm – Origins, Evolution, and Development, 48, 52 (Oliver E. Williamson and Sidney G. Winter eds. 1993).

[20] Demsetz suggested, though, that "it might be useful to adopt legal notions of what a firm is and what it is not". Demsetz, *supra* note 8, at 155. Clark also suggested that "a closer focus on actual rather than presumed legal doctrines and concepts might do much to refine our current theory of the firm." *Supra* note 15, at 55 (emphasis added). As remarked by Ronald Coase in his 1991 Nobel Lecture, "If we move from a regime of zero transaction costs to one of positive transaction costs, what becomes immediately clear is the crucial importance of the legal system in this new world." In Ronald H. Coase, *supra* note 17. A lot of energy has been spent on the *economic analysis of law*; spending time on the *legal analysis of economics* is at least equally fruitful.

use of the vocabulary: the linguistic and conceptual confusion between the firm (or enterprise) and the corporation (or company) is also surprisingly widespread among lawyers.

1.3 The Firm is not a Legal Person and Large Firms Operate in the Legal System via Corporations

7. Corporations are apart among the legal instruments used to legally structure firms. The reason for this is that they are treated by the legal systems as if they were "real" persons (with some adaptations), i.e. they can participate in the legal systems through the phenomenon of "juridical personality". They can own property, have debts, contract, sue and be sued in courts, get bankrupt, etc. –i.e. they can "function" in the economy like human beings because they are treated by the legal system as if they were "persons".

The importance of juridical personality has been disregarded by many.[21] Some actually dismissed its significance by calling it a "legal fiction" – essentially because only people are deemed to be "real". As a key example of this not so benign neglect for the legal structure of the firm, Michael Jensen and William Meckling wrote in one of their renowned articles that:

> "...most organizations are simply legal fictions. This includes firms, and even governmental bodies such as cities, states... The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships..."[22]

It is of course true in some sense that corporations are "fictions". You can't have lunch with Microsoft Inc.. But then the United States of America is also a "legal fiction", the European Union is a "legal fiction" and the United Nations is a "legal fiction". Even if one accepts that, in a very discrete meaning, these "juridical persons" are "fictions", they are pretty significant ones and actions and acts -admittedly always done or committed by individuals but attributed *by law* to these "fictions"- have very significant consequences. If some unknown person mistakenly calling himself the President of the United States declares war on Iraq, nothing happens. If one George W. Bush does the same after going through the legal process of becoming elected President of the United

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[21] *See* Margaret M. Blair, *The Neglected Benefits of the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, in Corporate Governance and Firm Organization: Micro foundations and Structural Forms 45 (Anna Grandori ed. 2004).
[22] Jensen & Meckling, *supra* note 9, at 8-9.

States of America, thousands of people will die, billions of dollars will be spent and the whole world will be affected. Note that most of the people affected in the world were not offered an opportunity to participate in the process which led to the election of Mr. Bush and still had to bear the consequences. In other words, the interests affected by the executive power of a legal fiction (in this case, the United States of America) can go well beyond those treated as its constituents. Similarly, the interests affected by the executive power of the other type of "legal fiction" of interest for us -the large listed corporation- go well beyond those who are offered an opportunity to vote: the shareholders. Calling the corporation a "legal fiction" to deny its economic significance seriously misses the importance of juridical personality -and in particular (a) of the ability to act on behalf of legal persons owning assets and (b) of being part of the constituents of the "legal fiction". In a society where relations among individuals and institutionalized groups are in great part structured by this phenomenon called "law", it is of high importance to take into account *which* are the "fictions" habilitated by the legal system to own property, have debts, contract, sue and be sued in courts, get bankrupt or accumulate assets and live an infinite life.[23] And it is of equal importance to be aware of *which* groups or institutions or notions are *not* treated as "legal fictions", and therefore *cannot* own property, have debts, contract, etc. The first ones can have recourse to the State legal and force systems to get their rights enforced. They are also subject to the legal and enforcement systems and can have obligations imposed upon them. That's the flip side of the coin and it is a very significant consequence of having legal personality: the enforcement of the contracts they conclude can be imposed upon them; and they are subject to laws and regulations. And they can have liabilities. As for the groups or institutions which do not have legal personality, they do not exist in contemplation of the law as persons; they do not have rights and, conversely, they cannot incur liabilities. As we will see, this is a key issue: organizations (firms) have found the way to operate as if they had rights (through corporations) without incurring the liabilities they create as organizations existing beyond their corporate structure.

8. Disregarding the importance of legal personality in the theory of the firm is particularly damaging because it is the corporation which has legal personality and **not** the firm. Many of the issues in the theory of the firm and in the so-called "corporate governance"[24] debate come from the fact that the

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[23] Actually, as Searle emphasizes, "creating a so-called fictitious "person" ... is an important breakthrough in human thought. ... I regard the invention of the limited liability corporation ... as one of the truly great advances in human civilization". John R. Searle, *What is an Institution?*, J. of Inst'l Econ. 1, 17 (2005).

[24] It is quite significant that the debate is not on "firm governance". Although corporate finance concerns the financing of *enterprises*, for historical reasons, the idea of enterprise that became

[Footnote continued on next page]

corporation is a "legal fiction", that the firm is none and that the consequences of this difference have been ignored by many. As we will see, as a consequence of the distinction between the two, corporate and firm governance should be analyzed as two very different topics.

1.4 The Not So Relevant Theories of Corporate Personality

9. It is not necessary for the purposes of this article to go into much detail on the issue of whether a corporation is really a "legal fiction" or not.[25] For centuries, there were debates among lawyers on this question.[26] Broadly speaking, three theories emerged, under different names.[27]

The first theory is the "State grant theory", also called "fictitious personality theory", or "concession theory" or "hierarchical theory". Under this theory, groups gain legal status by the process of *incorporation* and only the State can incorporate groups and give them juridical personality. Corporate personality is *created by the State*, in the realm of *public law*, and the rights and duties attaching to juridical personality are determined by the State at its discretion.

[Footnote continued from previous page]
ingrained in corporate finance coincided with the legal notion of *corporation*, and the field was subconsciously shaped by this identification of the object of study with the legal entity known as a corporation. *See* Zingales, *supra* note 8, at 1626. It is untrue, though, that "in the past, the legal notion of a corporation captured closely enough the economic boundaries of the firm"; *id*. at 1643. This has *never* been the case. It has always been and remains true that "what defines corporate finance is its focus on the challenges raised by financing the unique combination of assets and people that we call firms. Understanding what makes this combination unique is a fundamental step we cannot postpone any longer." *Id*. at 1643.

[25] *See generally* Reuven Avi-Yonah, *The Cyclical Transformation of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, 30 Del. J. Corp. L. 767 (2005). *See also* French, Peter A., The *Corporation as a Moral Person*, 16 Am. Philo. Q. 207 (1979).

[26] *See generally* Ron Harris, *The Transplantation of the Legal Discourse on Corporate Personality Theories: from German Codification to British Political Pluralism and American Big Business*, 63 Wash. & Lee L. Rev. 1421 (2006) for a general presentation of the theories and how they evolved and migrated between legal systems. And generally Morton Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. Va. L. Rev. 173 (1985).

[27] There are actually even more names for the three "triads" than the ones indicated in this paper; *see generally* Katsuhito Iwai, *Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance*, 47 Am. J. Comp. L. 583 (1999) who refers to "fiction theory / corporate nominalism / corporate realism" and reminds that other "triads" have been "fiction theory / bracket theory or expansible symbol theory / corporate realism or fellowship theory" (Maitand); or "fiction theory / subjective rights theory / theory of reality of corporate personality" (Hallis); or "Savigny's fiction theory / Jhering's symbolist theory / Gierke's realist theory" (Derham); or "creature theory or concession theory / group theory / person theory" (Shane).

The second theory is the "contract", or "aggregate" or "partnership theory". Groups become legal entities by the voluntary and consensual *agreement* among their members. The birth of the new juridical entity happens in the realm of *private law*.

The third theory is the "real entity theory", or "natural entity theory". The *social existence* of a group makes it a legal person distinct from its members. The entity exists as such and the law does not create it: it is bound to recognize and respect its real existence. The arising conscience of the existence of the firm as an organization beyond its corporate structure leads to a rebirth of this theory.[28]

10. Even for lawyers, perceived as being prone to live in a world of fiction, accepting the idea that there can be legal persons who are not individuals has been a lengthy and painful process. The debates have been intense, of course very much politically charged, but are not very relevant for our analysis at this stage. Whatever the historical origins of corporate personality (which are *very* relevant for other purposes), creating a limited liability corporation having separate legal personality today is an uneventful process, a mere formality. For most of history, it was quite the opposite, until (broadly) the first half of the nineteenth century in the United States and the second half in Europe.[29] This "liberalization movement" came as a result of a mix of competition among firms and, derivatively, among States to facilitate firms' activities. States were led to abandon their initial resistance to letting private parties creating limited liability corporations. This relaxation of corporate law has been nicknamed in the US the "race-to-the-bottom" by some and the "race-to-efficiency" (or "to the top") by others.[30] Similar developments took place in Europe, in the wake of the expansion of free trade *via* treaties in the last third of the nineteenth century.[31] As a result of this historical process, today, a single individual (as "incorporator") often can sign articles of incorporation, go through certain registration formalities and obtain the creation of a corporation. Today, the corporation is therefore *not* a concession (the content of the articles of incorporation is set by the individual with very limited constraints); it is *not* a contract (it can be created by one individual only); it is *not*

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[28] *See generally* Yuri Biondi et al., *supra* note 4.

[29] *See generally* Jean-Philippe ROBÉ, L'entreprise et le droit 46-61 (1999) available at http://www.globalization-blog.info/.

[30] *See generally* Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev. (2003). *See also* R.E. Seavoy, The Origins of the American Business Corporation (1784-1855) - Broadening the Concept of Public Service during Industrialization (1982).

[31] Robé, *supra* note 29, at 60-61. For France, *see*, for example, C.E. Freedeman, Joint-Stock Enterprises in France 1807-1867: from Privileged Company to Modern Corporation (1979). For England, *see* for example B.C. Hunt, The Development of the Business Corporation in England, 1800-1867 (1969, 1st ed. 1936).

a "real person" deriving from the social existence of a group (there is no group from which any "real person" could derive). It is a mere technical legal device made available by the legal system to facilitate the organization of business activities.[32]

It might be a different story for the firm. But the firm clearly does not exist as a separate legal person either via State law creation or private law mechanisms. The question of whether it exists *as such* as a "real" entity (the third theory) is a much more complex one. To address it, we have to go into the details of the firm's legal construction and operation.

2. The Creation and Growth of a Firm

11. To facilitate addressing the legal complexity of large firms and the numerous issues their existence raise, I will now start using an example to show how things can start and progressively develop.

Episode 1

2.1 How to Address the Issue of the Incompleteness of Contracts via Assets Partitioning

John and Bob are postgraduate students. John studies biology and Bob engineering. One evening, after a drink or two, they come up with a brand new idea: they think they know how to develop a product (the Sleepless device) which will allow people to sleep half the time they usually need. They start spending every Saturday in John's garage developing the Sleepless device. The first results are promising. They even obtain a patent in their two names; but they need money to go further. They go to see their banks, trying to get a loan; the answer is "no" - the project is too risky; and they have no asset to give as collateral (the bankers are not in the business of providing equity capital -capital at risk- and think the patent is worthless; and, for some reason, they do not trust John). But John has his uncle Ken, wealthy, interested in the project and ready to

[32] There is indeed so little restriction now that businesses exist which maintain inventories of inactive corporations and sell them to their clients needing them in a hurry. "They just sit there like orphans waiting to be adopted"; Henry P. Hill, Accounting Principles for the Autonomous Corporate Entity, 36 (1987).

invest 1,000,000 $ -but not at all interested in doing anything else. They need to agree on how to legally structure the venture.
They start drafting an agreement among them describing who will do what in the venture, who will get what in case of success, what will happen in case of failure. Having a hard time finding a solution to all their problems, they decide to hire a lawyer. The lawyer is quite unimaginative and advises them to create a corporation - Sleepless Inc. - equally among them. The reasoning is that John and Bob have an equal right in the patent and they have an equal need to get Ken contribute the required funds. And Ken agrees to consider that the present value of John and Bob's patent is 2,000,000$. So they decide to create a corporation jointly controlled. The lawyer explained them that their relationship in connection with the venture will be ruled by the company's articles of incorporation and bylaws and that, in case anything is missing in these documents, the corporate law of the State of incorporation will provide a solution.

12. In the standard neoclassical economic theory, the issues John, Bob and Ken face are not to be addressed by economists: the firm is taken as a given, no attention is being paid as to how it came into existence or to its internal organization.[33] Neoclassical theory views the firm mainly in technological terms, the firm being a perfectly efficient "black box" inside which everything operates perfectly smoothly. There is no incentive problem within the firm; the theory has nothing to say about the internal organization of the firm or where its boundaries lie.[34]

Things changed with Coase's seminal article on the "*Nature of the firm*"[35] and subsequent developments, in particular the work of Oliver E. Williamson on transaction costs economics.[36] Since part of the economic activity takes place within firms and firms do not operate internally via prices why, if markets are so

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[33] *See* Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, in The Nature of the Firm – Origins, Evolution, and Development 138 (Oliver E. Williamson and Sidney G. Winter eds., 1993). *See also* Coase's Nobel lecture, *supra* note 17, at 229 and 233 where he optimistically remarked that "The time has surely gone in which economists could analyze in great details two individuals exchanging nuts for berries on the edge of the forest and then feel that their analysis of the process of exchange was complete."

[34] Oliver D. Hart, Firms, Contracts and Financial Structure 17 & 18 (1995).

[35] Ronald H. Coase, *The Nature of the Firm*, 1937 Economica N.S. 386.

[36] "... transaction costs economics is by design, an interdisciplinary undertaking"; in Oliver E. Williamson, The Economic Institutions of Capitalism 1 (1985).

perfect, do firms exist in the first place? There must be some costs associated with the operation of the market which firms allow reducing. The answer lies in "transaction costs": there are costs of operating the economic system, and since firms exist in a market economy, they somehow must be efficient at economizing the costs of using the market or even at making possible transactions otherwise impossible because of excessive market transaction costs. To find what these costs are, some of the unrealistic assumptions of the classical theory were relaxed: we live, in fact, in a world in which there is (in particular) imperfect information, bounded rationality (i.e. individuals are "*intendedly rational, but only limitedly so*"), opportunism (i.e. individuals are "*self-interest seeking with guile*"[37]), uncertainty, asset specificity, and so on. In such a world, there are transaction costs of writing contracts. It is not possible to think about, plan for and write down provisions for all future events in a "comprehensive contract" specifying precisely the parties' obligations in every conceivable state of the world.[38] The view developed by Williamson and others is that we live in a world were

> "transaction costs are pervasive and large. As a consequence ... the parties to a relationship will <u>not</u> write a contract that anticipates all the events that may occur and the various actions that are appropriate in these events. Rather, they will write a contract that is <u>incomplete</u>, in the sense that it contains gaps or missing provisions... . A result of this incompleteness is that events will occur which make it desirable for the parties to act differently from the way specified in the contract. As a consequence the parties will want to revise the contract. In addition the parties may sometimes disagree about what the contract really means; disputes may occur and third parties may be brought in to resolve them."[39]

Oliver Hart went one step further and concluded that the incompleteness of contracts opens the door to a theory of ownership.[40] If the contract the parties write is incomplete, ownership of the assets involved will be an important source of power enhancing the owner's bargaining position during renegotiations. The owner is in a strong position because of the *residual rights of control* characterizing ownership. The owner of an asset may bind himself and the asset via a contract; but for anything which is not specified in the contract, the owner has the residual control rights and therefore has a strong *ex post* bargaining

[37] *Id.* at 47.
[38] Hart, *supra* note 33, at 140.
[39] Hart, *supra* note 33, at 141 (emphasis in original).
[40] Hart, *supra* note 33, at 141.

position.[41] This idea forms the basis for the theory of integration developed by Grossman and Hart,[42] although Hart later acknowledged that a major limitation of their analysis is that financial resources constraints are ignored and the owner of the asset is assumed to be a single individual.[43] He recognized that external financing introduces a further class of parties interested to the transaction: creditors and equity holders, which "*complicates the ownership puzzle greatly*".[44] In our example, we have a real life ownership puzzle "greatly complicated": two parties co-owning an asset (the patent) and one would-be party required to finance the venture. We have to think further.

13. To simplify the ownership puzzle greatly, I will open a different door leading to an understanding of the importance of juridical personality <u>and</u> of locating key assets within the ownership of an "artificial" legal person. In a situation where it is difficult or even impossible to agree details in advance in a complete contract, parties intendedly rational -even if only limitedly so- will *not* choose to write an incomplete contract and see what happens, as suggested by Williamson. They would be foolish to put themselves in a position where they know in advance events will occur forcing them to revise the contract, on which

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[41] This view has been criticized by Demsetz on several accounts; one of them being that the value of assets derives from the value of all rights in it and not just from the residual control rights – which is correct; another one being that "it is not impossible to contract meaningfully for the entire bundle of residual control rights" –which is wrong. And Demsetz himself gives an example which actually proves that he is wrong: "Consider land known to contain valuable mineral –Demsetz writes. Party X initially owns all rights to this land… Suppose that he is interested only in being able to mine this land for its minerals. He can profit from the sale of all other rights to use the land by selling them with the proviso that they may not be exercised in ways (not presently describable) that <u>raise</u> [emphasis added] the cost to him of mining the land for its minerals. … If Y accepts the offer, he will not be able to use residual control rights in ways that some future court judges to have infringed on X's ability to exercise the rights he has retained." Fine. But if some future technology is discovered which allows to <u>reduce</u> X's cost of mining and Y is in a position to prevent X to use it because of the residual control rights he owns, the proviso X inserted in the sale contract will be useless. Demsetz just demonstrated that X -advised by Demsetz overly confident that he could draft a contract transferring residual contract right- is unable to compete in the market place and goes bankrupt. He could not *"contract meaningfully for the entire bundle of residual control rights*", which is precisely Hart's point; see Harold Demsetz, Book review of *Firms, Contracts and Financial Structure*, by Oliver Hart, 106(2) J. of Pol. Econ. pp. 446-452 (1998), at 448-450. And even if Party X and his advisor Demsetz were to try to develop a theory demonstrating that preventing from *reducing* costs in effect is the same thing as *increasing* costs, they would have to convince a third party judge that such is the case. They would have a hard time and even if they succeed -an unlikely outcome- they would have put themselves in the "incomplete contract" scenario they wanted to avoid in the first place.

[42] Grossman & Hart, *supra* note 12.

[43] Hart, *supra* note 33, at 154.

[44] Hart, *supra* note 33, at 154.

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they will most likely disagree (given opportunism) which will put them in the hands of a third party to resolve their dispute. Businessmen acting in such a way go bankrupt.

Rather, a solution is (a) to create a separate juridical entity to own or control the key assets used in the firm's operations and (b) to specify (in the articles of incorporation and bylaws, or even via a side shareholders' agreement) the *procedures* which will be followed to operate the venture. And if the procedures provided for in the articles of incorporation and bylaws are incomplete, corporate law and general contract law will specify the rights and obligations of the parties.[45] One of the key advantages of creating a juridical person owning or controlling the assets used in the business is precisely that it avoids having to agree in advance on detailed contracts among the shareholders to specify who will do what in what circumstances and get what in return. All the rights, including the residual control rights in connection with the various assets contributed to the business, are now owned by the "artificial" juridical person, not by any of the contracting parties. After contribution of the assets to the corporation, decisions about their use will *not* be made by contracting parties negotiating to revise their contract with some parties having residual control rights over the real assets while others have none. The decisions will be made by the officers or directors or shareholders, in accordance with the company's articles of incorporation and the applicable corporate law, which provide for procedural rules governing how decisions will be made through time in connection with the venture. It is precisely because we do *not* live in a comprehensive contracting world that there is room for creating corporations, as separate legal persons, to own businesses and as a consequence deal with future issues as they arise in accordance with the by-laws and corporate law.[46] *The incompleteness of contracts indeed leads to an understanding of ownership: to an understanding of ownership by separate juridical persons.* The so-called "legal fiction" of the corporation, far from being negligible in economic analysis, *is actually central to it*.

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[45] Contracts are never truly "incomplete" because contract law specifies the parties rights and obligations if they fail to do so themselves. *See generally* Baker, *supra* note 14. And "contract law default rules allocate bargaining power during negotiations in much the same way that ownership does"; *id*. at 13. In real life, in our example, put and call options on the shares would most likely complete the picture.

[46] *See* Oliver Hart, *An Economist's View of Fiduciary Duty*, U. of Toronto L. J. Vol. 43, No. 3, Special Issue on Corporate Stakeholder Debate: The Classical Theory and Its Critics (Summer, 1993), 299, 301. *See also* Oliver Hart, *Corporate Governance: some theory and implications*, Econ. J. 678, 680 (1995).

14. So far in our example, though, a partnership having separate legal personality,[47] would have worked just as well. A corporation was not particularly needed at this stage. What was needed was having an entity having separate legal personality to own or control the assets used to build the firm.

Episode 2

2.2 How to Economize on the Costs of Transacting with Third Parties by Using a Separate "Fictitious" Legal Person to Structure the Business

John & Bob knew they would rapidly need to hire employees. But who would be hiring them? John? Bob? Ken (who does not want to be involved)? The three of them jointly? But how? Who would be buying the computers required, sign the lease for the required premises, and so on?

In case no separate entity having legal personality is created, John, Bob and Ken have a practical problem: who is going to conclude the contracts with third parties required to develop their activity? Without the creation of a "legal fiction" to serve as counterparty to the contributors of resources to the venture, the structuring of their business would be very complex. Are the employees going to have three employers? Who is going to pay their salary, and in what proportion? What happens if one of the co-employers does not pay? Do the other two have to pay his share of compensation? What happens if one of the co-employers wants to fire the employee and the other two don't? The issues are endless and exist, in continuously renewed ways, with regards to all contracting parties whose input is required in the operation of the firm. Creating a legal entity also solves this problem: it greatly reduces the transaction costs of operating the business by making the drafting and enforcement of the contracts much simpler. Not only is it therefore necessary to locate property rights in the ownership of a separate legal person to facilitate future decisions about them; creating a separate legal person to operate the business also greatly simplifies its operations and the drafting and performance of contracts with third parties.

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[47] Partnerships do not always have separate legal personality and, historically, the absence of personality was more the rule than the exception. See, for example Stanley E. Howard, *Business Partnerships in France before 1807*, 7 The Accounting Review pp. 242-257 (1932) and the comparison between US and French partnerships at 245.

15. But in this regard too, a partnership having separate legal personality would have worked just as well: it could have been the contracting party opposite the employees, the seller of the computers, the landlord, etc..

Episode 2 (continued)

2.3 How Using a Separate "Fictitious" Legal Person will Facilitate the Venture's Accounting

The lawyer also told John, Bob and Ken that the Sleepless device will now be developed by a separate legal person -Sleepless Inc.- which will own the assets acquired with the capital contributed and the cash flows of the company and execute the contracts with third parties. As a company, it will have its own separate accounting, balance sheet and profits and losses statements, which will determine whether Sleepless Inc. is making a profit or losses over a period of time (say a civil year) and that they will share equally these results.

Having separate legal personality facilitates the management of the venture: the inputs are being purchased or leased by the legal entity and the outputs are being sold by it, the legal entity pocketing the difference. It makes it practical to have a specific set of accounts for the venture. Without it, the accounting of the venture would be much more complex because the assets and liabilities would be attached in the first place to other legal (physical) persons, whatever the contractual arrangements among the parties to consider that they should be treated as one bundle of assets and liabilities "of the business". Ronald Coase always insisted on the importance of accounting, considering that the theory of the accounting system is part of the theory of the firm.[48] His view was that "*outside the firm prices and therefore costs are explicit ... and are determined by the operation of the market, within the firm there are explicit costs ... but they are provided by the accounting system. This internal system takes the place of the pricing system of the market*."[49] Accounting does play a key role in the theory of the firm. But when one makes the distinction between firm and corporation, one immediately realizes that the operation of the <u>firm</u> will be guided by the accounting of the <u>corporation's</u> legal activity. What is accounted for and

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[48] *E.g.* Ronald H. Coase, "Accounting and the theory of the firm", in Biondi et al., *supra* note 4, pp. 82-91, at 90.
[49] *Id.*

how will be a key determinant of the firm's activity. But what is accounted for is that part of the firm's activity which gets translated into events to be accounted for at the corporate level – which does not necessarily comprise the whole of the firm's impact on costs and prices.

16. Here also though, there is no difference between the corporation and other forms of "legal fictions". The differences start now.

Episode 2 (continued again)

2.4 How Using a Corporation Protects the Shareholders' Wealth

Ken in fact never trusted his nephew John (whom he thought was a brat merely interested in playing poker) but thought Bob was a really smart guy. He was relieved to learn (from his own lawyer) that each shareholder's personal liability would be limited to the contribution made to Sleepless Inc.. In case of success, Ken will become richer; and in case of failure, he will loose at a maximum the 1,000,000 $ invested, but his other assets will be isolated from this misfortune.

To protect himself from his liability going beyond the 1,000,000 $ invested, Ken could make a loan, to John, to Bob, to the two of them or to the company they would create. But then, in case of success, he would get his 1,000,000 $ back plus interest, and nothing else. And in case of failure, he gets a worthless claim either against individuals who have no assets or against a bankrupt company. His risk is not compensated (the interest being assumed to be only the compensation of the time use of his money). If he invests in equity (he gets shares in the company which will develop the business), of course he loses his investment in case of failure. But in case of success, he gets his share of the success (the percentage of the value of the company his shares represent). That's the difference between debt and equity.[50]

If Ken, who is wealthy, were to form an unlimited partnership with John and Bob,[51] he would be at risk of losing *more* than the 1,000,000 $ invested. In

[50] Although the difference gets blurred for many complex securities combining aspects of the two. This allows structuring the allocation of risks and rewards in a sophisticated fashion.

[51] In this paper, I will ignore intermediary forms between the unlimited partnership and the corporation. These intermediary forms exist in all sophisticated economic-legal systems and combine elements of the two to make them more suitable to the needs of specific businesses than

[Footnote continued on next page]

case of failure, creditors would go after him, because he is the only one who could pay the partnership's debts. Such a legal structure would force him to get involved much more than he would like to in the business affairs, because he would (at least) have to monitor John and Bob closely to stop the venture from going too far into disaster. He is ready to invest 1,000,000 $ but not more. Limited liability will do this for him: it will (1) limit his exposure to losing the 1,000,000 $ invested <u>and</u> (2) allow him to have a relaxed attitude about the management of the company.[52] In contradistinction, partnerships are limited as legal vehicles to be used for the development of large firms on a series of accounts. The partners do not enjoy limited liability in connection with the partnerships' operations which reduces the possibility to make passive equity investments in the business.[53] Unlimited liability is also an impediment to the development of a market for equity securities, reducing the firms' ability to tap equity financial markets. Also, there is no strict separation of the business and personal assets of the partners, which implies a limitation in the liquidity (marketability) of the shares. In addition, it makes it harder for external financiers to extend debt financing since they cannot rely on the continued existence of a pool of assets, liabilities and contracts (i.e. the continued existence of a business) sufficiently partitioned from the partners' to be financed without taking into account the identity of the partners, their personal situation (personal wealth, debts, marital and family status, health, etc.) and the risk factor they represent. Death of one of the partners is also a significant issue for the continued existence of the business. The financing of partnership is therefore made inherently risky and limited, both for equity and debt investors.

There are circumstances where an activity can be developed without using a corporate vehicle. This is true, however, only as long as the firm does not need any significant external financing. When it does, external financiers request a partitioning of the assets via the creation of a corporation to reduce their risks and isolate the firm from the incidents which may occur in the life of the partners, such as death, divorce, sickness and so on. No large business, even when

[Footnote continued from previous page]
the extreme forms. Excluding the study of intermediary forms from the analysis avoids side issues which can be addressed separately along similar lines.

[52] *See* Blair, *supra* note 21, at 52. The point had been made by Easterbrook & Fischel: limited liability reduces the costs of the separation of investment and management, it makes diversification and *passivity* rational strategies and it makes the identity of the other shareholders irrelevant; *see* Easterbrook Frank H. & Daniel R. Fishel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89 (1985), at 94-95.

[53] *See* The Report of the Task Force of the ABA Section Of Business Law Corporate Governance Committee On Delineation Of Governance Roles & Responsibilities, August 1, 2009 (hereafter "The 2009 ABA Report"), at 4.

controlled by billionaires, is directly owned by these individuals. Corporate structures are always interposed between them and the business.

17. To continue with the analysis of what's happening in our example, for Ken, limited liability is not of "*distinctly secondary importance*" as asserted by Henry Hansmann and Reiner Kraakman.[54] They think the same result can be achieved by contract. Easterbrook and Fischel also.[55] I don't: (a) assuming *contractual* limited liability could be obtained by inserting in each and every contract executed by the corporation a clause limiting liability to the net assets of the company (as they suggest), it would impose a heavy duty on Ken to check John and Bob's actions and in particular that they do, in practice, introduce the clause in each and every contract executed by Sleepless Inc.. Practically, this can not be done, even with a vast expense of efforts. And remember: Ken does not want to do anything –a perfectly legitimate attitude. And (b) there is no way such a protection could be obtained against *tortious* liability: if in the process of developing the Sleepless device someone gets hurt, there will be no contractual clause agreed to in advance by the victim of the accident to limit Ken's liability.[56] Limited liability deriving from the existence of a corporation interposed between the business and the shareholders is of "*distinctly primary importance*". And it can't be obtained by contractual means.

Episode 3

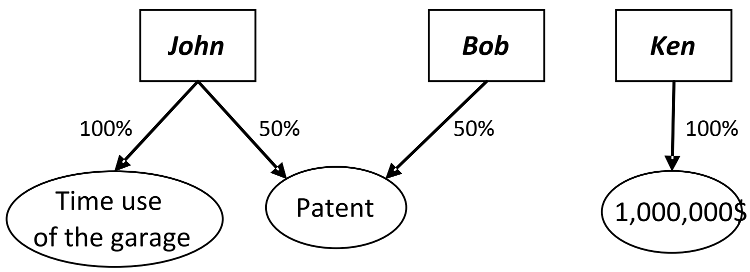
2.5 How the Creation of a Corporation Locks-in the Assets Contributed and Leads to the Creation of an Autonomous and Separate Form of Assets: Shares

The three of John, Bob and Ken created Sleepless Inc.. Ken got 33 shares; Bob got 33 shares and John got 34 shares. In exchange of their (let's say) 1/3 of the share capital of Sleepless Inc., John and Bob each brought their 50% property right in the patent to the company, John contributed time use of the garage and Ken

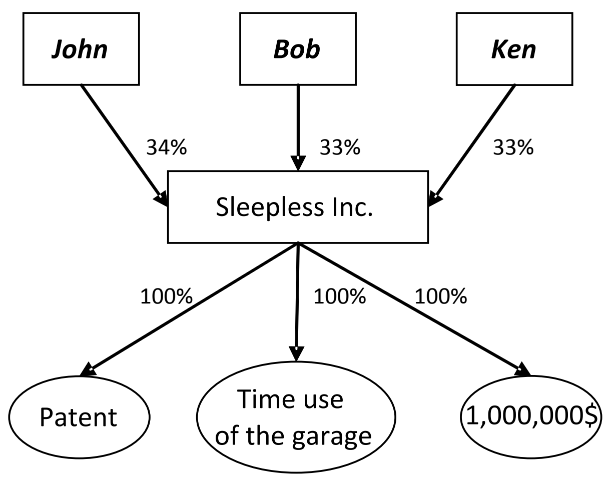
[54] Henry Hansmann & Reiner Kraakman, *The Essential Role of Organizational Law,* 110 Yale L. J. 387, 440 (2000).
[55] Frank H. Easterbrook & Daniel R. Fishel, The Economic Structure of Corporate Law (1991), [chapter 2].
[56] According to Hansmann & Kraakman, this is of "secondary importance" (Hansmann & Kraakman, *supra* note 54, at 431). I disagree. In twenty-first century America, there is no doubt Ken would not invest a cent in the venture if his whole fortune could go away because John and Bob get it wrong.

brought the 1,000,000 $ required for the development of the device.
John, Bob and Ken signed articles of incorporation, the lawyer did some formalities and one day sent them a certificate of incorporation: they were each the proud owner of (approximately) one third of the share capital of the newly created Sleepless Inc.

Before the creation of Sleepless Inc., ownership is as follows:



After the creation of Sleepless Inc., ownership is as follows:



We have (1) each of John, Bob and Ken owning one third of the shares issued by Sleepless Inc. and (2) Sleepless Inc. (a) fully owning the patent formerly jointly owned by John and Bob, (b) entitled to use the garage, and (c) owning the cash contributed by Ken. Note that neither John nor Bob owns the patent anymore; they exchanged their *split* property right in the patent against a *full* property right over a certain number of shares which gives each of them 1/3 of the capital and voting rights in Sleepless Inc.. The patent is fully owned by Sleepless Inc. and the shareholders, as shareholders, cannot get it back. It is "locked-in".[57] And Ken does not own the money contributed anymore; he also owns shares now. The money is owned by Sleepless Inc.. The very different forms of properties John, Bob and Ken contributed to Sleepless Inc. (two co-ownerships in a patent, the use of a garage and full ownership in 1,000,000 $) have now been converted into the full ownership of a certain number of securities (34, 33 and 33 shares) issued by Sleepless Inc. each having exactly the same characteristics and giving them shareholders' rights in proportion of the number of shares owned. Property in the various types of assets (patent, use of the garage and money) is now fully owned by the corporation.[58] Shareholders willing to exit their investment will from now on have only one way out: selling their shares. There is therefore no issue of "residual control rights" over the corporation's assets among them: full title to the assets is owned by the corporation. (This conversion of the ownership of very *diverse* assets into the ownership of *identical* securities will have another fundamental consequence when the company will become public as it will allow the ownership of potentially illiquid assets to have been converted into the ownership of identical securities, fully liquid on an organized market. We will examine this in more details at episode #11).

18. The conversion of property rights via the process of incorporation is another fundamental feature of incorporated businesses. It is often neglected and authors sometimes consider that shareholders "own" firms and, indirectly, therefore "own" the assets. Nothing could be further from the truth, legally speaking. Not distinguishing between the firm and the corporation, Demsetz, for example, writes that "*While we can describe with fair clarity who owns which rights under which circumstances, we cannot stipulate with equal clarity which party owns the assets of <u>the corporation</u>*".[59] Fortunately, it is quite the opposite: the corporation owns the assets and the shareholders own the shares issued by the corporation. If this clarity in who has legal title to what did not exist, the worlds of structured finance, private equity, leveraged buy-out, securitization, etc. would simply not exist. And for better or worse, they do. If the shareholders were owners of anything else other than the shares, the whole edifice would crumble. This clarity as to who has legal title to what exists because the corporation has a strong form of separate legal personality which allows partitioning assets and therefore

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[57] *See generally* Lynne A. Stout, *The Nature of Corporations*, University of Illinois Law Review 2005(1): 253-267.

[58] *See* The 2009 ABA Report, *supra* note 53, at 4.

[59] Demsetz, *supra* note 41, at 450, emphasis in original.

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breaking *any* property right connection between the shareholders and the firm's assets and activity conducted via the corporation. It is the neglect of this fundamental characteristics of the corporation in the analysis which leads to a lack of clarity in economists' understanding as to who owns what, not some uncertainty in the law or some mind boggling complex phenomenon.

19. This strict partitioning of assets has key economizing consequences. We have seen at episode #2 that because of limited liability, John, Bob and Ken are all shielded from Sleepless Inc.'s potential failure. A failure of the business has no impact over their assets other than on the value of the shares they own in the corporation owning and operating the business. What has been named the "strong entity shielding"[60] effect of the business corporation - i.e. this strict separation between the full ownership by the shareholders over the shares and the full ownership by the corporation over the assets - leads to another result. This time, it is the *corporation's* assets which are protected from the three shareholders: if they themselves face misfortunes in their personal lives, their creditors can only go after what they own: their shares in Sleepless Inc. (and their other personal assets). The shareholders' creditors can *not* collect against the assets which are now owned by Sleepless Inc.. The autonomy and integrity of the business is therefore protected. This strong entity shielding plays a key role in the development of large firms, the nexuses of contracts with other providers of resource to the firm remaining unaffected by events occurring at the shareholders level.

The strong form of legal personality of a corporation therefore *both* protects the shareholders' welfare from the misfortunes of the business and the corporation's welfare from the shareholders' misfortunes.

Episode 4

2.6 The First Separation of Ownership and Control; or How the Corporation as an Un-Owned Person is Being Run by Non-Owners

Sleepless Inc. can now be used as a legal vehicle for the development of the Sleepless device. But at this stage, John, Bob and Ken are only shareholders. As such, they do not have any

[60] *See* Henry Hansmann, Reiner Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 Harv. L. Rev. 1333, 1338 (2006) who define strong entity shielding as a situation in which corporate creditors enjoy a prior claim to the corporation's assets and are also protected from attempts by shareholders or their personal creditors to liquidate those assets.

> *access to Sleepless Inc.'s assets. This is fine for Ken, who never wanted to do anything anyway; the corporation allows him to do just that: nothing. But John and Bob want to manage the development of their idea. It is therefore decided that they will all become board members (directors) -although Ken immediately opted to designate a representative as he does not want to be involved-, that Bob will become Chief Executive Officer and that John will be appointed as Chief Financial Officer.*

As officers of Sleepless Inc., John and Bob will now be in a position to manage the corporate affairs on a day-to-day basis. But they do not have the full autonomy of owners: they can only do with the assets owned by the corporation what the articles of incorporation and bylaws and the corporate laws of the State of incorporation allow them to do under the direction and supervision of the board of directors. Ken's position as a minority shareholder is somewhat protected in this regard. None of Ken, John or Bob has access to the assets *as a shareholder* and John and Bob have access to the corporation's assets only via their positions *as officers* of the company. And in this role, their corporate powers must be exercised under the authority and under the direction of its board of directors.[61] One could think that since John and Bob are together majority shareholders and together hold a majority position at the board,[62] they can easily abuse their position to Ken's detriment. One could imagine, for example, they could try to get too much compensation for their jobs as officers or job "perquisites".[63] But although Ken is in a minority position, corporate law protects him to a certain extent: for example, the setting of John and Bob's salaries is a so-called "interested party transaction" on which John and Bob are bared from voting; so Ken effectively decides how much John and Bob are making as officers of the company (something neither Ken nor his lawyer would have thought about by the way...; but contract and corporate law are very useful to substitute for so-called "incomplete" contracts…). Thus, although John and Bob are majority shareholders and the officers of Sleepless, Inc. they are bared from acting as *owners* of Sleepless' business.

[61] Section 8.01.(b) of the Model Business Corporation Act. In this regard, it is not true that a "way to eliminate the personality from a corporation is simple: it is to have someone own more than fifty percent of its shares. That someone ... acquires an absolute control over the corporation." Iwai, *supra* note 27, at 14. Even in such a case, the fifty-one percent shareholder must go through the constraints of corporate law to get access to the assets, with the fiduciary duties unchanged.
[62] There may be shirking issues between them, however.
[63] *See* Jensen & Meckling, *supra* note 9.

20. It is important to note that even at this early stage of the legal construction of the firm, strictly speaking, no one owns the corporation. This is contrary to a widespread belief, as reminded by Margaret Blair and Lynn Stout: "*Who owns a corporation?"* they asked. *"Most economists and legal scholars today seem inclined to answer: its shareholders do*."[64] Strictly speaking, though, *no one* owns the corporation because it is *not* an object of property rights. It is only according to current folklore that a corporation is considered to be owned by its shareholders.[65] What shareholders own are shares issued by the corporation; and the corporation owns the assets. But no one owns the "corporation-in-itself".[66] The shareholders can do as they please with their shares: give them, sell them, destroy their share certificates, etc.; they *own* them. They cannot do as they please with the corporation. The only thing they can do with regards to the corporation is exercise the rights they have as a consequence of their ownership of the shares, i.e. mostly vote in shareholders assemblies and collect dividends when they are distributed.[67] These are quite significant rights[68] but they are not akin to a property right over the corporation. Shareholders owning a majority of the shares in a corporation can appoint the directors and indirectly control the corporate affairs (within the constraints of corporate law). But they do not become owners of the assets in the process;[69] and nor do they own the corporation,[70] which is not

[64] Blair & Stout, *supra* note 11, at 248.
[65] The word "folklore" is the one used by Henry Hill, former National Director of Accounting and Auditing Services for Price Waterhouse & Co. to describe the present state of affairs; e.g. Hill, *supra* note 32, at 26 (emphasis added). "Clearly, the reality is that the stockholders do not own the company; they own shares issued by the company"; *id*. at 27.
[66] This was made clear by Demsetz who clearly stated that "What shareholders really own are their shares and not the corporation"; Harold Demsetz, *Toward a Theory of Property Rights*, 57(2) Am. Econ. Rev. 347, 358 (1967).
[67] The shareholders have no rights regarding decisions whether to pay dividends or to reinvest profits; these decisions are reserved wholly to the board of directors. E.g. The 2009 ABA Report, *supra* note 53 at 6. The shareholders have a few other rights as well and for a general description of shareholders' rights in a public company, *see* Clark, *supra* note 15, at 57-58. In particular, they may initiate derivative lawsuits. But their success benefits the corporation and therefore the firm as a whole. *See* Blair & Stout, *supra* note 11, at 292-297.
[68] *Contra,* Blair & Stout, *supra* note 11, at 310, who consider the shareholders' voting rights as "virtually meaningless".
[69] *See* Paddy Ireland, *Company Law and the Myth of Shareholder Ownership*, 62 The Modern Law Review 32-57 (1999) at 33 & 41.
[70] Someone who acquires more than fifty percent of the shares of a corporation does not acquire "an absolute control over the corporation" as written by Iwai; *supra* note 25 at 14. The board of directors, even if it can be changed by the new majority shareholders, is still under the duty to manage the corporate assets in the corporation's interest; the question being then whose derivative interest must be furthered: those of the shareholders only or those of a wider group of constituents and/or affected parties? On these issues, see Part III of this article.

a "thing".[71] Their lack of ownership is such that, strictly speaking, shareholders can not even sell the corporation. In the real world, there is no such thing as a "Company Sale and Purchase Agreement"; what exist are "Share Sale and Purchase Agreements" ("SPAs") because only shares exist as property rights and can be bought and sold; companies are not property rights and no one has ever been able to buy or sell a "company" in the strict sense of the word. And SPAs are complex contracts, comprising numerous representations, warranties and covenants, in particular because what is of interest to the purchaser of the shares are the underlying assets and liabilities; but these are not sold directly. Access to them is only obtained indirectly, through the ownership of the shares and with the continuing constraints of corporate law.

21. Katsuhito Iwai is right to stress the significance of the duality of ownership relations in an incorporated business firm. But it does not derive from some dual nature of the corporation as both "person" and "thing" as he thinks. The corporation is a juridical person in its own right rather than a mere asset or a bundle of assets.[72] This classical confusion has led Iwai to write that "*the shareholders own the corporation as a legal thing and the corporation as a legal person owns the corporate assets*."[73] The "things" (in fact, the "property rights") owned by the shareholders are not the corporation but the shares; and a share is not a "*fraction of the corporation as a thing*" as written by Iwai.[74] Owning shares is not like "co-owning" a corporation. The word "share", in this regard, is a bit of a misnomer because shareholders do not *share* the use of any property they would own in common.[75] A share is not a fraction of some larger object of property

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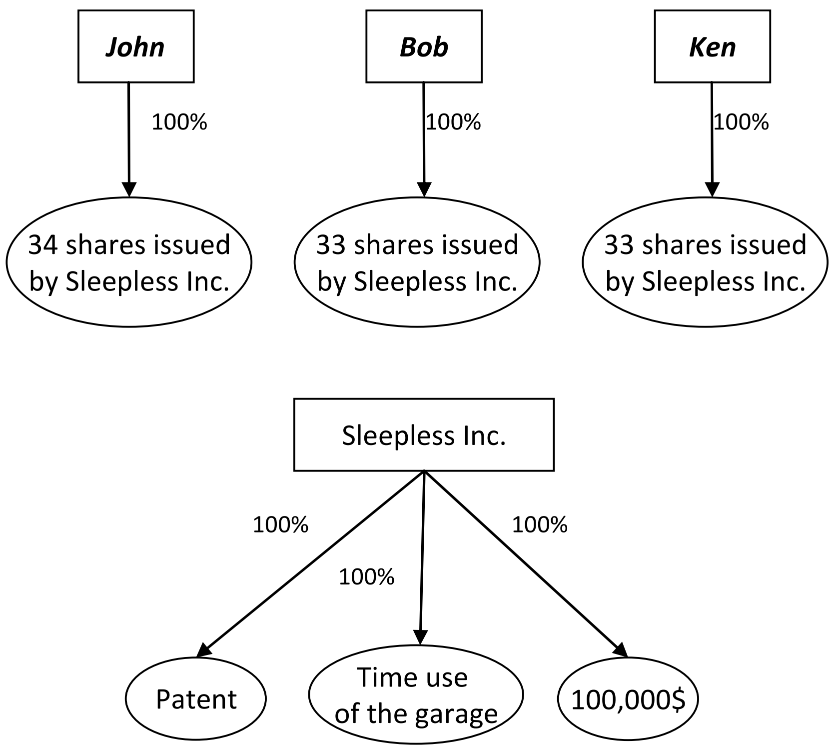
[71] *Contra,* Iwai, *supra* note 25, who disregards the importance of the shares as a separate form of property.
[72] *E.g.* The 2009 ABA Report, *supra* note 33, at 5.
[73] Iwai, *supra* note 27, at 3-4.
[74] *Id.* at 11.
[75] *E.g.* Paddy Ireland, *supra* note 69 at 45. As one would expect, proponents of the prevalling view over the corporation hold the opposite position. For example, John Armour, Henry Hansmann & Reiner Kraakmann consider that there are five core structural characteristics of the business corporation across jurisdictions: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital. *See* in *The Essential Elements of Corporate Law,* European Corporate Governance Institute, Law Working Paper n°134/2009 (2009) at 7. In fact, the fifth "shared characteristic" is precisely the <u>absence</u> of "shared ownership": the corporation fully owns the assets and each shareholder fully owns each shares he or she owns. Later in the same article, they make reference to the "*firm's owners (the shareholders)*", specifying in a footnote that they "*use the term "owners" simply to refer to the group who have the entitlement to control the firm's assets*". The confusion between firm and corporation being set aside, it is a mischaracterization of a corporation's governance (as further explained in this article) to describe the shareholders as being entitled to control the firm's assets.

right: a shareholder owning 34 of the 100 shares issued by a corporation does not own 34 percent of each share -which would be a co-ownership with the other shareholders- she owns 100 percent of each of the 34 shares. And she does not own 34% of the corporation either; she owns 34% of the shares issued by the corporation. The difference is *very* important and will be particularly significant when the company will become public, i.e. when its shares will be listed on a regulated market, which will allow shareholders to sell all or part of their shares as they please, *each* as an autonomous object of property, in total autonomy from the other shareholders and from the other shares.

22. The usual way to present "ownership in a company" – which I have used hereabove[76] – is therefore misleading. It gives the impression shareholders own the firm, or at least the corporation. A less misleading presentation of the ownership structure in a firm would be:



And even this representation is misleading as, for example, John's ownership should be represented as *34 times a 100% ownership in one share*

[76] I will (unfortunately) continue to use this conventional method for simplicity sake.

issued by Sleepless Inc.. Each share, being an autonomous object of property, can be "managed" (sold, leased, given, etc.) in total autonomy from the others.

23. Adolf Berle and Gardiner Means path breaking contribution on the understanding of the process of "separation of ownership and control"[77] was also somewhat misleading in this regard. Their thesis was that in the early twentieth century, a process had taken place whereby managers who did not own the firm / company (they did not make the distinction in their book[78]) now controlled it. In their analysis, though, they confuse two separations of ownership and control:

> "It has long been possible for an individual to incorporate his business even though it still represents his own investment, his own activities and his own business transactions; he has in fact merely created a legal alter ego by setting up a corporation as the nominal vehicle. … The corporate system appears only when this type of private or "close" corporation has given way to an essentially different form …: a corporation in which a large measure of separation of ownership and control has taken place through a multiplication of owners."[79]

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[77] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).

[78] In their book, Berle and Means constantly use the words "firm" and "corporation" as synonyms. For example, on page 7, they write that "Though the American law makes no distinction between the private corporation and the quasi-public, the economics of the two are essentially different." Since the distinction between private (or close) and public corporations is an issue of *corporate* (and securities) law, "corporation" here really means "corporation". But when they write on page 313 that "the modern corporation may be regarded not simply as one form of social organization but potentially (if not yet actually) as the dominant institution of the modern world", the word "corporation" is used as a synonym of the word "firm". Later, Berle wrote an article with a promising title: *The Theory of Enterprise Entity*, 47 Colum L. Rev. 343 (1947) (or, for a reprint, in Biondi et al., *supra* note 4). But he mostly addressed some corporate law issues created by the existence of groups of corporations and never treated the enterprise (or firm) as an organized economic activity. For example, Berle writes that "whenever an enterprise is composed of more than one corporate entity, two distinct sets of relationships are entailed. The first consists of a body of relationships which the enterprise has with individuals… A second and wholly different set of relationships exist by reason of the distribution of liabilities or security holdings within the enterprise." Clearly, in Berle's mind, the enterprise is some sort of composite *corporate* vehicle, which can comprise several corporate entities. It is not an organized economic activity comprising other contributors of resources beyond the shareholders. Berle advocates further that courts should be "dealing frankly with the fact that an enterprise is itself an entity"; or that "the enterprise, and not the incorporation papers, is the true entity". But he was more concerned about reviving some sort of "real entity" theory adapted to the phenomenon of groups of corporations rather than having a broader understanding of the firm as an organized economic activity.

[79] Berle & Means, *supra* note 77, at 5; emphasis added.

In fact, strictly speaking, there are two separations of ownership and control in the development of a large firm: a first separation of ownership and control takes place at the incorporation stage. That's the one we have just seen in our example. The corporation is not an *alter ego* of the incorporator and treating it as one may actually entail the dire consequences of committing embezzlement. Margaret Blair rightly points out that when a corporation is formed, initial investors not only commit a pool of capital to be used in the business, they also yield control over the business assets and activities to a board of directors that is legally independent of shareholders.[80] It derives from the fact that the "pool of capital" is now fully owned by the corporation. The process Berle and Means described is the different one, coming later in our example, through which directors, who do not own a majority of the shares in the corporation, come to control it. That is a second separation of ownership and control: ownership of the *shares* and control of the *firm/corporation*. But separation of ownership of the *assets* and control of the *firm/corporation* takes place earlier.

24. In 1980, Eugene Fama already warned that "*ownership of the firm is an irrelevant concept. Dispelling the tenacious notion that a firm is owned by its security holders is important because it is a first step toward understanding that control over a firm's decisions is not necessarily the province of security holders*".[81] This warning has unfortunately been ignored by many and has led to the false notion that the shareholders own the firm. As a consequence of this confusion, the agency theory of the firm developed.

Basically, the idea at the root of this theory is that since the shareholders own the firm, the directors are their agents. Being mere agents, the directors must act in furtherance of the shareholders' interest only in the management of the firm. Roberta Romano puts it squarely: "... *the classic agency problem ... goes to the heart of corporate law ...: how do principals -the shareholders- ensure that their agents -the managers- behave faithfully*".[82] But as we have just seen, the agency literature (as it relates to corporate governance) is built on a fundamental error: the shareholders do not own the corporation, the assets or the firm. They

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[80] Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387 (2003), p. 393.

[81] Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288, 290 (1980).

[82] Roberta Romano, Foundations of Corporate Law 85 (1993), emphasis added. *See also* Jensen & Meckling for whom « Since the relationship between the stockholders and manager of a corporation fits the definition of a pure agency relationship it should be no surprise to discover that the issues associated with the "separation of ownership and control" in the modern diffuse ownership corporation are intimately associated with the general problem of agency..."; in Jensen & Meckling, *supra* note 9, at 309-310.

own shares. If shareholders entrust the management of their shares to a third party, that party is their agent and must manage their property -the shares- in their sole interest. That is an agency relationship.[83] And the agent must follow the orders of the principal: an agent owes a duty of obedience to the principal.[84] And the principal can terminate the agency relationship and manage his assets himself. But managers do not manage the shareholders' property: they manage the corporation's property. They are not and cannot be the shareholders' agents: they can only be the agents of the corporation which is their sole principal since it is the sole owner of the assets they manage on its behalf.[85]

25. Of course, a majority shareholder may remove the directors and indirectly fire the officers. But that is because she is a *majority* shareholder – not "a" shareholder. Controlling a majority of the shares no doubt gives power; but it also gives duties: a controlling shareholder owes duties similar to the ones owed by directors.[86] A controlling shareholder is therefore treated differently by the legal system from a non-controlling shareholder. He becomes part of the "team"[87] because of his monitoring position. But any analysis of the shareholders' relationship to the corporation and firm must start with the general and then deal with the particular; i.e., in this instance, with what is different when a shareholder has the ability to commend the outcome of shareholders' assemblies. At this stage of our analysis, we just have to bear in mind that when a shareholder owns a majority of the shares, she still does not own the corporation or the assets or the firm and the managers are still not her agents. A majority shareholder may remove the directors from office, but not by terminating an *agency relationship* the managers have with her[88]: by voting for other officers during a shareholders assembly meeting. She cannot step in as a shareholder and deal with the assets as her own. She has to appoint new officers. And these officers will then not be under a duty to act on her behalf; they will have to act on behalf of the corporation, with the continued and same constraints imposed by corporate law.

26. The widespread belief that directors are the "agents-of-the-shareholders-who-own-the-corporation" does not correspond at all to the reality of

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[83] There is an agency relationship in an unincorporated business operated by a manager on behalf of its owner. The owner is the principal and the manager her agent. But managers can't be the *agents* of individuals who do not own the assets they are operating –who therefore can not be *principals* in connection with these assets. *See also* Iwai, *supra* note 27, at 44.

[84] Restatement (Second) Agency § 385 (1958).

[85] Clark, *supra* note 15, at 58.

[86] *See* The 2009 ABA Report, *supra* note 53 at 7 and 34.

[87] On this notion, *see* Alchian & Demsetz, *supra* note 10.

[88] As Clark puts it, "stockholders cannot withdraw authority they delegated to the board of directors, for they <u>never</u> delegated <u>any</u> authority to the directors." Clark, *supra* note 15, at 57.

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the legal relationships among directors, shareholders and the corporation. Directors do not have agents' duties towards shareholders at law; and they are not subject to direct control or supervision by anyone, including the corporation's shareholders.[89] In reality, in the governance of the corporation:[90]

(1) the officers of the corporation are agents of the corporation itself (usually as employees);

(2) directors are not "agents" of the corporation (they are not its employees);

(3) neither officers nor directors are agents of the shareholders (they do not manage the shareholders' property). It is inaccurate to consider that shareholders "*delegate day-to-day control to a board of directors which in turn delegates it to management*."[91] Shareholders (as shareholders) cannot manage the corporation's property (they don't own it) and therefore they cannot delegate to officers or directors an authority they don't have in the first place. The board's governance powers are determined by law and corporate charters and are neither delegated by, nor derived from, the shareholders.[92] And in the decisions they make, the directors must make their own judgment based on the best interest of the *corporation* and bear full liability for those judgments. Unlike shareholders, whose liability is limited to the value of their investment, directors and officers are subject to liability for their actions – and inactions. And they can not escape liability by deferring to the viewpoints of some or even *all* the shareholders, which underlines yet again the fact that they are not agent of the shareholders. They can not take instructions from shareholders with respect to matters which are within their decision

[89] *See* Margaret M. Blair, *Firm Specific Human Capital and Theories of the Firm*, in Employees and Corporate Governance 58, 290 (Margaret M. Blair and Mark J. Roe eds. 1999). And as a consequence, "... an important but neglected job for agency cost theorists is to try to understand, in economic terms, the main features of the actual legal relationship between stockholders and managers"; Clark, *supra* note 15, at 59 (emphasis added). *See also* John F. Olson for who the directors are not "mere "agents", carrying out the detailed instructions of shareholder "principals". Rather, they are fiduciaries who are, by law, charged to manage or provide for the management of the business and affairs of the corporation"; in *Is the Sky Really Falling? Shareholder-centric Corporate Governance vs. Director-centric Corporate Governance*, 9 Transactions - The Tennessee J. of Bus. L. 295, 304 (2008).

[90] *See generally* Clark, *supra* note 15, at 56.

[91] Hart (1995), *supra* note 46, at 681.

[92] *E.g.* The 2009 ABA Report, *supra* note 53, at 5.

responsibilities.[93] Shareholders (as shareholders) do not have any such liability and cannot dictate board actions;[94]

(4) the board of directors is a decision-making body of the corporation, as a separate juridical person. Directors are not making decisions for the shareholders as a group and shareholders do not delegate any authority to the board. In contrast to the limited powers of shareholders, the board has broad powers to initiate and adopt corporate plans, commitments and actions.[95] In fulfilling their duties, the directors are required to act under the high standards imposed on fiduciaries.[96] The directors of the corporation have to make their decisions in the best interests of the corporation, with a duty of loyalty and a duty of care. The duty of loyalty prohibits self-dealing or the taking of a corporate opportunity while, under the so-called "business judgment rule" standard of judicial review, the duty of care requires that (a) directors make their decision on an informed basis; (b) directors act in good faith; and (c) directors act in the honest belief that the action taken was in the best interest of the *company* (not the shareholders); and

(5) in the management of the corporation, both officers and directors have fiduciary duties towards both the corporation and the shareholders because the shareholders' interests are affected by the power they exercise. We will see in the last part of this article that their power also affects other interests in the management of the firm and that the distinction between the corporation and the firm allows addressing this issue as a distinct one.

27. At this stage of the development of Sleepless as a firm, the first separation of ownership and control deriving from the interposition of a corporation, as a separate juridical person having a strong form of legal personality, between the assets and the shareholders took place; we will analyze the second separation and its consequences on the issue of corporate and firm governance when it happens: at a much later stage.[97] Until episode #11, we will

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[93] *Id.* at 10. On the fact that the principles are the same under UK and Canadian law, *see* Stephen Bottomley, The Constitutional Corporation – Rethinking Corporate Governance, Asgate (2007) at 82.

[94] *E.g*. The 2009 ABA Report, *supra* note 53, at 5.

[95] *Id.* at 9.

[96] *Id.*

[97] *See infra* Episode #11.

see what John and Bob will do as officers of Sleepless Inc. to build and manage the *firm*.

Episode 5

2.7 How the Use of a Separate Corporate Person to Run the Business Enhances Credit

As Sleepless Inc.'s officers, John and Bob went to see a bank which was pleased to see that Ken invested enough money to finance the development of the Sleepless device. It granted Sleepless Inc. a small line of credit.

Why did the bank's position change? The creation of the corporation played an important role: a separate legal entity now owns the assets required to develop the Sleepless device (the patent and enough money); and these assets are protected (for example) from John's potential excesses as a poker player. This characteristic of the corporation, which allows holding assets separate from the personal property of the shareholders and/or managers, is a fundamental accomplishment of corporate law. The corporate form makes it possible for creditors, employees and suppliers to enter into long-term relationships with a greater assurance the pool of assets will remain in the business.[98] This shielding of the assets of the entity from the claims of the creditors of the entity's shareholders or of its managers is a truly essential aspect in the development of corporate law; some claim more important than limited liability, which protects the shareholders' assets from the claims of the entity's creditors.[99] The assets are now under the control of a board of directors having both a duty of loyalty and a duty of care. In other words, these duties, which we have seen are important for Ken as a minority shareholder, are also important for parties who are not shareholders and, in particular, creditors. Added to the "strong entity shielding" effect of corporations, they increase the credit of the corporation and facilitate the financing of business ventures.

[98] Blair, *supra* note 21, at 55 and 57.
[99] Hansmann & Kraakman, *supra* note 54, at 390.

Episode 6

2.8 Building the Firm Around the Corporation

Under John and Bob's direction, Sleepless Inc. hired three employees and rented an office were Sleepless Inc.'s headquarters were moved. Sleepless Inc. bought furniture, leased computers, etc. and, one sunny day, the operations started.

28. Let's see in details what took place here. Sleepless Inc. had the control over certain assets because it owned them (the patent, the time use of the garage and 1,000,000 $). It needed to control other resources to develop its activities: have financing, an office and laboratory space, employees, computers, desks, chairs, and so on. So the company's officers (John and Bob) went to meet the people in control of these resources to negotiate the consideration and other conditions against which they would be ready to hand the control over these resources to them. They went to negotiate contracts, i.e. binding agreements, enforceable in court on behalf of Sleepless Inc. with the owners of these resources or their agents. Having obtained a line of credit, John and Bob now have financing available so that, added to the funds contributed by Ken, they will be able to pay, on behalf of Sleepless Inc., up to a certain amount, the considerations required to get control over the other resources needed to develop the business.

The owners of the computers, desks and chairs transferred to Sleepless Inc. their title over these objects against payment of a *price*.

The bank extended the line of credit to Sleepless Inc. (i.e. allowed it to dispose of funds) against a specific type of consideration: *interests* paid at a certain rate over time.

The owner of the office/laboratory leased it to Sleepless Inc. against payment of a *rent*. Under the lease, Sleepless Inc. will have access, for a guaranteed period of time, to the space needed to develop the venture. It will be in a position to install the physical assets and locate the employees needed to develop the firm's activities.

Employees are a special type of contracting party. The other persons John and Bob negotiated with own the resources (or are the agents of the resources' owners). They own the money, they own the building, and they own the chairs. With employees, John and bob want people to come in the morning, do their job and leave in the evening (late, if possible). The resources are the people themselves. The question of whether one owns oneself is technically a difficult

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one at law.[100] And part of the property rights approach of the firm was criticized for failing to integrate human "assets" into the analysis.[101] It was argued that humans cannot be integrated in such an analysis because they cannot be bought or sold. In my analysis, this is irrelevant. Whether or not individuals own themselves, and irrespective of the fact that they can not be bought or sold, they have a constitutionally protected freedom to come and go and -more importantly for us- to contractually surrender this freedom against compensation. Since the fortunate abolition of slavery, people can only lease their services for a time against a consideration: a salary, payable on a periodic basis. Whether or not they "own" themselves is irrelevant; they are the only ones in control of what to do with their time and having the right to bind themselves to perform an activity through time.[102] In this respect, an employment contract is therefore not so different from another contract pursuant to which the control over the use of a resource is obtained.

29. Employment contracts play a very important role in the theory of the firm. The employment contract is a contract of subordination. What is important in this relationship is not so much that it allows giving orders. It allows the employer to be the decision maker in connection with the employee's activity during his time of employment. In an employment contract, all the tasks are not detailed in numerous clauses providing for a catalogue of compensations for every possible activity of the employee.[103] Against a compensation set for a time (say a month or a week), the employee accepts, within certain limits,[104] to do a job as directed by his employer in the sphere in which he accepts to be subordinated. In connection with a job broadly defined in the contract[105] -what Herbert Simon

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[100] *See generally* Ngaire Nafine, *The legal Structure of Self-Ownership: Or the Self-Possessed Man and the Woman Possessed*, J. of L. & Soc'ty 193 (1998).

[101] *See* Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757 (1989), at 1772-1773. Another perceived weakness of the property rights approach was its failure to take account of the separation of ownership and control present in large, publicly held corporations. *Id*. at 1774. But we can do that by understanding that there is a series of separations between ownership of the assets, of assets derivatives (shares) and who controls them.

[102] On that basis, I would take the view that human rights are *not* property rights: they can neither be bought nor sold nor leased. Barzel is of the opposite view, considering that "The distinction sometimes made between property rights and human rights is spurious. Human rights are simply part of people's property rights." *See* Barzel, *supra* note 13, at 2. Human rights *are* rights; but because they can not be traded, they probably cannot be considered as *property* rights.

[103] The postponement of the employer's decision to determine the employee's activity is defined by Simon as a "liquidity preference", the liquid resource being the employee's time instead of money. *See* Herbert A. Simon, *A Formal Theory of the Employment Relationship*, Econometrica 293, 304 (1951).

[104] Coase, *supra* note 35, at 391.

[105] If you are director of marketing, you usually cannot be ordered to sweep the plant's floor.

called the "*area of acceptance*"-[106] the employer is entitled to direct the employee's activities. The employment contract eliminates the need to renegotiate all the time and the employee has a duty to yield obedience to all reasonable rules, orders and instructions of the employer.[107]

30. Ronald Coase had an original insight on this, considering that the substitution of authority to price mechanisms to coordinate economic activity was the "nature of the firm".[108] This was a key contribution although, as Coase later recognized, his insight should have been extended to include - as I am doing here - all "*the contracts that enable the organizers of the firms to direct the use of capital (equipment or money) by acquiring, leasing, or borrowing*".[109]

In 1964, Armen Alchian was considering, similarly to Coase, that "*the firm is a surrogate of the market place, but differs in that longer-term general service contracts exist without continuous renegotiations at every change of type of service*".[110] In 1972, though, Alchian and Demsetz took the opposite view: "*Long-term contracts between employer and employee are not the essence of the organization we call a firm*".[111] Their view then was that "*to speak of managing, directing and assigning workers to various tasks is a deceptive way of noting that the employer <u>continually is involved in renegotiation of contracts on terms that must be acceptable to both parties</u>*."[112] In the reality of firms' operations, it is (fortunately) quite the opposite. The employment contract *avoids* having to renegotiate all the time. It *avoids* having to negotiate at length to agree on the details of how discrete tasks will be performed, for how long, for how much, and so on. It gives authority to the employer (and, in fact, to the members of the firm's management team, as agents of the employer) to direct the employee because the employee *accepted* entering into a legal relationship of this kind. Alchian and Demsetz held the opposite view and considered that "*the presumed power to*

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106 *See* Simon, *supra* note 103, at 294. *See also* Herbert A. Simon, "Organizations and Markets", in Biondi et al., *supra* note 4, pp. 54-72, at 59.
107 *See also* Cheung, *supra* note 19, at 5.
108 *See* Coase, *supra* note 35.
109 *See* Ronald H. Coase, *The Nature of the Firm – Influence*, in The Nature of the Firm – Origins, Evolution, and Development 65 (Oliver E. Williamson and Sidney G. Winter eds. 1993). Coase considers the main weakness of his groundbreaking article as giving an incomplete picture of the nature of the firm by using the employer-employee relationship as the archetype of the firm. He points, however, to a footnote (n°3) were he warned that the firm may imply control over another person's property as well as over their labor; *see* at 64.
110 *See* Armen A. Alchian, *Corporate Management and Property Rights*, in Economic Policy and Regulation of Corporate Securities 337, 348 (H. G. Manne Ed. 1964).
111 *See* Alchian & Demsetz, *supra* note 10, at 777. To be fair, Alchian has since rejected this position in 1984, followed in 1995 by Demsetz.
112 *See* Alchian & Demsetz, *supra* note 10, at 777, emphasis added.

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manage and assign workers to various tasks" is "*exactly the same as one little consumer's power to manage and assign his grocer to various tasks*."[113]

Now, maybe my grocer and my house keeper are atypical (although I suspect they are not); but if I ask my housekeeper to clean the kitchen instead of the bathroom, he does it. But if I were to ask my grocer to clean the floor of her shop (I don't really dare doing it), I am pretty sure she would either stare at me, or laugh or even call me names.

Alchian and Demsetz disregarded what is the essence of an employment contract: the employee *agrees* via the employment contracts to be subordinated and in all likelihood will abide by his agreement (or he will run the risk of being rightfully sanctioned or even fired); the grocer, on the other hand, never *agreed* to be a subordinate of his "little consumer". In addition, one can reasonably assume that the grocer has many customers and is not forced to cope with patrons pretending to order her to clean the floor (she doesn't really care being "fired" by these nuts, i.e. lose their business because one can reasonably assume that over the course of her carrier as a grocer, she will encounter very few "little consumers" making it a condition to their purchase that she first cleans the floor of the shop). The employee, on the other hand, most likely has only one boss who just happens to be the one paying him what he needs to be in a position to pay his own bills at the end of the month... Being fired by one's boss or being "fired" as a grocer by a "little consumer" are not "*exactly the same*" thing. Also, I know of court cases where employees have been considered the victims of all sort of harassments; I am not aware of any similar case of grocers being harassed by their "*little consumers*".[114] I suggest using as a test that if a contractual relationship can be *abused* (as is the case, for example, of a relationship of subordination) and another one can not (as is the case of a *quid pro quo*, instantaneous, sale and purchase contracts), they are not "*exactly the same*". Oversimplifying and reducing an employment contract to a series of instantaneous *sale* contracts is an elegant attempt to consider that firms and markets are, at the end of the day, basically the same thing. They are not.[115] Equalizing them misses the significance of the existence of relationships of *power*; and in particular of those deriving from subordination extending through time, i.e. employment contracts. And in real

[113] *Id.*

[114] The situation may actually be different with "big consumers" who may end up having power over their grocer and abuse it.

[115] For Herbert Simon, the employment contract differs fundamentally from a sales contract because (a) "in the sales contract, each party promises a specific consideration" and (b) "the seller is not interested in the way in which his commodity is used once it is sold"; *see* Simon, *supra* note 103, at 294.

firms, there are relationships of subordination: there are employment contracts and these are not a series of constantly renegotiated purchase and sale contracts.[116]

31. As a consequence of the cluster of contracts concluded via Sleepless Inc., control over a series of resources has been gained. What Bob and John can do as a consequence is create an "organization" which will be in a position to develop their idea. They are entitled to use the premises leased as they want (as long as it is in compliance with the provisions of the lease). They have authority to determine who can enter the premises and who cannot. They can decide whom to hire, under what conditions, whom not to hire and whom to fire. Under the employment contracts, they have authority to organize the work of the employees; ask them to do something and not to do something else. They can sub-contract the performance of tasks better performed by other firms (the classical "make or buy" decision), and so on. I contend that the firm is this organized activity, under the direction of John and Bob, as a consequence of their control over the resources (the property rights) they have thanks to the contracts signed by them, as agents of Sleepless Inc.. The firm is not the set of contracts; it is not the set of property rights. It is the organized activity developed as a consequence of these contracts they can conclude thanks to the resources they control via their official positions within Sleepless Inc. and giving them control over other required resources via the contracts signed.

32. Note that the firm also (a) uses assets it does not own and the use of which is not contractually transferred to it, such as roads, and (b) that it benefits from services available to society as a whole via the State apparatus, such as security. It pays for the use of these assets and the benefit of these services only indirectly through taxes (which it will actively try to reduce when, at a much later stage, it will create a tax department to perform effective "tax planning" which will become particularly effective when the operations will be on an international scale –when it will become a so-called "multinational" enterprise[117]). It can also make use of assets *no one* owns (public goods), such as air, and for which it does not pay anything.[118] Its abuses, just like anyone else's, may become an issue. And they will become an issue, depending on the nature of its operations,[119] when their size will increase significantly. This is a problem (the issue of the negative externalities) which will appear later in our example.

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[116] For a more thorough assessment of the specificity of the employment relationship and its legal bases, *see* in particular Robert F. Freeland, *The Social and Legal Basis of Managerial Authority*, 57 Entreprises et histoire, pp. 194-217 (2009).

[117] *See*, in particular, Reuven Avi-Yonah**,** *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harvard Law Review pp. 1573-1676 (2000).

[118] Unless it is under an enforceable obligation to purchase rights to pollute.

[119] Industrial activities polluting more than the provision of services, for example.

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33. A word on membership. Who is a member of the firm? John, Bob and the employees, for sure. The sellers of the chairs and computers certainly not; they only had one instantaneous *quid pro quo* relationship with the firm (via the corporation): title to a good has been exchanged instantaneously against payment of a price. Neither is the bank nor the landlord part of the firm. Although they also have signed contracts having duration with Sleepless Inc., their own activities do not become *organized* by Sleepless' management as a consequence.

Is Ken a member of the firm? This is a more interesting case, but no. Sure, he contributed equity capital to Sleepless Inc. but since then he hasn't done anything, just expecting a good return on his investment.[120] We know he does not own the firm nor the corporation (he owns shares). Now we learn he is not even a member of the firm…[121] And even in Alchian and Demsetz's model of the firm as a team, there is no need for a central party to "monitor his productivity" because he is not doing anything and he is not expected to do anything.[122] None of Ken's activities are being organized by Sleepless as a firm. And Ken does not hold the monitoring position (he does not want to do anything; he is entitled to do nothing. And he does nothing). Ken is not a member of the firm. Alchian and Demsetz reach the opposite conclusion merely because they do not differentiate between the corporation (of which Ken is clearly a shareholder, entitled to exercise his rights over his shares) and the firm, in which he is (close to) nothing, having a very remote impact as a passive shareholder.

34. The corporation has been instrumental in the creation of Sleepless as a firm. Interestingly though, a non risk-averse individual who would have Bob and John's talents and Ken's money *could have done the same*.[123] It is key to understand that a corporation had to be used *only* because assets required for the creation and operation of the firm were owned by different people and had to be located into a separate legal entity for the various reasons we have presented.

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[120] He therefore can hardly be considered as a team member; so this invalidates the "team production theory". Ken has a sunk investment (as long as the company is private, i.e. its shares are not publicly listed); but he is not part of the team. A similar point was made by Fama & Jensen, *supra* note 6, at 303, who note that the stockholders are not required to have any role in the organization other than being residual claimants because their residual claims are alienable without restriction.

[121] *See also* Mark T. Moore & Antoine Rebérioux, *Corporate Power in the Public Eye: Re-Assessing the Implications of Berle's Public Consensus Theory*, 33 Seattle U. L. Rev. (2010) at 12 & 14.

[122] Alchian & Demsetz, *supra* note 10.

[123] The individual would have to be non risk-averse because she would not be shielded from tortious liability potentially incurred in the operation of the venture. A risk-averse entrepreneur would need to create a corporation to limit her personal liability. In real life, tax considerations also have an impact.

Our risk loving, talented and rich entrepreneur could have concluded all the contracts needed to get access to the resources required for the development of the venture (buying the chairs, desks and the computers; leasing the office, hiring the three employees). But he would not be "*a firm*". The business organization he would have created would be. Hansmann & Kraakman consider that "*a natural person ... can ... serve as a firm*".[124] But their assertion derives from the fact that they make the classical confusion between the firm and the corporation. They treat the firm as a third party coordinating the economic activity of two or more persons. "*The firm ... serves ... as the requisite "nexus of contracts" for the persons whose activity is to be coordinated: it is the* <u>*common party*</u> *with whom each of these persons has an individual contra*ct."[125] The common party, however, is not the *firm*: it is either an *individual* or a *corporate body* having juridical personality; it cannot be the firm (the organization). In our example, the common party could have been a (risk loving, talented and rich) individual. But the individual common party to the contracts would not become a firm: the firm would be the economic activity this individual would be in a position to coordinate through the nexus of contract transferring him the control over the use of the resources required.

35. Note however that if the same activity as the one described so far could have been developed by a "risk loving, talented and rich entrepreneur", this is true only as long as the firm does not need any significant external financing. As soon as it does, external financiers will request a partitioning of the assets via the creation of a corporation to reduce their risks and isolate the firm from the petty incidents which may occur in the life of our entrepreneur, such as death, divorce, sickness and so on. The occurrence of these unpredictable events could prove devastating for the continued existence of the cluster of contracts assembling the resources required for the firm's operation.[126] And it could seriously diminish the value of the bank's collateral. If a bank were to extend credit to our "risk loving, talented and rich entrepreneur", it would run the risk that, in case of death of the entrepreneur (for example) the cluster of contracts allowing the organized operation of the assets used by the firm could disappear overnight or at least be very much challenged in its continued existence. The fate of the business will immediately depend on who inherits our entrepreneur's estate, whether it's one competent individual or 17 idiots.[127] With a corporation

[124] Hansmann & Kraakman, *supra* note 54, at 392.
[125] *Id.*, at 391 (emphasis added).
[126] More on this in Episode #10 and the accompanying footnotes.
[127] For a description of why I. M. Singer & Co. had to be incorporated to protect the business from the life of Isaac Merritt Singer, one of its founders, *see* Blair, *supra* note 21, at 57-60. Singer was spending his new wealth in eccentric ways, and in particular by having domestic relationships with

[Footnote continued on next page]

interposed, of course the death of the entrepreneur might be an issue,[128] depending on his importance in the operation of the business, whether a competent management hierarchy is in place or not, etc. But at least the cluster of contracts remains in place and the 17 idiots only inheritate shares, which fortunately gives them little say on how the business is being operated.[129]

Episode 7

2.9 On the Boundaries of the Firm in the World Wide Web of Contracts

The Sleepless device is (of course) a success. The demand is immediately enormous and the Sleepless device has to go into production on a large scale. Sleepless Inc. borrows more money (it can give the patent -now of great value and shielded from the shareholders- as collateral) and builds a factory. Machines are bought; more employees are hired.
Sleepless' management team starts creating a distribution network, entering into various kinds of distribution contracts. It wants to make sure that the Sleepless device gets quality presentation and that after sale service is of top quality and introduces in its standard distribution contract numerous clauses allowing it to check the distributors' actions and to terminate the contract in case the Sleepless device is poorly presented or serviced.

36. One interesting question is whether the distributors are members of Sleepless as a firm. One can contend that a distributor who contractually has no possibility to distribute anything else but the Sleepless device and is bound by a

[Footnote continued from previous page]
at least four women (one of them being his wife, though) with whom he had numerous children. His partner Edward Clark (a lawyer) was aware of the risks this was creating for the business should Singer pass away and insisted on protecting the business from the potential claims of all these numerous potential heirs by having recourse to incorporation.

[128] That is why banks, in such a case, ask for the taking of a key-man insurance policy.

[129] In contradistinction, the Islamic law of partnership (which did not recognize the existence of a separate legal person) and its egalitarian inheritance rules historically kept business enterprises small, simple and generally ephemeral. With the institutional evolution of Occidental legal systems allowing the development of corporate law, the Islamic traditional institutions became sources of competitive disadvantage. *See generally* Timur Kuran, *The Islamic Commercial Crisis: Institutional Roots of Economic Underdevelopment in the Middle East*, 63 J. of Econ. Hist. 414-446 (2003), especially at 415.

long term contract will have to do as he is commanded by Sleepless' management even if this is not specifically provided for in the distribution contract. His activity can end up being organized by Sleepless Inc.'s management. Depending on the degree of integration of his own activities within those of Sleepless, or on whether or not he has made specific investments, he may be considered as being integrated within "Sleepless", at least for certain issues. The same is true for many contracting parties; the result of the analysis really depending on Sleepless' effective power over them and on its ability to abuse it because of their lack of autonomy.

37. This leads us to the issue of the firm's boundaries. As put forward by Zingales, "*the defining characteristic of a firm is that it substitutes authority for the price mechanism in determining how decisions are made. ... Only by understanding the source of this power can we hope to explain where the influence of this power ends (i.e., the boundaries of the firm) and how this power operates within the firm's boundaries*".[130] There are, however, no neat boundaries to the firm. There are just grey margins surrounding the firm within which different answers may be given to the question, depending on the issue at stake. There is no bright line distinguishing "inside" and "outside" in all circumstances. The firm's boundaries are linked to the fact that the firm is an organization exercising power (authority) and within which power is being exercised. The source of the power lies in the control over resources, either because they are owned, or because they are controlled via contracts, by the firm's corporate structure. The limits could be said to exist where the effects of the power fade away. The boundaries are therefore not as precise, defined and intangible as State borders can be, for example. Components (think about sub-contractors in concentrated industries, such as the automotive industry) may actually fit within the boundaries of several firms.

38. Although the boundaries of the firms may be found at different places depending on the issue at stake, I disagree with Cheung, however, who considers that "*the truth is that according to one's view, a "firm" may well be as small as a contractual relationship between two input owners or, if the chain of contracts is allowed to spread, as big as the whole economy. ... Thus it is futile to press the issue of what is or is not a firm*".[131]

The "chain of contracts" is indeed as large as the world-economy. All economic exchanges in the whole world economy can be analyzed as a web of contracts relating to the allocation and use of resources. Elsewhere, I have called

[130] Zingales, *supra* note 8, at 1644.
[131] Cheung, *supra* note 19, at 17-18.

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this the "world wide web of contracts".[132] Many of these contracts are pure *quid pro quo*, purchase and sale contracts connecting dots (resource holders) in the world economy for an instant only. When there is an isolated act of purchase and sale, no continuing association, where buyer and seller accept no obligation with respect to their future conduct, we probably have what approximates most a pure market transaction.[133] The pure market transaction is at one extreme of the spectrum of economic exchange: ownership of something is instantaneously exchanged against immediate payment of a price. There is no lasting relationship. At the other extreme, there are *clusters* of contracts having duration connected in such a way (via corporations) as to give power to those in control of these clusters (through corporations) over the resources connected via the cluster of contracts. One such cluster allows operating the firm called "Microsoft"; and another one allows operating the firm called "Toyota". All the firms in the world, although they are interconnected via the *world wide web of contracts,* are legally structured using semi autonomous clusters of contract allowing the exercise of *power* via these contracts and sets of property rights. They allow the operation of "Microsoft" and of "Toyota" as organizations, as "hierarchies". These semi-autonomous power systems have loose boundaries because the cluster of contracts connecting resources over which they exercise their authority does not end abruptly like the limits of a State's territory. In between, there are all sorts of arrangements, extending through time, in particular when the matching, both qualitative and quantitative of individual enterprise plans is necessary.[134] This is the case, in particular, for certain suppliers of inputs and certain distributors of output. This is the case for joint-ventures. The limits of the firm may therefore not be clearly delineated. But if the limits to the effectiveness of the authority exercised within a firm and allowing it to operate as an organization are not clear cut, at their core, firms operate via legal instruments allowing them to issue *orders* and exercise *authority*, whilst instantaneous "horizontal" market transactions among equals are at the opposite end of the spectrum of economic transactions.[135] As it happens, Microsoft's and Toyota's clusters of contracts are probably directly in contact with each other: it is likely that Toyota benefits from Microsoft licenses

[132] *See* Jean-Philippe Robé, "Conflicting Sovereignties in the World Wide Web of Contracts – Property Rights and the Globalization of the Power System", in Soziologische Jurisprudenz, Festschrift für Gunther Teubner, Graf-Peter Calliess, Andreas Fischer-Lescano, Dan Wielsch and Peer Zumbasen (eds.), Berlin, De Gruyter Recht (2009), pp. 691-703.
[133] *See* G. B. Richardson, *The Organization of Industry*, Economic Journal 883, 886 (1972).
[134] *Id.* at 892.
[135] *See also* Yuri Biondi, *The Firm as an Entity: Management, Organization, Accounting*, Università degli Studi di Bescia, Dipartimento di Economia Aziendale, Paper numero 46, August (2005) at 33, available at http://ssrn.com/abstract=774764.

and it is quite possible that many of the Microsoft company cars are Toyotas. But none of the arrangements pursuant to which Toyota uses Microsoft's softwares or Microsoft uses Toyota cars gives any *authority* to the managers of any of the two firms to *command* those of the other. "Microsoft" and "Toyota" both operate in the world wide web of contracts; but "Microsoft" is not "Toyota".

This presentation of the firm as acting within the world wide web of contracts echoes Simon's visual metaphor:

> "… Any creature floating to our Earth from Mars would perceive the developed regions to be covered mostly by firms, these firms connected by a network of communications and transactions we know as markets. But the firms would be much more salient than the markets, sometimes growing, sometimes shrinking, sometimes dividing or even swallowing one another. Surely they would appear to be the active elements in the scene."[136]

Surely it is in line with John Kenneth Galbraith who considered it is a *fraud* to talk about a "market economy" and to neglect in the process what he calls the "corporate system.[137]

Episode 8

2.10 The Firm and Its Environment

One issue starts worrying Sleepless Inc.'s board of directors. The operation of the Sleepless device requires the use of a consumable – oil from a rare flower growing only in Amazonia, which is in very short supply. Its price has considerably increased with the huge sales of the Sleepless device. To make sure it has access to this essential consumable, Sleepless Inc.'s management has

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[136] Herbert A. Simon, An Empirically based Microeconomics, Cambridge: Cambridge University Press (1997), at 35.

[137] "Reference to a market system is ... without meaning, erroneous, bland, benign. ... No individual firm, no individual capitalist, is now thought to have power; that the market is subject to skilled and comprehensive management is unmentioned even in most economic teaching. Here is the fraud. Another name for the system does come persuasively to eye and ear: "the corporate system". None can doubt that the modern corporation [Galbraith means the "firm"] is a dominant force in the present day economy ... Nonetheless allusions to it are used with caution or not at all. ... Better the benign reference to the market." In John Kenneth Galbraith, The Economics of Innocent Fraud – Truth for our Time, 7-9 (2004).

> *negotiated supply contracts guaranteeing suppliers it will purchase them certain quantities of oil over a number of years in exchange for guaranteed prices. The suppliers buy large strips of the Amazonian forest to clear cut it and grow the required flower.*

39. Are the suppliers bound by long-term contracts part of "the firm"? Maybe yes, maybe not. It really depends here also on the extent of the control exercised over them.[138] Eventually, Sleepless Inc. will need to guaranty the sourcing of the consumable and, in all likelihood, it will attempt to get control over at least part of the suppliers. The reason for this is that in the absence of such control, in its future renegotiations of the supply contracts, the suppliers would be in a strong bargaining position. Sleepless Inc. will have made substantial investments which value will be dependent on the possibility to get access to sufficient flower oil. As summarized by Oliver Hart, "*the benefit of integration is that the acquiring firm's incentive to make relationship-specific investments increases since, given that it has more residual control right, it will receive a greater fraction of the ex post surplus created by such investment*."[139] Otherwise, it is better of using the market (competition) to get the best available mix of price and quality.

40. The careful reader has also noticed that now Sleepless starts having an impact on the natural environment. This is a key problem in a globalized world were decisions affecting Amazonia (in our case) are in great part being made at Sleepless Inc.' headquarters (somewhere in the Western world), with a limited ability for the authorities having territorial jurisdiction over Amazonia to impact on them. This creates a very difficult governance issue. Our mode of thinking is based on the idea that polities are somehow closed with a separation between private and public, autonomy and regulation, the principle being that people are free to do what they want, rules being there to internalize costs not otherwise appropriately taken care of by the market system (contracts) via rules (regulations). The dominant school of thought on firm governance (or "corporate governance" – the distinction between the two being rarely made) assumes that all externalities are adequately internalized via contracts or regulations.[140] This

[138] Zingales has the right insight but the wrong vocabulary when he notes that "in the traditional firm ... the realm of transactions governed by power rather than by prices tended to coincide with the legal boundaries of the corporation". Zingales, *supra* note 8, at 1641-1642. The correspondence is with the boundaries of the *firm*, of the *enterprise*, found where the power to direct the assets ends.

[139] Hart, *supra* note 34, at 33. *See also, generally*, Williamson, *supra* note 36.

[140] *See* hereunder #63 et seq. *Cf.* also Biondi, *The Problem of Social Income* (forthcoming, January 2011).

assumption, however, does not correspond to the reality of a globalized world with no global State in which divided States are competing to offer firms a legal environment attractive enough so that they will locate at least part of their activities on their territory. States have to do this to create local employment, wealth and a taxable base so that they can keep on existing as States. But the existence of this competitive game among States blurs the distinction between private/public, autonomy/heteronomy, economic/political decision, etc. Not much can be said here about this key issue in today's world.[141] But it can not be addressed if one does not differentiate between firm and corporation. Global firms, as global organizations making use of the differences among the State legal systems, are among the key factors creating this issue; but once they are being observed through the glasses of the State legal systems, they disintegrate, at best into networks of contracts connecting resource holders via corporations. Their existence as organizations is addressed nowhere in the legal system.

41. Let's see why with the continuation of our example.

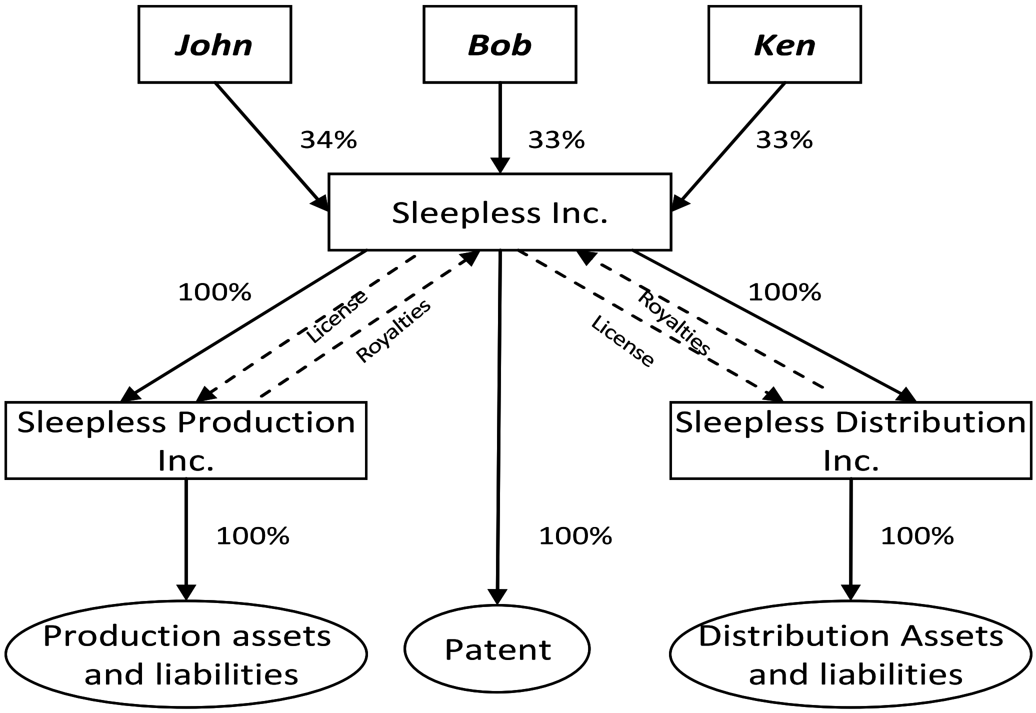
Episode 9

2.11 The Development of the Firm and of its Corporate Legal Structure as a Group of Companies

Despite the dramatically increased production of the Sleepless device, demand is still not satisfied. More is needed. Sleepless Inc.'s board of directors decides to create two subsidiaries: one for production (Sleepless Production Inc.), and one for distribution (Sleepless Distribution Inc.). All the production assets are located in the first subsidiary and all the distribution assets are located in the second (of course, many other forms of organization could be adopted). Sub-subsidiaries (and so on) will then be created as required in various parts of the world to fulfill the needs felt by Sleepless to produce and distribute the Sleepless device. Sleepless' corporate structure is now a group of companies. Sleepless Inc. still owns the original patent (it will sign licensing agreements with the subsidiaries, which will then pay royalties to it), and shares in its two subsidiaries, which own shares in their own subsidiaries and so forth.

[141] *But see* Robé, *supra* note 132 and Jean-Philippe Robé, *Les Etats, les entreprises et le droit – Repenser le système-monde*, 161 Le Débat pp.74-87 (2010).

Ownership now (using the misleading but classical method to present it) is as follows:



42. Does it change anything? For Sleepless as a *firm*, as an organization, things change a little bit but not much. Sleepless is still one single *firm*, one single organization, although its *corporate structure* has evolved into a group of companies. It is still the same people who are making the key decisions and giving the orders, irrespective in the main of the formal corporate governance of the subsidiaries.[142] There might be local CEOs in local subsidiaries who, under local corporate laws, are treated as the autonomous executive of the local entity, with authority to contractually bind it, for example. And these local CEOs may have substantial potential personal liabilities as a consequence. And they may therefore have a say over the firm's local organization. But, although their personal status may be quite complex and give them some authority within the firm,[143] they are part of the governance structure of the firm as an organization,

[142] *See* Jean-Philippe Robé, *Multinational Enterprises: The constitution of a Pluralistic Legal Order*, in Global Law without a State 66-67 (G. Teubner ed. 1997).
[143] *See* Jean-Philippe Robé, "Enterprises and the Constitution of the World Economy", in 2 *International Corporate Law* 45-64, Fiona Macmillan, ed., Hart Publishing (2003).

not autonomous skippers of the local subsidiaries and, for all practical purposes, are subordinates within the hierarchy set in place at the mother company's headquarters level.

In terms of ownership -and of assets partitioning- the situation is quite different when the corporate structure of the enterprise becomes a group of corporations. Whereas Sleepless Inc. used to own *all* the real assets and be the central party to the cluster of *all* the contracts, it now only owns a patent and *shares* in two companies. There are now *several* sub-clusters of contracts, in relative isolation from each other because of the legal personality and limited liability of the corporate vehicles used for the corporate structuring of one single firm, one single organization. The existence of the shares, conveying limited liability, protects Sleepless Inc. from the fate of the subsidiaries. It is now the group's subsidiaries which own the real assets and are parties to the contracts with *part* of the suppliers and firm members. It is to the group's subsidiaries that the consequences of Sleepless' activity legally attach in the first place.

As a consequence, the development of the corporate structure of the firm, which hardly affects Sleepless in its inner operation as a *firm*, changes things for Sleepless' *environment*. How? Let's imagine an issue arises in connection with the distribution of the Sleepless device. One of the distributors sees his contract with Sleepless Distribution Inc. wrongfully terminated. He sues Sleepless Distribution Inc., wins and gets punitive damages. But he can (normally) collect against Sleepless Distribution Inc. only – not Sleepless Production Inc. or Sleepless Inc., which were not party to the contract. And certainly not Sleepless-as-such, as a "firm" (but this was never the case, even before the creation of the two subsidiaries since the "firm" does not exist at law). What happens here is the same thing as what took place when Sleepless Inc. was incorporated. It shielded its *shareholders* from liabilities which could arise at the level of Sleepless Inc. (remember how Ken, the only one of the three shareholders having deep pockets, was pleased when he learned that); the same principle applies here: Sleepless Inc., as a shareholder, is shielded from liabilities which may arise at the level either of Sleepless Production Inc. or Sleepless Distribution Inc.. Unless some sort of abuse takes place, unless the subsidiary is found to be a mere "alter ego" or "agency" or "instrumentality" or "dummy" or unless there is a tort committed by Sleepless Inc., for example, this is usually considered as legitimate in most State legal systems.[144] Such a corporate structure can certainly allow abuses. But it is way too

[144] *See generally* Michael Carey, *Piercing the Veil When Corporate Subsidiaries Commit Torts* (November 30, 2008). Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1309302. The laundry list of factors considered by courts to determine whether a corporation is a mere *alter ego* for another one include the disregard of corporate formalities, undercapitalization,

[Footnote continued on next page]

excessive to consider as a general principle that the justifications for limited liability for investor shareholders simply don't fit the "economic reality" of parent companies as shareholders.[145] There are numerous perfectly legitimate business reasons to use the assets partitioning characteristics of the corporation within groups of companies, such as adapting the corporate structure to the specific financing needs of the different segments of the firm's activity, the granting of security interests other specific bundles of assets and liabilities located in specific corporate vehicles, developing new businesses while protecting the existing ones, allowing different compositions of the ownership of the share capital of the corporate vehicle used to structure a business,[146] investing abroad through entities incorporated locally, etc. In various areas, the law has adapted and takes into account the fact that the business enterprise extends beyond any particular corporate vehicle.[147] Although disregarding the separate existence of the legal entities might be warranted in more situations than is now the case, one has to be cautious not to throw away the baby with the baby's bath and to consider that it should be the case in all instances.

43. Note that when I say that creating a group of companies to serve as Sleepless' corporate structure does not change much for Sleepless as a firm, it is only true as long as it's "business as usual". In case of a disaster, this structure normally isolates the consequences of this disaster into one of the corporate vehicles (which may become bankrupt without affecting the whole group of corporations) used by Sleepless instead of contaminating the whole firm. Here also, the fact that the subsidiaries of the group have their own separate legal personality and that the shareholders have limited liability has significant consequences.

44. Note also that when I say that this changes things mostly for the *environment*, I mean contracting parties, but also third parties and the *natural* environment. Imagine Sleepless Production Inc. has created a sub-subsidiary to operate a plant say in India (Sleepless Production India, Inc.) and a Bhopal-like disaster occurs. Local employees, suppliers, neighbors, etc. are quite negatively affected. But their recourse is against Sleepless Production India, Inc. in the first

[Footnote continued from previous page]
shareholders treating the corporation's assets as their own and the control of daily operations; *id*. at 13.

[145] *E.g.*, Kurt A. Strasser & Phillip I. Blumberg, *Legal Models and Business Realities of Enterprise Groups-Mismatch and Change*, CLPE Research Paper 18/2009, vol. 05, n°03 (2009), at 8.

[146] Keeping the subsidiaries as separate corporate vehicles allows having minority shareholders investing in one of the firms businesses without investing into the whole enterprise.

[147] For a rapid presentation of the consequence of "enterprise analysis" in certain branches of US law (securities regulation, labor law, corporate tax law, procedure and contracts), *see* Strasser & Blumberg, *supra* note 145, at 13-22.

place, unless they get very imaginative lawyers. And maybe this corporate structure allowing isolating certain assets in one legal entity and shielding the other assets located in other legal entities from issues arising in connection with them has led management to disregard the consequences of the firm's activities over the environment much more than if everything would have been in one pot... Depending on the facts, piercing the corporate veil, and therefore eliminating the privilege of limited liability, might be warranted.[148]

45. There are, of course, many other issues deriving from the fact that a *single firm* uses a *group of companies* as its corporate structure. For example, employees collective rights may be affected by the fact that they are formally employed by different subsidiaries; of course, much of the content of their individual rights will depend on the law applicable locally (minimum salary, working hours, working conditions, etc.); or, with regards to taxation, some intra-firm transactions appear as transactions between different legal entities which may give rise, when they are located in different jurisdictions, to so-called transfer pricing issues. (Basically, the issue is that the firm may locate its profits in low tax jurisdictions by tampering with the "transfer prices" –the prices paid in connection with transactions between legal entities belonging to the group of corporations used as the firm's corporate structure). As a consequence, multinational firms and national tax offices negotiate on what should be the level of the transfer prices all the time. Or yet another example: *intra-firm* transactions actually translate into *inter-national* transactions when they are between subsidiaries located in different jurisdictions, affecting the statistics over international trade.[149] The consequences and issues are endless, particularly when the corporations used to legally structure the firm are located in different national jurisdictions. That is the main challenge posed by globalization: we have to deal with a wealth of complex issues because of the legal structure of multinational firms and because of the splintered legal environment in which they operate. But economists are in the main useless to help addressing these issues given their disregard for the firm's legal structure. The issues raised by globalization can be understood and addressed properly *only* if one differentiates strictly between the firm and the corporation.[150]

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[148] *See also* Hansmann & Kraakman, *supra* note 1.

[149] *See*, for example, Julius DeAnne, Global companies and public policy: the growing challenge of foreign direct investment (1991). *See also* Robert B. Reich, Supercapitalism – The Transformation of Business, Democracy and Everyday Life 62 (2008).

[150] In this respect, the linguistic confusion which leads to treating the words "firm" and "corporation" as synonyms is particularly damaging. It just does not make sense to use expressions like "international *companies*" or "multinational *corporations*" or "transnational *corporations*" and so forth. The corporate vehicles are all organized under the laws of one

[Footnote continued on next page]

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46. When the operations of one single enterprise are structured using a group of corporations, the accounting of the operations is more complex as well. Each legal entity in the corporate structure has its own accounting, its own balance sheet and profit and loss statements. These financial statements give a view of the operations of each entity which have to stand on their feet. It has to be so because each legal entity has its own creditors and debtors whose rights and obligations are towards the legal entity only. But to get a view of the consolidated operation of the firm as a whole, consolidated accounts have to be prepared, disregarding the existence of the subsidiaries as separate entities and treating the firm as one single organization for accounting purposes. The preparation of consolidated accounts is a difficult exercise, one first issue being to determine the perimeter of the enterprise. It is usually based on a notion of "control": the activities of all the entities under a common control are treated as the activities of one consolidated concern. The value of the equity stakes in the subsidiaries and sub-subsidiaries, etc. are being eliminated and the operations of all the entities deemed to be under a common control are treated as if they were the operations of one single accounting entity.

But the fact that a notion of "control" is used as the criteria to set the limits of the firm for the purposes of preparing consolidated accounts does not mean that the Holy Grail of the definition of the firm's boundaries has been found. Accounting definitions of corporate control define, *for accounting purposes only* and from the point of view of the firm, the corporate vehicles which have to be retained as being part of the corporate group structuring one single organization. But the firm, as an organization, uses many other forms of controls: employment contracts, distribution contracts, etc. and the employees or distributors are not "consolidated" and, of course, neither should they be. The point is that consolidated accounts give one view of the firm's operations via its corporate structure and of the accounting of the operations delineated in this fashion. But it's a much redacted representation of the firm's total operations, power and impact.

47. In this regard, although it is attractive to think of the firm as an "entity", one has to be careful not to be misled by what is merely a metaphor. First, legally speaking, the firm is not an entity. It has no juridical personality, cannot act in the legal system, has no liabilities, etc. It is an organization, with limits which are not easily fond and actually are located at different places depending on the issue to be addressed. And whatever issues this fact creates, it is very doubtful that it should, or even could, become an entity in the legal sense of

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particular state. What is transnational, multinational, international, global (whatever one means by that) can only be the business organization, i.e. the *firm*, or its synonym, the *enterprise*.

the word. One firm can have several activities and it is quite legitimate to have separate legal entities for separate businesses. Why should firms be always forced to put all their eggs into one basket? Asset partitioning has its benefits: financing can be structured in different ways for different businesses; there might be a need to have minority shareholders for one activity, but not for the others; or for different minority shareholders for different activities. Why should this not be possible? In case the possibility to partition assets is not abused and there is no systemic problem which can not be addressed otherwise, one should keep the various legal entities separate.

Second, finding the boundaries of the firm is a hopeless task and it is quite hard to use the word "entity" to describe something which has no fixed, clear cut "boundaries". Take employees for example. They are clearly part of the firm, but only during their working time. Outside of the plant or office or shop, apart from some general duties not to disparage or compete, they are free and are not being "organized" by the firm. On Sunday, they go fishing, to the movies or have a beer –as they please. Certain suppliers and distributors might be pretty much organized in the structuring of their operations when they deal with one firm but not when they deal with others. And, maybe more importantly, large firms change all the time: people get hired, resign, new distributors get involved, plants are sold, branches are purchased, etc. The word "entity", attractive in first approximation, is quite deceptive in many respects and has to be used with great caution.

Episode 10

2.12 The Sudden Death of a Not So Key Man

Bob is victim of a car accident and dies. As a womanizer, he had a rich and fruitful life and many of his former female partners claim that their child is his and, incidentally, the heir of his shares in Sleepless, Inc.. Armies of lawyers start fighting over the fate of Bob's estate.

48. Does this death have a serious effect on Sleepless? No. Bob was instrumental in the beginning, but the Sleepless device is relatively simple and professional managers are now running Sleepless. And the numerous claims over Bob's fortune have no impact on Sleepless: what matters are the resources controlled by the corporate structure as a consequence of the contracts. And this is not affected by Bob's death. Who will end up being the owner of Bob's *shares* does not affect Sleepless Inc.'s ownership over its assets and the contracts concluded in connection with the production and distribution of the Sleepless device. Despite bitter legal battles over his estate, Sleepless is affected to the least extent possible.

Episode 11

2.13 Sleepless Inc. Goes Public

With the death of his buddy, John loses his interest in Sleepless. He starts drinking too much alcohol and absorbing all sorts of other intoxicating substances. Ken, who never had any trust in his nephew, knows that the time has come for him to sell his shares. They go to see an investment banker who convinces them to do an Initial Public Offering (IPO). Their shares are sold to the public and become listed on NASDAQ.

49. The position of the shareholders towards Sleepless Inc. has now fundamentally changed. Sleepless Inc. being a *public* corporation, the shares it issued can now be bought and sold on the stock exchange without restrictions. The value of the shares is somehow connected to Sleepless Inc.'s fate.[151] But as a form of property separate from the corporate and contractual combination of the assets and liabilities located within Sleepless Inc. as a legal vehicle, the share price evolves in a semi-autonomous (although not independent) fashion.[152] Now that the company is public, the shareholders are totally autonomous from each other. We have seen that owning a share is not akin to co-owning some larger object of property right with other owners.[153] This is always true, in both close and public corporations. But in a close corporation, although the shareholders are not co-owners, they are somehow stuck with each other because there is hardly any market for their shares. They can't "exit" their investment easily. They have to use whatever "voice"[154] the legal system is giving them, i.e. little. A

[151] With various methods applied to determine this value, on the basis of available information, with different results achieved since, by definition, any transaction implies a seller (who thinks the price is higher than the value) and a buyer who thinks the opposite.

[152] Berle & Means, *supra* note 77, at 250-252 already noticed that the shares have a value represented by their *market price* which is not immediately dependent upon, or is at least only obliquely connected with, the *underlying value* of the assets. They concluded that the concept of a share of stock must now be vigorously changed, as it can no longer be regarded as a pro rata share in an asset fund.

[153] *See* hereabove at #21.

[154] Albert O. Hirschman, Exit, Voice and Loyalty - Responses to decline in Firms, Organizations and States, Harvard U. Press (1970). *See also* Blair, *supra* note 21, at 68.

consequence is that they have fiduciary duties among themselves. When the corporation becomes public, this changes radically: the shareholders gain absolute autonomy from each other; they can buy and sell their shares as they want ("exit" is very easy) and do not have to cope either with management or the other shareholders if they disagree with them. The shareholder in a public company is therefore in a very different position towards the company and the other shareholders than was Ken in our example.

50. The position of the managers towards Sleepless Inc. (and Sleepless as a firm) is also very different. The second separation of ownership and control (the one described by Berle & Means) has now taken place:[155] the rise of the size of the organization led to the increased role of professional managers owning a limited number of shares in Sleepless Inc., directors themselves owning very few shares. Those in control of the operations do not have ownership of a majority of the shares. They do not necessarily have a direct personal interest in creating profits. Legally speaking, the officers now in charge only have the role of agents of the corporation whilst, at the origin, John and Bob, while they were officers of Sleepless Inc. were also directors and majority shareholders. The officers are still under the supervision and direction of a board of directors which is a body of the corporation, the directors being no one's agents. But the directors themselves are not large shareholders: Bob is dead, John and Ken have sold and the shares (in our hypothetical case) are widely held in the public. The board still has to fulfill its duties in the interest of the "corporation". But what does this mean? The corporation is a "legal fiction"; the notion that it has an "interest" is a legal construction. What does it correspond to? We are now addressing this issue where we left it at the end of episode #4.

3. Firm Governance vs. Corporate Governance

51. As first remarked by Zingales, the identification of the *enterprise* (firm) with the *corporation* has greatly reduced what should have been a debate among economists and other social scientists on the governance of the *firm* into a debate on *corporate law*.[156] This reduction has led to dramatically severe consequences as "corporate governance" is a very poor surrogate to "firm governance"; and "corporate governance" is based on a totally false agency theory.

There are two main schools of thought in the literature on "corporate governance".

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[155] Berle & Means, *supra* note 77.
[156] Zingales, *supra* note 8, at 1627.

The dominant contender -the shareholder value model- derives from the idea that shareholders own the firm, that managers are the shareholders' agents, and that they must therefore manage the firm in the shareholders' interest only. This approach is based on the assumptions that (a) we live in a society where there is a strict separation between governmental and economic activities, and (b) that all externalities are being internalized by efficient rules and institutions. The only issue to be addressed by corporate governance theorist is then to design rules and institutions ensuring that the managers are accountable to shareholders only and pursue an objective of profits maximization. With the assumptions made, this mode of governance is deemed to be *for the benefit of all*: the shareholders, of course; but also the other stakeholders and society as a whole.

The challenger is a much looser aggregate of ideas turning around the notion that firms do not have only *stockholders* but that they also have *stakeholders* -people whose contribution is also important and/or whose interests are affected by the firm's activities- and who should be taken into account in the management of the firm.[157] Stakeholder theory was initially developed as a *management* theory to help managers acknowledge and deal with the complex reality they face.[158] It tried to address, from the managers' point of view, the issues of the real world and has been found to be quite useful by numerous real life managers.[159] For many, stakeholder management *is* management.[160] Its appeal then led to many variations. Several analyses address governance issues by concentrating on the management of the enterprise's constituents (which is the province of disciplines such as "strategic planning", "business policy" or "strategic management").[161] Other analyses look at the governance issues from the point of view of society, the assumption made by the shareholder value model about a perfectly regulated world being totally unrealistic in a globalizing economy regulated by a State system in which anarchy dominates. This is the domain of fields described as "business ethics", "social issues in management" or "corporate social responsibility".[162]

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[157] *See generally* Ronald K. Mitchel, Broadley R. Eagle & Donna J. Wood, *Toward a theory of stakeholder identification and salience: Defining the principle of who and what really counts*, 22(4) Academy of Management Review, pp. 853-886 (1997).

[158] R. Edward Freeman, Jeffrey S. Harrison, Andrew C. Wicks; Bidhan L. Parmar & Simone De Colle, Stakeholder Theory – The State of the Art, Cambridge U. Press (2010), at 224.

[159] *Id.* at 115.

[160] *Id.* at 151.

[161] E.g. *Id.*, at xvi.

[162] *Id.* at xv.

52. Both schools of thought share common errors. In particular, both confuse firm and corporation and take it as a given that shareholders own firms.

For the shareholder value model proponents, there is simply no issue any more in the determination of the ends to be pursued in the governance of the firm. We have reached the "end of history" and those challenging shareholder value maximization are ignoring "*200 year's worth of work in economics and finance*".[163] Stakeholder theory is perceived as being merely an "*asserted contender*" with shareholder value maximization. Jensen goes as far as contenting that it is "*purposely*" incomplete to serve "*the private interest of those who promote it*", and as being developed for the benefit of stakeholders which include "*terrorists, blackmailers and thieves*".[164]

The stakeholder proponents, working on the same false assumption that firms and corporations are the same thing and that firms are owned by shareholders, have a hard time advocating alternative governance mechanisms. Since they do not challenge the shareholders' ownership of the firm, they are placed in the position of asking shareholders to give up some of their ownership rights, or to exercise these rights in "socially responsible" ways, either by arguing that it will be in their own long-term interests to do so or by appealing to their altruism.[165]

Understanding that shareholders own *shares* and not *firms*, that the shareholders ownership of the shares is not being challenged and that the management of the firm is not akin to the management of the shareholders' property allows looking at the debate under a different light.

3.1 The Shareholder Value Model

53. The *shareholder value model* is embraced by most economists. For them, the shareholders own the firm/corporation (they don't make the difference); so the corporation/firm must be managed in the *shareholders'* interest. The only problem left is an agency issue: mechanisms have to be found so that the managers, as agents, manage the corporation/firm in the interest of their principals, the shareholders. Most of the writings on corporate governance concentrate on the appropriate monitoring devices to make sure shareholders' profits (identified as the principals' sole interest in the firm) are maximized.[166] Identified risks are that

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[163] Michael C. Jensen, *Value Maximization, Stakeholder Theory and the Corporate Objective Function,* 12 Business Ethics Quarterly 235-256 (2002), at 239.
[164] *E.g.* at 236.
[165] *E.g.* Paddy Ireland, *supra* note 69 at 33.
[166] Jean Tirole, Corporate Governance 1, 2 (2001).

managers may produce insufficient efforts, that they may make extravagant investments, pursue entrenchment strategies or even engage in self dealing.[167] Dysfunctional corporate governance is only analyzed from the point of view of the shareholder. It can take many forms: a lack of transparency in the various forms of compensation granted to top management, the sheer level of the compensation packages, often tenuous links between performance and compensation or even accounting manipulations.[168] Board of directors are often criticized for their lack of independence, the insufficient attention they pay to the issues faced by the business, the insufficient level of their incentives and conflict issues.[169] Repeated scandals and crisis lead to the issuance of new laws and codes of good governance, providing for rules and recommendations targeted to address these particular issues. Recommendations are that the number and influence of independent directors should be increased; the roles of chairman of the Board and of CEO should be split; managers should be paid in stock options, etc. The facts are that none of these devices have the predicted effects on the outcome of the corporate governance mechanisms thus promoted.[170] But, as is often the case, contradictory facts have almost no effect on a dominant theory until a viable alternative is offered.[171]

54. Milton Friedman has a lasting influence on this classical view over corporate governance.[172] His views on the social responsibility and purpose of the firm have become canonical and much of the writing in finance, economics and management assume that they are correct and provide an appropriate description of the law.[173] His errors, however (which the reader will easily identify), are striking in a widely cited article in which he wrote:

> "in a free-enterprise, private property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as

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[167] Jean Tirole, The Theory of Corporate Finance, Princeton U. Press 16-17 (2006).
[168] Tirole, *supra* note 167, at 17-20.
[169] Tirole, *supra* note 167, at 30-32. *See also* Freeman et al., *supra* note 158 at 227.
[170] *E.g.* Sumantra Goshal, *Bad Management Theories are Destroying Good Management Practices*, 4 Academy of Management Learning & Education, pp. 75-91 (2005), at 80. *See also* Sanjay Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Business Lawyer 921-963 (1999).
[171] T. S. Kuhn, The Structure of Scientific Revolutions, University of Chicago Press (1962).
[172] Tirole, *supra* note 167, at 16.
[173] Freeman et al., *supra* note 158, at 202.

> possible while conforming to the basic rules of the society (...) The manager is the agent of the individuals who own the corporation."[174]

This analysis lives up to the task of explaining what happens when a coffee shop owner retires and entrusts the management of his boutique to a hired manager. The manager of the shop is the employee of the owner of the business and has direct responsibility towards him. He must run the shop in accordance with the owner's desires, being his mere agent. And if the owner is unhappy, he can fire the manager and return behind the counter to manage the shop as he always did.

But applied to the large corporation with listed shares, Friedman's description is wrong on four key accounts. As this article has shown, in large firms legally structured around corporations with listed shares:

(a) the corporate executive is *not* an employee of the shareholders. She is an employee of the corporation, which is a separate legal person;

(b) the shareholders are not "*owners of the business*". They own shares issued by the corporation used to legally structure the business and do not own the corporation's business. The shareholders just can't step in and run the business, as owners could do. If a shareholder wants to run the business, she must go through the corporate procedures required to be appointed as officer; but even then (like John and Bob in our example at episode #4), she would not be allowed to act as an *owner*. She would have to abide by the constraints and duties provided for by corporate law, with the ancillary liabilities if she breaches them. To obtain the full autonomy of the owner, she would have to purchase all the shares and get rid of the corporation altogether (dissolve it). She would then own the assets and liabilities directly and she would be the counter-party to the contracts with the other resource providers. She would *then* be the indisputable owner of the business- with all the pleasant ensuing consequences: unlimited liability, no partitioning of the personal and business assets, fragility of the business since the cluster of contracts connecting the property rights would be centered on an individual person potentially affected by all the incidents of life (sickness, divorce, death, etc.). This would seriously affect the business, making its financing

[174] Milton Friedman, *The Social Responsibility of Business is to increase its Profits*, The New York Times, September 13, 1970, emphasis added.

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impossible if it is of some importance. No external financier would extend substantial financing to a business based on the fragility of human life;

(c) the corporate executive has no responsibility to conduct the business in accordance with the *shareholders' desires*. She is not under their supervision. She responds to a board of directors. She can't be (directly) fired by the shareholders, only by the board of directors -directors themselves not being the shareholders' agents; and

(d) there is actually no legal duty to maximize profits in the management of a corporation.[175] The myth that such a duty exists has probably been invented to keep alive the view that economic agents are maximizers, that the firm is an economic agent like any other one and that the only issue within the firm is to make sure that managers maximize the shareholders' welfare via the invention of a direct agency relationship between "owners" (maximizing shareholders) and firm managers. This allows going almost full circle back to the classical economic treatment of the firm as a black box,[176] the content of which is deemed to be irrelevant for economic analysis. Casting shareholders as "principals" of managers treated as "agents" allows applying the elegant mathematics of principal-agent models to the enormously complex issues related to the governance of giant firms operating worldwide and having a direct influence on the lives of millions of people and on the environment, social and natural, in which they live.[177] These models are built on either unrealistic or plainly false assumptions; and their prescriptions prove to be invalid. And yet, despite its lack of validity and empirical support, agency theory continues to dominate academic research and corporate governance.[178]

[175] *E.g.* Lynn A. Stout, *Why we should stop teaching Dodge v. Ford*, UCLA School of Law, Law & Econ. Research Paper Series, Research Paper No.07-11. *See also* Robert N. Anthony**,** "The trouble with profit maximization", in Biondi et al., *supra* note 4, pp. 201-215. And Yuri Biondi, *Governing the Business Enterprise: Ownership, Institutions, Society*, CLPE Research Paper 13/2009, Vol. 05, n° 03 (2009) at http://ssrn.com/abstract=1440889

[176] *See* hereabove at ft 7 and accompanying text.

[177] *E.g*. Sumantra Goshal, *supra* note 170 at 80.

[178] *Id.* at 81.

55. Friedman's fundamental error is to disregard the existence of the corporation as a separate juridical *person* and treat it as an *object* of property rights. The view that managers should maximize shareholders' interest prevails today because controlling or activist shareholders can sale their ware using an economic analysis founded on a fundamental misunderstanding of the actual content of corporate law and, maybe more importantly, on a fundamental ignorance of the importance of its mechanisms for the operation of the real economy.[179] "*In a free-enterprise, private property system*" in which limited liability corporations have been introduced in the legal system to allow the structuring of firms requiring the use of significant amounts of capital, Friedman's description of the law is totally false. If the law were as he describes it, no large firm would have developed since the benefits of assets partitioning, limited liability, corporate group creation and the development of securities markets would never have occurred. Issues of governance would admittedly be much simpler and very much in line with his conclusions – but we would be living in a frugal economy in which enterprise governance (the governance of boutiques and cottage industries in relatively closed polities) would hardly exist as an issue.[180]

If one wants to keep the advantages of large concentrations of capital and of large firms, in a world of positive transaction costs, one has to address governance issues while taking into account the *reality* of the legal rules without which such large concentrations of capital would not have been possible in the first place. The dominant analysis is based on an understanding of the law vaguely corresponding to its state in the frugal economies of the eighteenth century which is incompatible with the existence of large firms. As a consequence, economic "science" based on the ignorance of the legal structure of modern firms is there to assist forcing the concentration of management's efforts on the promotion of the interests of the sole shareholders who are being wrongfully presented as "principals", as owners. As we have seen, the whole purpose of modern corporate law was precisely to severe *any* property right connection between the shareholders and the assets used in the operation of the firm. It is only because

[179] There are currently roughly 13,000 hedge funds managing globally $1.8 trillion. They are driven aggressively to extract as much value as possible from their investment. *See* Robin Mayns Cowles & Brandon Meyer, Shareholder Activism: Proactive Defense and Informed Response, ICR Corporate Governance White Paper, May 2008, available at www.icrinc.com. "Activists normally present themselves as working for the greater good... the indisputable reality is that each and every fund is singularly and exclusively concerned with whatever course of action will most benefit its own interests. Unfortunately, this goal often conflicts ... with what may be the best for the company or its shareholders over the long term. ... hedge fund activists are typically focused on generating short term (less than one year) financial returns". *Id*. at 5.

[180] On how the Islamic traditional institutions became sources of competitive disadvantage when Occidental legal systems developed business corporate law, *see generally* Kuran, *supra* note 129.

agency theory disregards the reality and importance of the legal instruments used to structure large firms-as-they-are that a widespread ideology that "shareholders-own-the-firm-so-management-must-maximize-profits" could develop.[181] The irony in all this is that Friedman treated his opponents as being "*notable for their analytical looseness and lack of rigor*"…[182]

56. There is another part -societal- to the shareholder value model. A necessary assumption in the "demonstration" that shareholders' interests should be maximized in the firm's management is to assume that we live in a world with no monopolies and in which all externalities are being internalized by efficient contracts and appropriate laws. For example, the principal-agent models assume that labor markets are perfectly efficient: the wages of every employee represent the value of the contribution made. When they don't, employees are assumed to be in a position to immediately and costlessly move to another job.

Shareholders are then assumed to be in a totally different position. It is contended that whilst "*the interests of participants in the firm other than shareholders can generally be adequately protected by contract and regulation … the interests of equity investors in the firm... cannot be adequately protected by contract."*[183] The "demonstration" then is made that firm market value maximization is the only way to lead to an efficient social outcome. The demonstration is simple enough: it is not possible to maximize in more than one dimension (say profits and market share) at the same time. So if management is left with more than one dimension on which to concentrate, it will be left "*with no objective*", no scoreboard. Managers and directors will be left unaccountable. It will allow "*managers and directors to invest in their favorite projects that destroy firm-value whatever they are … without having to justify the value destruction*". This will lead to reduce social welfare "*just as in the failed communist and socialist experiments of the twentieth century*". There is even a world-history explanation as to why some people remain attracted by alternative stakeholder approaches despite the "demonstration" made: challengers to the prevailing model of corporate governance are described as victims of the "*deep emotional commitment of most individuals to the family and tribe. For tens of thousands of years those of our ancestors who had little respect for … the family, band or tribe probably did not survive. In the last few hundred years… market exchange … has brought huge increases in the welfare of humans and in their freedom of action*."

[181] *See generally* Hansmann & Kraakman, *supra* note 1.
[182] Friedman, *supra* note 174.
[183] Hansmann & Kraakman, *supra* note 1, at 449.

But many people are still victims of "*their evolutionary attachment to the small group and the family*."[184]

We have little room to challenge Jensen's impressive mastery of world history to determine whether it is probable or not that our individualistic ancestors survived and whether, symmetrically, retarded humans attached to the "tribe" should be eliminated by evolution... Nor to challenge the idea that increases in the welfare of humans is due to "market exchange" when the development of firms played such an important role. We will just concentrate on the fact that a key in his defense of the shareholder value model is the acknowledgement that "*when monopolies or externalities exist, the value-maximizing criterion does not maximize social welfare*".[185]

57. The problem is precisely this one. In a globalizing world, there is no global government in a position to internalize all externalities. And such a government or governmental system is nowhere in sight. There is no support for the position that we live in a world in which all the firm's participants (and its environment) are protected by contracts and rules. Jean Tirole himself acknowledged that,

> "... the legal and regulatory framework is itself imperfect (...) and it is often influenced by intense group lobbying. So when laws are "suboptimal", managers may need to substitute for the required reforms. (...) Shareholder-value maximization is, of course, very much a second-best mandate. In view of <u>some</u> imperfections in contracts and the laws, extremist views on shareholder value are <u>distasteful</u>."[186]

Looking at the state of the world economy, the sub-prime and subsequent financial and economic crises, global warming, child labor, deforestation, the rapid extinction of many species of plants and animals, all sorts of instances of tax and legal dumping (the existence of tax and legal "havens"), the offshore phenomenon (the use of corporate devices to locate the appropriation of wealth creation in low tax jurisdictions),[187] the rising number of working poor, and so forth, it is hard to agree that there are only "*<u>some</u> imperfections in contracts and the laws"* and that "*extremist views on shareholder value are* [<u>only</u>] *distasteful."* The evidence is that negative externalities are large and pervasive and existing

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[184] All the citations are from Jensen, *supra* note 163 at 244.
[185] Jensen, *supra* note 163 at 239.
[186] Tirole, *supra* note 167 at 61, emphasis added.
[187] *See generally* Ronen Palan, The Offshore World – Sovereign Markets, Virtual Places and Nomad Millionaires, Cornell U. Press (2003, 2006).

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modes of corporate governance play their role in this state of affairs. Shareholder value theorists obviously bear their share of *liability* for this situation. By oversimplifying the issues of corporate governance in a globalizing world, the proponents of shareholder value contribute to the sustenance of corporate governance systems which systematically *convert externalities* -costs imposed upon others and the environment, social and natural, via biased governance systems- *into profits*.

58. As we have seen, corporations having juridical personality are key legal institutions for the development of firms requiring large amounts of capital. A legal analysis of the economics of the firm, however, shows that the principal-agent theory of corporate governance is plainly false. A disclaimer should accompany the agency theory to prevent its use for the treatment of real life issues: it is based at best on mistakes, at worse on a false presentation of reality and has toxic consequences. Managers are now on a short leash: they are forced to manage in the interest of the "owners", including via biased compensation incentives (aligning the managers' compensation to the increase of the shareholders' welfare only)[188] and maximize profits via biased accounting systems (which take into account only part of the costs of a firm's production due to legal and political failures).[189] Managers then can hardly resist the shareholders' demands to sacrifice the other interests affected by the firm's activities beyond the minimum respect of contractual and regulatory

[188] Because the managers are supposed to act in the sole interest of shareholders, their compensation system is biased towards this end, via bonuses and stock-options. It is well known that designing pay that is sensitive to the performance of a single task leads to a neglect of the other tasks. *See* Tirole, *supra* note 166, at 26 and, *generally* Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, J. of L., Econ. & Org. 24 (1991). As a consequence, "shareholder value generates choices that are biased"; in Tirole, *supra* note 99, at 32. For "multi-tasks agents", such as firm managers, "an increase in an agent's compensation in any one task [stock options or a larger bonus for larger profits] will cause some reallocation away from other tasks. ... an optimal incentive contract can be to pay a fixed wage independent of measured performance... . More generally, the desirability of providing incentives for any one activity decreases with the difficulty of measuring performance in any other activity that makes competing demands on the agent's time and attention." Holmstrom & Milgrom, at 26.

[189] Because not all the costs and benefits of the firm's activity are centralized into one set of accounts designed for the *firm*. The accounts now available are mainly those of the *corporation* or the consolidated accounts of the *group of corporations* serving as the firm's corporate structure. For an attempt at developing new measures of wealth creation, *see* Hill, *supra* note 32. *See generally* Jacques Richard, *Comment la comptabilité modèle le capitalisme*, 161 Le Débat 53-64 (2010) and Biondi, *supra* note 140.

constraints.[190] They are enticed both by the prevailing ideology and by biased compensation systems to abuse the assets owned by corporations to the sole benefit of the shareholders in an environment where the legal and political systems are at a loss to provide the necessary regulatory counterweights.

For shareholder value theorists, the taking care of the interests affected by the firm other than the shareholders' are the province of "*the government*".[191] The argument has been clearly made by Friedman in that same famous article:

> "The executive … exercising … social responsibility … is in effect imposing taxes and deciding how the tax proceeds should be spent. … the imposition of taxes and the expenditure of tax proceeds are governmental functions. We have established elaborate constitutional, parliamentary and judicial provisions to control these functions."[192]

Yes we have. At the national level. And on the basis of eighteenth century political theories in the context of relatively closed economies in which agriculture and small businesses were dominant, in a world with no business corporations, no large firms, no global society, no global environmental problems. In today's global world, there is no such thing as "*the government*". We have competing States with competing interests hosting competing firms playing competing States to supply them with legal environments favorable to the improvement of their competitive position in the global economy.[193]

59. In this article, we have mostly dealt with the first simplification that shareholders own firms. The combination of this simplification with the notion that we live in a perfectly regulated world needs to be addressed as well to face the issues of firm governance. Firms as presently managed are engines *designed* to produce externalities to the advantage of shareholders. Operating in a less than perfect world which does not internalize all externalities, and being run for the advantage of one of its constituents only (the shareholders), costs generated by the firms' activities and not accounted for (since they are externalities which are not

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[190] The various species of funds have aggregated the "power of individual investors. To lure or keep these collections of shareholders, CEOs had to do everything possible to raise the value of the companies' shares. They had no choice but to focus ever more intently on creating "shareholder value""; Reich, *supra* note 149, at 71.

[191] Jensen, *supra* note 163, at 246.

[192] Friedman, *supra* note 174.

[193] *See also* Peer Zumbansen, *The Evolution of the Corporation: Organization, Finance, Knowledge and Corporate Social Responsibility*, CLPE Research Paper 06/2009, Vol. 05, n°01 (2009). *See generally* John Gerard Ruggie, *Continuity and Transformation in the World Polity: Toward a Neorealist Synthesis*, 35(2) World Politics pp. 261-285 (1983).

internalized in the accounting systems) are being imposed on other constituents and on the firm's environments –social and natural.

In a globalizing world, large companies simply can not assume they operate in a perfectly regulated environment. One could argue with great difficulty and a certain blindness to the imperfections of political institutions that they could do so in a closed economy with democratic political institutions – assuming such a strange combination could exist. But the assumption of a perfect regulatory environment just can't be made in an open economy regulated -so to speak- by the anarchy of the State system. A proper analysis of the way in which firms must be managed can not rely on an assumption that perfectly efficient political institutions exist. Such an assumption is always wrong but it is particularly wrong for large multinational firms which have spread their clusters of contracts connecting property rights to their corporate structure over the anarchy of international society. In a global economy without a State, neither firms as presently governed nor divided governments can address many of the social and environmental issues created by globalization.[194] The fact that contracts, regulations and political institutions are imperfect must be integrated into the analysis – and into the rules of firm governance.

3.2 The Limits of the Stakeholder Model

60. Stakeholder theory has been developed over the last thirty years to counter the dominant mindset according to which

> "corporations are seen as the property of their owners … and as limited in their liability for their effects upon others. In a world were concerns are primarily domestic, such models may be appropriate, since governments may well be able to abrogate any adverse effects in a way that is fair to all. There is no such world today."[195]

From the very beginning, stakeholder theory was therefore perceived as a means to address an issue of *government*.

The stakeholder approach, however, is far from being radical. Its proponents claim that there is little direct conflict between the shareholder view and the stakeholder view.[196] Like the proponents of shareholder value, stakeholder

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[194] *See* Reuven Avi-Yonah, *Taxation, Corporate Social Responsibility, and the Business Enterprise*, CLPE Research Paper, 19/2009, Vol. 05 n°03 (2009), at 15.

[195] Freeman et al, *supra* note 158, at 4.

[196] *E.g.* Freeman et al, *supra* note 158, at xv.

theorists usually confuse the notions of firm and corporation and view shareholders as the firm's owners. Some of the founding fathers of stakeholder theories actually acknowledge that their analysis is based on their rather limited understanding of the legal system and that there is an "*entire suite of issues around international law*". They acknowledge that these issues are crucial for understanding the problem of value creation and trade in a global business world but that these issues have received little attention.[197]

61. Given the fact that shareholders do not own firms and that, as a consequence, the agency theory of firm governance is false, the stakeholder theory has plenty of room to be more assertive. Developing firm governance systems to take into account stakeholders' interests is not only an ethical or a strategic issue. It is a legal, not to say *constitutional*, issue. It is not only an issue of fairness, of ethics, etc. It is an issue of promoting the appropriate system of exercise of *power* and of allocating responsibility and potential liability for failure to live up to one's obligations in this system.

The bad news for shareholder value maximizers is that shareholders do not own firms, that we *do* live in a world of negative externalities and that official governments are *unable* to provide the appropriate framework of rules within which the managers of large firms could only care about a one dimensional pursuit of firm market value maximization. Yes, firm management is government. Ignoring it and only treating the State as "government" to remain within an institutional framework designed to suit the needs of a frugal and mostly agricultural society is showing the utmost degree of disrespect for the rights of the individuals subject to these new forms of power. And, ultimately, to the individualistic values the shareholder value models purport to promote. Acknowledging this fact and trying to find proper firm governance principles does not mean one advocates returning to the collective life of tribal man having failed to see the light of the delights of market society. The issue is to face the world as it is and address the issues it creates, taking into account the realities of the firms' legal structure and of the legal environment in which they operate. While keeping the dynamism and creativity of a free society.

In turn, the problem with the stakeholder model is that the word "stake" covers too many different things to be operational. There is even now the notion that there are "*stakeholders to the stakeholder theory*"…[198] Generally, the stakeholder model (a) shares errors with the shareholder value model in the (legal) analysis of firms and makes the same confusion between the firm and the corporation; (b) treats shareholders on an equal plane with members of the firm

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[197] Freeman et al, *supra* note 158, at 165.

[198] Freeman et al, *supra* note 158, at 287.

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while they are not necessarily part of it as an organization; and (c) fails to integrate interests which have no "stake" (if this means a form of investment[199]) in the firm, which are not *members* but are, or can be, seriously affected by it (such as neighbors, the natural environment, the affected polities, etc.).

62. With my analysis which strictly differentiates between the firm and the corporation, we are led to abandon both the "shareholder" (or "property", or "contractual") and the "stakeholder" (or "social", "managerial", or "institutional") models of corporate governance.[200] The first model must be abandoned because shareholders do not own the firm and the second one must be abandoned because the "stakeholders'" relative positions with regards to the firm are so different that the notion that they each have a "stake" is devoid of any operational meaning.

I will try to draw some conclusions from the analysis developed.

3.3 Appointing and Removing Directors

63. The governance of the firm is an issue of public concern which goes beyond the classical corporate governance debate because the directors and officers of the listed corporations used as the firms' corporate structure are making decisions affecting at times millions of individuals, be they the firms' constituents, the shareholders or the firm's environment (natural and social) in a world of "suboptimal" laws. They derive their power to make decisions within the firm from their control over the use of the property rights owned by the corporations in which they hold corporate positions. But they do not own any of this property. They do not have the authority and legitimacy of the owner in the exercise of their authority. Executives have authority to use it because they are appointed by the Board. They are accountable to the Board and the Board is accountable to the shareholders. But it does not mean they should not be accountable towards other interests *as well*.

64. In effect, the shareholder value model connects two issues in the corporate and firm governance which are not necessarily linked. Its proponents consider that (1) only shareholders should have authority to appoint directors and (2) directors and officers should pursue a goal of profit maximization. For Tirole, the two are linked because, for instance, it would be hard for a manager to sacrifice profit to benefit some stakeholder if a profit-maximizing raider can take over the firm and replace her, unless that very stakeholder can deter the

[199] Blair & Stout, *supra* note 11.

[200] *See* William T. Allen, *Our Schizophrenic Conception of the Business Corporation,* 14 Cardozo L. Rev. 261 (1992), at 264-265.

takeover.[201] This is true, however, only to the extent that the manager is not under an enforceable obligation to take into accounts that stakeholder's interest. If the duty exists, the profit-maximizing raider will have to abide by this obligation *after* the takeover as well.

The two issues can therefore be separated: (a) there is support to the fact that shareholders should be the only ones having authority to appoint or remove directors (at least a majority of them) – not because they own firms, but because they own shares which put them in the position of being paid last for their contribution to the firm. But (b) it does not imply managers should maximize profits (i.e. shareholders' compensation for their contribution) in an absolute sense, i.e. by taking into account contractual and regulatory constraints to the minimum.[202] Such a mandate makes sense socially if contracts are perfect and all social costs are perfectly internalized by perfect political institutions producing perfect norms -which is patently not the case. And from the firm's perspective, shareholders are only one class of suppliers: they provide the equity capital the firm needs. The firm has to compensate their contribution in a way which satisfies them. It does not need to "maximize" their welfare and corporate officers are actually not under a legal obligation to do so. What is needed is only to keep them sufficiently happy so that they do not switch their capital to other uses.

We will now turn to these two separate issues: the appointment and removal of the directors and the interests to be pursued in the firm's governance.

65. In the construction of the governance of the firm as an economic institution having efficiency constraints, it does make sense for the authority to appoint the corporate directors to belong to the shareholders. The shareholders contribute a resource -equity capital- which has special characteristics in that it is the first resource in line to bear the risk of not being compensated by the firm's

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[201] Tirole, *supra* note 167, at 58.

[202] But Tirole, *supra* note 166, at 24, takes the view that "the stakeholder society means both a broad managerial mission and divided control" (emphasis added) and that "presumably, the two notions are related". By the notion of "broad mission of management", he means -adopting a utilitarian approach- that management should aim at maximizing the sum of the various "stakeholders' surpluses"; and by "divided control", he means a sharing of control by stakeholders. I do not think (a) that a utilitarian approach is appropriate (Tirole himself makes later in his article the remark that there is no accounting measure of the welfare of employees, suppliers or customers (at 26); and the situation is even worse for the natural environment) and (b) that the two are linked. A broad mission may be defined for managers with extended fiduciary duties towards those affected by the exercise of their power without taking control rights out of the hands of shareholders, who have a special position in the firm because they stand last in line to be paid for their contribution. *See also* Hansmann & Kraakman, *supra* note 1, at 447-448, who differentiate between a "fiduciary stakeholder model" and a "representative stakeholder model".

activities. All the other contributors of resources to the firm are senior to the equity holders.

Shareholders own securities entitling them to benefit from residual claims. In order to have within the firm's legal structure an in-built mechanism pushing managers to be efficient, those last in line to be paid must hold the stick. Whatever the system adopted to internalize externalities (rely on contracts and regulations, or add other mechanisms as well within the firm's governance procedures, as I will suggest), the shareholders are always, and will always be paid last for their contribution. And someone has to be paid last. The compensation of the shareholders' contribution to the firm is therefore dependent on the performance of the directors and officers in governing the corporation and the firm – whatever the constraints are, high or low, weak or strong to internalize the consequences of the firm's activities within the prices charged for its production. The shareholders' authority to hire and fire Board members is a consequence of their position as the most subordinated creditors.

This is so much the case that the right to vote in corporations actually *moves* and it is not *per se* the shareholders' monopoly: owners of common stock have the right to vote most of the time; but if the firm is in trouble and, for example, omits dividends to preferred stockholders, these stockholders commonly acquire the right to cast controlling votes; and when the firm is insolvent, the bondholders and other creditors eventually acquire control through the operation of bankruptcy laws. Voting rights thus flow to whichever group holds the residual claim.[203] That's how we keep firms/corporations efficient – again, whatever is being internalized via contracts, regulations or other mechanisms. These do not necessarily affect profits if prices are increased, i.e. if the full cost of the products and services are being paid by their acquirers. This right to vote is not connected to any king of ownership of the business (or corporation, or firm). For example, it is not *sold* to creditors when the company becomes insolvent. The right to vote is linked to the subordinate position of the classes of creditors and in case of misfortune in the firm's activities, it moves up to the class of creditors not totally wiped-out.

66. Beyond this, the interests of equity investors in the corporation are adequately protected without any mandate to "maximize" profits. It is not contractual protection shareholders enjoy; they are protected by something much more powerful: regulated securities markets.[204] As we have already seen, dissatisfied shareholders can easily sell their shares in public corporations. They

[203] *See*, for example, Romano, *supra* note 82, at 188-189.
[204] *See also* Freeman et al, *supra* note 158, at 112.

have almost zero cost of exiting their investment and are protected by organized securities markets.

In a listed company, the unrestricted alienability of the legal titles to the residual claims (the shares) gives rise to an external monitoring device unique to public corporations: the stock market.[205] Shareholders can easily come and go and this possibility has a disciplinary effect on directors and officers. Any sale of a company's stock affects the stock price and the greater the stockholders' dissatisfaction, the more shares relative to their total number will be sold and the lower will be the price of the company's stock relative to that of other companies.[206] Thus the shareholders' freedom to sell shares in a market that reflects the capitalized current value of managerial decisions tends to set limits on the managers' discretion.[207] Managers must take into account the shareholders' interests because otherwise, the cost of financing the business increases,[208] making it harder to compete against other firms treating their shareholders better; or the corporation they manage may be the object of a takeover leading to their replacement. For Easterbrook and Fischel, "*managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart. It is almost as if there were invisible hands*..."[209] Nothing else but the market (the "*invisible hands*" of stock exchanges) is needed here, and this conclusion should be particularly attractive to the proponents of the shareholder value model.

3.4 Firm Governance: Where to Start?

67. We have to start with the indisputable fact that all shareholders are owners. They own shares and have a subjective (property) right on their shares. Unless they are in a peculiar position (such as being a majority shareholder or exercising control in conjunction with other shareholders), they have no specific duty to use their property in one way or another – just like any other owner of any asset, be it a car, a house, a bond or a bicycle.

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[205] Fama & Jensen, *supra* note 8, at 313.

[206] Eirik G. Furubotn & Svetozar Pejovich, *Property Rights and Economic Theory*, J. of Econ. Literature 1137, at 1150 (1986).

[207] *Id*. at 1150.

[208] *See* Berle & Means, *supra* note 77, at 247. *See also* Dodd, *supra* note 2, at 1154, reporting General Electric's CEO comment that "I conceive my trust first to be to see to it that the capital which is put into this concern is safe, honestly and wisely used, and paid a fair rate of return. Otherwise, we cannot get capital. The worker will have no tools." *See* Moore & Rebérioux, *supra* note 121, at 20.

[209] Romano, *supra* note 82, at 99.

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In the firm's governance, a difference must be made between controlling and non-controlling shareholders. Non-controlling shareholders do not have the ability to impose their views on the way the firm should be managed. They are not members of the firm.[210] They have no fiduciary duties.[211] They are isolated from the liabilities created in conjunction with the firm's operation and are protected by the market for securities.[212] They only act in their own name and do not have any particular obligation in the "management" of their shares (i.e. selling or not selling).

Controlling shareholders are in a totally different position. They enjoy the same protection of limited liability as minority shareholders do; but they have the practical possibility of using the power they get from their control over managers in several manners. As owners of shares, controlling shareholders are entitled to use them and dispose of them as they want. As monitors of management (board members), however, controlling shareholders are members of the firm. Their monitoring position within the firm is not at all the one of *owners*. Today, proponents of the "shareholder value" model give them full legitimacy to act as "owners". But they should not be allowed to use their prerogative as such.

Our point in demonstrating that shareholders do not own the firm is that if controlling shareholders (or their agents at the board) use their power to direct the firm's operation as if they owned it, they have to be ready to assume the consequences. For an owner of a majority of shares, acting as owner of the firm is *abusing* the privilege of limited liability and should be sanctioned by unlimited liability for the consequences. Controlling shareholders cannot have it both ways, as is the case today.[213] It is already acknowledged under existing case law that majority shareholders owe fiduciary duties towards other (minority) shareholders, i.e. they *cannot* use their property (the shares) in full autonomy as other shareholders can do.[214] Within groups, also, companies holding the shares of another one are sometimes acknowledged as being in a situation where there is a rebuttable presumption they behave as owners and should bear the liabilities attached thereof if they do not rebut the presumption. But an understanding that shareholders do not own firms should lead the law to evolve beyond that. Limited

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[210] *See* hereabove at #33.

[211] *See* hereabove at #25 and #49.

[212] *See also* R. Edward Freeman & William M. Evan, *Corporate Governance: a Stakeholder Interpretation*, 19 Journal of Behavioral Economics 337, 1990, at 344.

[213] This was made clear as early as 1839 by Chief Justice Taney who wrote that if the entity were disregarded, each stockholder would be liable to the whole extent of his property for the debts of the corporation; Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519, 586 (1839).

[214] *See* hereabove ft 86 and accompanying text.

liability should be lifted in many more instances than is now the case.[215] To prevent liabilities created in the firm's operation from contaminating them, the controllers of the firm, be they the managers or the controlling shareholders, need to be in a position to demonstrate they have taken into account -in the strict sense of the expression- the other interests affected by the firm's activity. It should be part of the managers' job. And controlling shareholders should let them do it and actually make sure they do it to avoid the risk of their own liability being triggered. If they want to keep their limited liability, they have to remain in their position of suppliers of equity capital to the firm, entitled to collect residual claims, i.e. what is left after *everything else is paid*. But before they collect, "everything else" must be paid and their role is to make sure that "everything else" is paid. The difficulty then of course lies in determining what "everything else" is in a world of imperfect contracts, laws and regulations. This is of course a very complex issue on which much work remains to be done. But this is a work which has to be done with the right understanding of the firm's legal structure and of its environment.

3.5 Governing the Firm in a Global Economy

68. A recurring issue for the stakeholder theory has been to determine who stakeholders are and how firms relate to them, and to prioritize among them.[216] By understanding the legal structure of the firm and the role played by the corporation in the firm, one can isolate different classes of "stakeholders". We do not pretend to be in a position to present all the ramifications of our analysis. But a precise understanding of the firm's legal structure allows differentiating the issues:

- One can distinguish those who are the firm's constituents from those who are in its environment. Constituents are members of the organization and can be defined as those organizing the firm and those whose activities are being organized by the firm. They comprise, in particular, controlling shareholders, managers and employees, sometimes distributors or suppliers for certain issues. They are those which are being within the firm's "boundaries" which, as we have seen at Section 2.9 hereabove, vary depending on the issue at stake.

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[215] A position also supported by Hansmann & Kraakman, *supra* note 1.
[216] Freeman et al, *supra* note 158, at 206.

- There are then those contributing to the firm's success without being constituents. They include minority shareholders and the surrounding territorial communities.
- There are then those who are none of the above but directly bear the consequences of the firm's activities. They include neighbors, for example. It is highly questionable that they are "stakeholders" (again, if the word means a form of investment). And although firms can not have a responsibility to address the problems of society as a whole,[217] mobilizing or taking care of "stakehoders" is not enough. Firms must take into account the interests, societal and environmental, directly affected by the firm's activity.[218]

The managers of large firms exercise the power deriving from the concentration of the resources they manage without owning them -the corporation does- and since they are not owners and do not act on behalf of individuals, they should be recognized as having fiduciary duties towards all those directly affected by the exercise of their power -which goes beyond the shareholders.[219] When either contractual or regulatory means are effective at preventing abuses of power, there is no need for the intervention of fiduciary law.[220] Managers can use the full decision making autonomy granted by the control other the property rights owned by the corporation. They can strictly enforce contracts and abide by regulatory constraints since there is no need to supplement them. But when there are contractual and regulatory failures, then there should be acknowledgement of the existence of fiduciary duties making it a duty for managers to take into account the interests affected.[221] The legitimacy of their power is hardly sustainable otherwise.

69. The existence of fiduciary duties is acknowledged in the inner functioning of the corporation towards shareholders. Because the firm, as an organized economic activity, impacts on numerous interests other than those of the shareholders which can not be adequately protected by contracts or laws, the acknowledgement that the firm's management is subject to fiduciary duties towards certain constituents of the firm and its environment may actually be an efficient method to lead managers to internalize the costs associated with the

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[217] *See also* Freeman et al, *supra* note 158, at 246.
[218] *Id*. at 260.
[219] *See also* Jean-Michel Darrois & Alain Viandier, *L'intérêt social prime l'intérêt des actionnaires*, Les Echos, 27 juin 2003.
[220] *See* Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 811 (1983).
[221] *Id.*. *See also* Clark, *supra* note 15, at 76.

firm's production within the firm's production prices.[222] Private powers can be made accountable in this manner. Clearly, in certain circumstances, competition among firms will make it difficult for managers to fulfill these duties when competitors don't. But even then, firms have means to promote the adoption of norms – via industry standards, publicity or lobbying, for example – in cases where they need external norms to be able to compete on a leveled playing field. When they are aware of substantial negative externalities, managers just can't rely on less than perfect political institutions and should be under a positive duty to act.[223]

4. Epilogue

70. We are back to Berle & Means' original research program,[224] actually quite different from the account often given of their work.[225] Only limited progress has been made since they initially defined it –eight decades ago. A reason may be that the agency theory has been such a strong ideology that it has prevented adequate research on the real issues of governance. Where can you go when you have reached "the end of history", as some have claimed? In the 1932 preface of their essay, Berle wrote:

> "Accepting the institution of the large corporation (as we must) and studying it as a human institution, we have to consider the effect on property, the effect on workers, and the effect upon individuals who consume or use the goods or services which the corporation [Berle probably meant to say 'the enterprise'] produces or renders. This is the work of a lifetime; the present volume is intended primarily to break ground on the relation which the corporation bears to property."[226]

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[222] The last paragraph of Freeman's path breaking book is entitled "*The manager as Fiduciary to Stakeholders*". *See* R. Edward Freeman, Strategic Management – A stakeholder Approach, Cambridge U. Press, 1984, at 249.

[223] On the fact that some are plainly aware that such is their responsibility, *see*, for example, Paul Polman, *Redefining Business Success*, Paper presented at the Economist Third Annual Sustainability Summit in London on February 25, 2010 on the theme "After Copenhagen: How can business face the Climate Change Challenge?".

[224] *See also* Michel Aglietta & Antoine Rebérioux, Dérives du capitalisme financier 349-350 (2004).

[225] *See generally* William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34(1) The Journal of Corporation Law 99-152 (2008); Moore & Rebérioux, *supra* note 121.

[226] Berle's preface to the 1932 edition of Berle & Means, *supra* note 77, at liii.

Now, not only do we need to assess the impact of the large firm on "*property, workers and individuals*"; we also have to take into account the effect on the environment (natural and social), and on public institutions due to the phenomenon of globalization which, in great part, is a globalization of firms.

71. In this regard, the optimism of the preface to the 1967 edition of their book is in total contradiction with the most recent works on the theory of the firm:

> "We are well underway toward a recognition that property used in production must conform to the conception of civilization worked out through democratic processes of American constitutional government. Few American enterprises and no large corporation [note, again, the confusion], can take the view that their plants, tools and organizations are their own, and that they can do what they please with them."[227]

Berle & Means analysis suffered from their lack of distinction between the firm and the corporation, which led them to mix up the issues of property: the plants and tools <u>are</u> owned by the <u>corporate structure</u> of the firm. The officers, directors and shareholders, however, do not own the assets nor the corporation nor the firm, and they never could legally "*do what they please with them*".

Although the technical analysis was wrong "*on the relation which the corporation bears to property*",[228] their intuition at the end of their essay was correct:

> "... the enterprise assumes an independent life, as if it belonged to no one [it indeed belongs to no one]... the enterprise becomes transformed into an institution which resembles the State in character. The institution here envisaged calls for analysis, not in terms of business enterprise, but in terms of social organization. (...) Such a great concentration of power and such a diversity of interest raise the long-fought issue of power and its regulation – of interest and its protection. (...) Just as there is a continuous desire for power, so also there is a continuous desire to make that power the servant of the bulk of the individuals it affects. (...) Absolute power is useful in building the organization. More slow but equally sure is the development of social pressure demanding that the power shall be used for the benefit of all concerned."[229]

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[227] *Id*. at xxxviii.

[228] Although this was precisely the task they defined for themselves at the outset of their work; *see supra* note 226 and accompanying text.

[229] Berle & Means, *supra* note 77, at 309-310.

72. It is not very clear that, today, there is so much pressure on private power to "*be used for the benefit of all concerned*" and, in this regard also, Berle & Means may have been guilty of wishful thinking.[230] They did not anticipate the fortune of the agency theory of the firm and the spreading of an ideology in the so-called "corporate governance" debate claiming that private power should be used for the benefits of shareholders only, the defense of the other interests being the realm of officially "public" institutions. With a deficient theory of the firm, shareholders' interests are now overweighed in firms' governance. By what miracle isolated States could reestablish equilibrium via their laws in a global world[231] in which they are part of the competitive system is a mystery.

73. What is certain is that Berle & Means final words demonstrated an extraordinary clairvoyance:

> "In still larger view, the modern corporation [again, they really meant 'enterprise'] may be regarded not simply as one form of social organization but potentially (if not yet actually) as the dominant institution of the modern world. (...) The future may see the economic organisms now typified by the corporation [they really meant to say the enterprise], not only on an equal plane with the State, but possibly even superseding it as the dominant form of social organization. The law of corporations, accordingly, might well be considered as a potential constitutional law for the new economic State, while business practice is increasingly assuming the aspects of economic statesmanship."[232]

We are there. We need statesmen at the helm of large firms. To allow them to fulfill their role, it is necessary to loosen the leash subjecting them to the shareholders by a mistaken agency theory. We then have to address the

[230] In the US, the average compensation of CEOs represented 40 times the average of workers salaries in 1983, 85 times in 1990 and 400 times in 2003; *see* Aglietta & Rebérioux, *supra* note 224, at 344. The managers' relative take was therefore *lower* prior to the triumph of the "shareholder model". Interestingly, advocates of this model claim that it allows reducing the ability of the managers to serve themselves at the expense of other constituents (*see*, for example, Hansmann & Kraakmann, *supra* note 1, at 444 who claim that "when managers are given great discretion over corporate investment, they tend to serve disproportionately their own interests"). If anything, the shift in relative allocation of wealth production generated by this model is not from *managers* to shareholders. The relative increase in shareholders' take is at the expense of the *other* interests affected by the firm. But the advocates of "convergence" in the models will be pleased to learn that over the last twenty years, the income of top managers of German listed companies increased 750% (*see* La Tribune, July 11, 2008 at 22).

[231] As suggested by Hansmann & Kraakman, *supra* note 1.

[232] Berle & Means, *supra* note 77, at 313.

complexity of the challenge of our time which is that given the process of globalization of the economy, the "*potential constitutional law for the new economic State*" is a global issue.[233] In a global economy dominated by global firms, the Berle and Dodd's debate needs to be seriously revisited to be adapted to this new context. Given the shortcomings of the apparatus of norm creation at the international level, large firms must be understood as part of the political system of allocation of resources. Existing theories of the firm, based on errors in the analysis of the firm's inner legal organization and on unrealistic assumptions about the legal and political environments within which they operate, are a substantial part of the problem and lead us away from the solution. Berle and Dodd may not give us answers suitable to the issues of our time –those of a global world economy. But, at least, Berle and Dodd asked the right question.

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[233] *See* William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34(1) The Journal of Corporation Law 99-152 (2008); Robé, *supra* note 141. *See, generally,* Global Law Without a State (Gunther Teubner ed. 1997). *See also* Larry Cata Baker, *The Autonomous Global Corporation: on the Role of Organizational Law. Beyond Asset Partitioning and Legal Personality*, 41 Tulsa L. Rev. 101 (2006).

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