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A Comment on "The Legal Structure of the Firm"

Kurt Strasser

Abstract

"The Legal Structure of the Firm" presents two core points. First, it argues that economic reality of the modern business enterprise, what it calls the "firm", is different from and much broader than the legal entity or entities into which it is organized. My comment will argue that this first point is correct, well presented here, and a real contribution to our understanding. Second, "The Legal Structure of the Firm" argues that this separation between the legal entity and the business reality is a good thing, enabling positive asset partitioning and other positive attributes of capital formation which should be preserved. My comment will argue that this point is at best incompletely supported and most likely misdirected.

KEYWORDS: firms, corporations, enterprise, limited liability, asset partitioning, corporate governance

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"The Legal Structure of the Firm" presents two core points. First, it argues that economic reality of the modern business enterprise, what it calls the "firm," is different from and much broader than the legal entity or entities into which it is organized. My comment will argue that this first point is correct, well-presented here, and a real contribution to our understanding. Second, "The Legal Structure of the Firm" argues that this separation between the legal entity and the business reality is a good thing, enabling positive asset partitioning and other favorable attributes of capital formation that should be preserved. My comment will argue that this point is at best incompletely supported and most likely misdirected.

The modern business enterprise is a much broader economic organism than the legal entity or entities into which it is divided and by which it is owned.[1] Even a casual glance at the legal structure shows that enterprises ("firms") are made up of many nominally separate corporate entities that are commonly owned, controlled, and operated as one integrated enterprise.[2] This paper makes a most valuable contribution in explicating this distinction and exploring its economic significance. Business reality and legal form do not match here.

Along the way, the author offers a deep explanation of the concept of ownership of corporations which is most interesting and thought provoking. Shareholders do not own the corporation, the argument runs. Rather, they own a bundle of specific rights, including the right to participate in selecting the directors, who will then select managers of the company. The emphasis here is on the argument, surely correct, that shareholders do not directly own the corporation's assets or directly have the right to manage its operations. Yet, the paper does not fully develop its conception of the implications of the specific rights that shareholders do have. Those rights, together with the claim on residual profits that shareholders clearly have also, come together to support a dynamic idea of what the collective exercise of these may mean. The paper makes great progress in specifying ownership and control rights over the legal corporate entity; based on what it teaches us, we need to go further to explore how these specific but limited rights will play out in dynamic control mechanisms. Much of what the paper describes is an accurate representation of the reality of investor shareholders. Of course, in the large modern corporation, shareholder influence operates in a context in which it is so substantially diluted and fractured that only

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[1] Jean-Philippe Robé (2010) "The Legal Structure of the Firm", *Accounting, Economics and Law: A Convivium*, pp. 5-9.

[2] *See, e.g.*, P. Muchlinshi, *Multinational Enterprises and the Law* (2d. ed. Oxford, 2007) ch. 2; K. Strasser and P. Blumberg (2010), "Legal Forms and Economic Substance of Enterprise Groups: Implications for Legal Policy", *Accounting, Economics and Law: A Convivium*, pp. 1-4.

a truly dynamic idea of either collective action or influence by individual large shareholders is worth considering.

However, this penetrating discussion of the rights and control of investor shareholders sheds little light on the reality of the rights and control exercised by parent corporations as shareholders of subsidiaries, which they typically operate together as parts of a unitary business enterprise. Considered from a reality-based, dynamic perspective, the control of sole shareholder parent corporations is complete. The parent is a sole shareholder; it choose the subsidiaries' directors and officers as part of the larger enterprise management strategy, and this is functionally the same as direct ownership even though it nominally operates through filters of legal structural requirements.

Returning to the distinction between enterprises and legal entities, the paper argues for an expanded idea of enterprise that extends beyond any legal structure, including the familiar parent and subsidiary one, to include all economic activity related to its conduct. For example, the concept of a "firm" offered here extends to contractual relationships necessary to conduct business, even when these are not with commonly owned or controlled parties and convey only a partial control over other parts of this larger "firm." This expansive idea of the firm then serves as the basis for the paper's normative claim that the firm should be governed with reference to all its impacts on parties that its operations touch, using the familiar idea that the group of "stakeholders" whose interests are to be considered is much broader than the group of "shareholders" of the legal entity or entities.

The stakeholder argument is familiar and well presented here, and the paper adds a substantial new contribution to it with the idea of firm as distinct from the legal entity.[3] The paper could have gone further, to offer a defense of the normative claim, as well as some ideas about how it could be practically implemented. Further, a clear consideration of the limits of the affected stakeholder group is also needed. Within the workings of modern global markets, the impacts of the operations of this expansive "firm" will be quite broad indeed; taking account of these in practical management decision making and real world operations does not appear. Some consideration of the outer limits, or consideration of whether there should be limits, is needed.

Managing the business operation to control for its external impacts will, of necessity, return us to the domain of legal rules and principles. A key concept is determining which part or parts of the business enterprise law we should look to in order to apply these rules and principles. Here, the paper argues that our present distinction between firms and corporations—the separation between individual corporate entities and realistically conceived business enterprises—is useful and

[3] Y. Biondi, A. Canziani, Th. Kirat eds (2007). *The Firm As An Entity: Implications for Economics, Accounting, and Law*, New York and London: Routledge.

functional; on this point I must disagree. As others and I have argued elsewhere, law and legal institutions should consider whether the entire business enterprise is the proper place to locate legal rights and legal responsibilities.[4] The argument is that law should consider whether looking to the larger business enterprise rather than the individual corporate entity components better serves the law's purposes in the particular area at issue and better recognizes modern business realities. This inquiry is the core of enterprise analysis we have proposed.[5]

Of course, this is novel, unfamiliar, and indeed rank heresy in the orthodox cannon of corporate law.[6] Yet the argument's unorthodoxy does not refute its claim. If we want to apply legal rules to control and channel the conduct of economic activity and its external impact, then we must consider whether we need to reach broadly and encompass the relevant economic actor and not stop at the boundaries of its legally constructed subunits. By reaching the entire business enterprise with legal controls, where appropriate, we can much more effectively achieve the social results which the applicable body of law seeks.

Yet the author presents two important points that question the use of this enterprise analysis, and these need serious consideration. First, the paper's conception of enterprise—as "firms"—extends beyond even the largest legal entity that exists. The broad conception of a firm reaches all the related economic activity, such as contractors providing services. In contrast, the application of our idea of enterprise analysis will typically reach only to commonly owned and controlled legal entities, stopping short of this broader concept of "firms." While this is typically the result of applying enterprise analysis, it is not a necessary limitation. For example, enterprises formed by contract rather than ownership can fit quite well within the economic unit determined by our enterprise analysis, as the examples of franchises, licensors and health care institutions show.[7]

At its outer reaches, enterprise analysis can extend even beyond commonly controlled entities. A key to such extensions, and indeed to all use of enterprise analysis to reach beyond each individual corporation component, is a careful consideration of what must be done to effectuate the legal policies at stake. Enterprise responsibility should apply when the policies of underlying

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[4] K. Strasser and P. Blumberg (2010), Legal Forms and Economic Substance of Enterprise Groups: Implications for Legal Policy, Accounting, Economics and Law. P. Muchlinshi, *Multinational Enterprises and the Law*
(2d. ed. Oxford, 2007); P. Blumberg, K. Strasser, N. Georgakopoulas & E. Gouvin, *Blumberg on Corporate Groups*, (Aspen, 2005).

[5] A short version of the argument is presented in Strasser and Blumberg, *supra* note 2.

[6] For example, the principal paper argues: "But it is way too 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 and shareholders." "The Legal Structure of the Firm", *supra* note 1, at 41 (citing K. Strasser and P. Blumberg, *supra* note 2.)

[7] P. Blumberg, et. al, *supra* note 3, at Chs. 160-173.

body of law need it to be effective. For example, consider the broad reach of modern product liability law. Legal responsibility extends to many businesses in the chain of manufacturing, distributing, selling and servicing a consumer product that causes harm. This broad reach is based not on traditional conceptual formalism of nominal legal entities, but on the need to put liability on business activities that can spread the cost and take the necessary precautions, and thereby protect consumers who can do neither.[8] Enterprise analysis, properly understood, can reach quite broadly, but only when there is a good legal policy reason to do so and the reach comports with the underlying economic reality.

The author also presents a second serious objection to enterprise analysis that must be considered. He argues that the idea of expanding legal responsibility beyond the individual legal corporate entity to reach the economic enterprise risks disrupting capital markets and discouraging capital formation. The paper contnues:

> There are numerous perfectly legitimate business reasons to use the asset 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 [in] other specific bundles of assets and liabilities located in specific corporate vehicles, developing new businesses while protecting existing ones, allowing different compositions of the ownership of the share capital of the corporate vehicle used to structure a business, investing abroad through entities incorporate locally, etc.[9]

The claim that enterprises may well find such asset partitioning to be useful is surely correct, as the widespread use of it confirms. Indeed, this is a specific version of the more general argument for limited liability for shareholders. However, that claim does not by itself provide a persuasive reason why law should automatically respect the partitioning that business enterprises choose to use internally by strategic use of subsidiaries and other legal entities, regardless of its effects.

The argument that enterprise analysis interferes with capital markets and capital formation presents two serious concerns. First is the empirical question: is this a real problem? Has the prospect of enterprise-wide responsibility, based on enterprise analysis, been shown or persuasively argued to disrupt capital markets and deter capital formation? Certainly no evidence or argument has been offered to date. In fact, there is reason to suspect that these problems are not likely. We

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[8] P. Blumberg, et. al, *supra* note 3, at Ch. 62.
[9] "The Legal Structure of the Firm", *supra* note 1, at 41.

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now have de facto enterprise responsibility in a number of specific legal areas such as securities, labor law, as well as products liability.[10] Yet, this author has not been able to find any discussion of capital problems in these settings. Indeed, the claim appears not to even have been made, much less proved, in any of these areas. If enterprise responsibility really presents such a problem, it surely should have been seen in areas where we currently have enterprise responsibility and have had for some time. To this point, the claim has not been persuasively shown to be a real problem.

Second is the normative question: if making enterprises properly responsible for the legal impacts of the whole enterprise, by applying enterprise analysis, interferes with business as usual in capital markets, is that necessarily a bad thing? Enterprise analysis emphasizes the law and policy of the legal area at issue, as well as the economic realities of the business entity. If these indicators point to legal responsibility for the larger enterprise, reaching beyond the particular component of it located within one corporation, then perhaps the broader responsibility is justified and market preferences of capital markets should not override them. Surely most economic actors would prefer less legal responsibility; from their economic perspective, no responsibility would be ideal. That preference, while certainly understandable, does not offer a reason to embrace it in law.

While enabling and supporting capital formation is an important goal of legal policy, it should only be so for capital formation supporting activities that are not inappropriately imposing other external costs on society. Capital formation to operate enterprises should be done within the bounds of existing law and policy, and if that law and policy calls for expanded responsibility, then the requirements of capital formation should not override them. For example, securities regulation in the U.S. reaches beyond the individual corporate entity to apply its restraints to all those that control or are commonly controlled by it. Of course, such as example of enterprise responsibility is an exception. The law's conventional approach to determining responsibility within an enterprise is based on an outmoded emphasis on corporate entities; it should not be enshrined into incontestable dictate without analysis.

In sum, "The Legal Structure of the Firm" has much to teach us about the economic realities of business and the nature of ownership in legal corporations. Noting and exploring the distinction between the two is most important and useful. The matter is much more problematic in deciding whether the legal status of this distinction is good law and good policy.

[10] Several examples are presented Strasser and Blumberg, *supra* note 2.

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