

The Evolution of the Corporation: Economics and Law

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Synopsis

- The role of model building in economics and law
- The legal nature of the business enterprise
- The concept of the commons and its application to the corporation
- Implications for corporate governance research and policy

Model building in economics and law

- Should models be realistic?
- Contrasting theory-driven and data-driven approaches to model building
- Theory-driven approaches build a model of a given phenomenon from basic axioms (e.g. the 'rational' actor) and engage in empirical research to see how far the model is valid (falsification of hypotheses).
- The problem with theory-driven models is that they 'are less open to signals in the data suggesting the theory is incorrect or in need of modification and will, therefore, run the risk of producing empirically irrelevant and misleading results' (Katharina Juselius, 2011).

Data-driven models

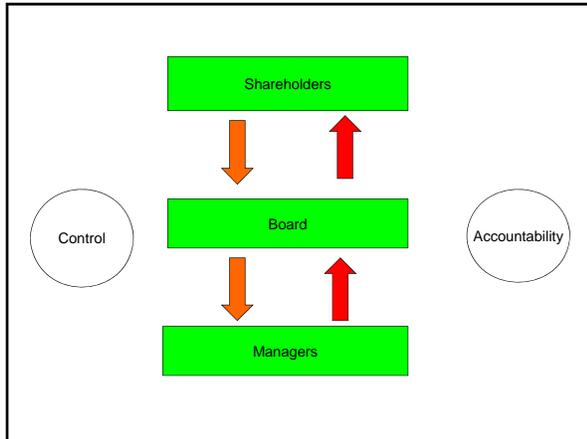
- Data-driven models do not deny the need for theory to generate testable hypotheses or propositions for research.
- However, data-driven approaches do not derive models purely from axioms, but from widely observed empirical phenomena which are then embedded in the model.
- Rather than discarding a model only when a better theory comes along, in data-driven approaches the model is periodically adjusted in the light of what is known, empirically, of the phenomenon being studied.

Origins of the corporation

- Law as constituting the market
- The western legal tradition: legal autonomy and the public-private divide (Harold Berman, *Law and Revolution*)
- Legal capacity and the juridical form of associations
- 'Every human person, but only the human person, has capacity' (Friedrich Carl von Savigny)
- The contemporary ubiquity of the corporate 'person'

The shareholder primacy model

- Ultimate control over the corporation rests with the shareholder class
- The managers of the corporation are charged with the obligation to manage the corporation in the interests of its shareholders
- Other corporate constituencies, such as creditors, employees, suppliers, and customers have their interests protected by contractual and regulatory means rather than through participation in corporate governance
- The market value of the publicly traded corporation is the principal measure of its shareholders' interests (Henry Hansmann and Reinier Kraakman, 2001)



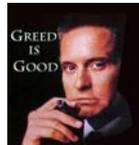
Managers as the shareholders' agents

- '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 possible while conforming to the basic rules of the society (...) The manager is the agent of the individuals who own the corporation' (Milton Friedman, 1970)

Shareholder value theory... in practice

'Greed is all right, by the way... I think greed is healthy. You can be greedy and still feel good about yourself' (Ivan Boesky, Haas School of Business commencement speech, May 1986)

'I am not a destroyer of companies. I am a liberator of them! The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA.' (Gordon Gekko, *Wall Street* (1987))



A false model

- '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... 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' (Jean-Philippe Robe, 2011)

The firm

- The 'firm' is an organisation engaged in the production of goods and/or services.
- To do this it combines physical, human and virtual assets, with a view to realising a surplus.
- The task of combining these assets rests with a specialised function within the firm, its management.
- If management is successful in its core tasks, the firm can meet its commitments to the original owners of the assets it uses (investors, creditors, workers) and reinvest what remains for its own future development.
- The organisational reach of the firm means that its activities are felt, both positively and negatively, by third parties.
- At the same time, the firm's resources and its organisational capacities endow it with the means to absorb, control and diversify the risks of harm to third parties.

The corporation

- The 'corporation' is the principal legal mechanism by which firms, as defined above, operate in contemporary market economies.
- The corporation is a device through which the legal system assigns legal personality, and hence the capacity to function as an economic actor able to hold property, make contracts and more generally assert its own legal interests, to the organisational structure of the firm.

Functions of corporate law

Institution	Function
<i>Corporate personality</i>	Asset partitioning; organisational continuity
<i>Limited liability</i>	Capital allocation, diversification, risk allocation
<i>Delegated management</i>	Managerial coordination
<i>Transferability of shares</i>	Capital liquidity

Related areas of law

Area of law	Function
<i>Employment law</i>	Managerial coordination; human capital formation
<i>Health and safety law/tort law</i>	Managerial coordination; corporate social responsibility
<i>Tax law</i>	Public goods provision
<i>Competition law</i>	Innovation/market structure issues

- ### *Dysfunctional* aspects of corporate law
- Legitimate uses of corporate form for entity shielding and asset partitioning may be difficult to distinguish from its use in ‘creative avoidance’ of tax and other obligations
 - Concentration of economic power facilitates corporate lobbying to the detriment of regulatory effectiveness and provision of public goods

- ### The concept of the commons
- Collectively managed natural resources (fisheries, irrigation systems, forests)
 - Tragedy of the commons: free riding undermines common pool resources (Mancur Olson)
 - Solutions: Leviathan or free market (Gerrit Hardin)
 - State-supported property rights seen as the answer (Harold Demsetz)
 - Governing the commons: beyond the state/market dichotomy (Elinor Ostrom)

Property rights in common pool resources

Right	Content
<i>Access</i>	a right to enter a defined physical property
<i>Withdrawal</i>	a right to harvest the products of a resource such as timber, water, or food for pastoral animals
<i>Management</i>	a right to regulate the use patterns of other harvesters and to transform a resource system by building improvements
<i>Exclusion</i>	a right to determine who will have the right of access to a resource and whether that right can be transferred
<i>Alienation</i>	a right to sell or lease any of the above rights

Design principles for common pool resources

Principle	Content
<i>Well-defined boundaries</i>	rules defining the boundaries of a resource system and the set of users with rights over it facilitate cooperation and rule enforcement
<i>Proportionality between benefits and costs</i>	equivalence between inputs and returns enhances the legitimacy of rule systems and assists observance and enforcement
<i>Collective choice arrangements</i>	where all or most users participate in rule formation, rules are more likely to fit local contexts and be adaptable to changing circumstances
<i>Monitoring</i>	graduation of sanctions allows for infractions to be recognized while acknowledging the possibility of misunderstandings, mistakes and exceptional circumstances

Design principles for CPRs (cont.)

Principle	Content
<i>Graduated sanctions</i>	graduation of sanctions allows for infractions to be recognized while acknowledging the possibility of misunderstandings, mistakes and exceptional circumstances
<i>Conflict-resolution mechanisms</i>	localised, low-cost dispute resolution mechanisms allow for conflicts in the interpretation and application of rules to be settled in such a way as to maintain trust
<i>Minimal recognition of rights</i>	rights of local users to make their own rules should be recognized by higher-level entities
<i>Nested enterprises</i>	where common-pool resources are part of a wider system, local units should be allowed to match rules to local conditions, within a wider framework of institutions designed to govern interdependencies among smaller units

Is the corporation a commons?

- The concept of the commons does not imply an ‘ownerless resource’, rather a resource over which there are multiple and overlapping property-type claims (Ostrom)
- In many CPRs, alienation rights are less salient than access and management rights
- The firm is not owned by the corporate shareholders, but nor is it ‘ownerless’; it is a resource subject to multiple and sometimes conflicting claims
- How, and how far, to maintain the resource of the corporation over time is the issue to be addressed by the legal framework and wider corporate governance system

Property rights in the business enterprise

Right	Content
<i>Access</i>	entry conditions for participation in the firm as shareholder, employee, creditor, etc.
<i>Withdrawal</i>	rules on distribution of capital (dividends, share repurchases), employee remuneration and benefits, rights of secured and unsecured lenders, claims of fiscal authorities, etc.
<i>Management</i>	rules concerning the division of powers between the board and different constituencies on matters of corporate decision making (shareholders’ rights to vote on major transactions; employees’ rights to be consulted over restructurings; rights of creditors in an insolvency, etc.)
<i>Exclusion</i>	rules determining the scope of voice, participation and income rights of different constituencies (e.g. distinctions between holders of common stock and preference stock, ‘core’ employees and others, different categories of creditors)
<i>Alienation</i>	rules governing alienability of shares, securitization of financial claims on the firm, etc.

CPR design principles and corporate governance

- Proportionality, collective choice and monitoring principles are closer to multi-stakeholder model of governance than shareholder value model
- Minimal or devolved recognition of rights and nesting of regulatory levels implies a role for multi-level governance and acceptance of diversity of local solutions

Conclusions (1)

- The firm is best seen as a collectively-managed resource or ‘commons’ which is subject to a number of multiple, overlapping and potentially conflicting property-type claims on the part of the different constituencies or stakeholders who provide value to the firm

Conclusions (2)

- The sustainability of the corporation depends on ensuring proportionality of benefits and costs with respect to the inputs made to corporate resources, and on the participation of the different stakeholder groups in the formulation of the rules governing the management and use of those resources

Conclusions (3)

- Viewing the corporation as a commons in this sense is the first step towards a better understanding of the role that the corporate form can play in ensuring wider social and natural sustainability