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Organising the Firm

Theories of Commercial Law, Corporate Governance and Corporate Law

Springer

Chapter 4
Theory of Commercial Law: Management-Based Commercial Law

4.1 General Remarks

The lack of a theory can be cured by using a management-based research approach and adopting a theory that we will call the theory of management-based commercial law (MBCL).

While there cannot be a "norm-based" theory of commercial law (there are too many legal norms influencing firms, the norms are too heterogenic, and the norms do not share the same public policy objectives), there can be a *management-based* theory of commercial law (firms can share the same objectives at a high level of generality).

The theory of MBCL recognises the existence of *firms* with one general goal: their own long-term *survival* in a competitive environment. Firms try to reach their commercial and legal *objectives* by using *legal tools and practices* in order to survive. Firms try to reach their objectives at many *levels* of corporate decision-making. One can distinguish between general MBCL and particular branches of MBCL depending on the commercial *context*.

The theory of MBCL is thus a framework that tries to explain the behaviour of various kinds of business organisations in different commercial contexts.[1] It can be applied to firms in the broad sense: family businesses, large listed firms, NGOs, and other firms.

[1] This can be contrasted with the German legal area of Unternehmensrecht (enterprise law or "law of the firm") which consists of normative legal rules. See, for example, Zimmer D, Internationales Gesellschaftsrecht. Schriftenreihe Recht der Internationalen Wirtschaft. Band 50. Verlag Recht und Wirtschaft GmbH, Heidelberg (1996), Zweiter Teil A III at p 136: "... als spezifisch unternehmensrechtlich werden hier diejenigen Normen bezeichnet, die die Privatautonomie der Eigentümer und der ihnen eingesetzten Geschäftsführer zugunsten solcher Anliegen beschränken, die ausserhalb des 'klassischen' gesellschafstrechtlichen Beziehungsdreiecks stehen."

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One could say that MBCL is also an attempt to revisit the original ideas behind the great commercial law codifications of Europe, that is, Code de commerce and the German HGB. The CC and the HGB regulate, with minor variations, the following areas: business forms; financial information; commercial contracts in general; as well as the commercial exchange of goods. These areas are united by the requirements of the firm. Obviously, the firm needs a business form. It needs a large number of contracts for its operations. The contracts can be of various kinds. Many of them regulate sales, distribution channels, and logistics in the broad sense.

There is nevertheless a fundamental difference. As said above, mainstream legal research focuses on legal norms applied by the court. In MBCL, the starting point is the firm. The firm is regarded as the user of law with its own legal objectives. The management-based research approach thus means the study of the legal practices of firms, or how firms get things done by legal means. The scope of MBLC is not limited by the scope of existing regulation.

4.2 The Firm

The firm is a concept that has been defined in various ways in economics and management science (see Chap. 2). In legal science, however, the concept of the firm must be aligned with existing laws.[2]

Not a normative concept. We can first discuss what the firm is not. The firm is not used here as a normative concept that can be defined through the interpretation of laws. According to the theory of MBCL, the firm is a functional concept. There are nevertheless several related normative concepts.

First, there are norms that apply to all *firms*, business undertakings, or traders in the jurisdiction. Such norms customarily require registration, bookkeeping and accounting, and the payment of taxes.[3]

[2] Fleischer H, Zur Zukunft der gesellschafts- und kapitalmarktrechtlichen Forschung, ZGR 4/2007 pp 502–503: "Gefragt sind hier die Qualitäten des Gesellschafts- und Kapitalmarktrechtlers als eines *Interface Actor*. Wo ihm die benachbarten Disziplinen Teilergebnisse bereitlegen, beginnt seine eigentliche Aufgabe: Er darf sich nicht mit einer unreflektierten Teil- oder Vollrezeption fachfremder Theorien begnügen, sondern muss jedes Einzelargument auf der juristischen Ebene erneut prüfen und dem rechtswissenschaftlichen Zugriff zugänglich machen, sofern er es für überzeugungskräftig hält."

[3] For example, Article 3(1) of Directive 2009/101/EC (that applies to limited-liability companies): "In each Member State, a file shall be opened in a central register, commercial register or companies register, for each of the companies registered therein." § 1 HGB and § 238(1) HGB (on bookkeeping duties for traders): "Jeder Kaufmann ist verpflichtet, Bücher zu führen und in diesen seine Handelsgeschäfte und die Lage seines Vermögens nach den Grundsätzen ordnungsmäßiger Buchführung ersichtlich zu machen . . ." Article 3(1)(c) of the OECD Model Tax Convention on Income and on Capital (on the definition of an enterprise).

Second, there are norms that apply to certain *activities* regardless of the legal form of the entity carrying out the activity. Many norms can thus apply to firms, undertakings, or the party that carries out the activity.[4]

Third, consumer laws customarily regulate the relationship between consumers and parties that act in a *commercial or professional capacity*.[5]

Fourth, there are a large number of norms that regulate the *attribution* of circumstances to legal entities. Circumstances that are connected to one legal entity can be attributed to another legal entity or both, when the legal entities belong to the same firm, undertaking, or group. The same can be said of circumstances that are connected to a person. (a) For example, some entities must prepare consolidated accounts.[6] Rules on the consolidation of accounts tend to be based on: the proprietary concept (also known as the ownership theory or the proportionate consolidation theory); the entity concept (the economic unit concept); or an intermediary concept (the parent company concept or the parent company extension concept).[7] (b) Furthermore, there are minimum capital requirements for banking groups under the Basel II/III Framework since all financial activities conducted within a banking group are captured through consolidation.[8] (c) EU competition law applies to undertakings.[9] According to the case-law of the ECJ, the concept of an undertaking "covers any entity engaged in an economic activity, regardless of its legal status and the way in which it is financed",[10] and "must be understood as designating an economic unit even if in law that economic unit consists of several persons, natural or legal".[11] The conduct of one legal entity may thus be attributed to another legal entity.[12] (d) Generally, the attribution of acts is an important issue in the area of contract law, tort law, and the criminal liability of companies.

Not the business form. Neither does the firm mean the business form of the organisation. MBCL distinguishes between the firm and the legal entity.

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[4] For example, Article 3 of Directive 2000/12/EC: "The Member States shall prohibit persons or undertakings that are not credit institutions from carrying on the business of taking deposits or other repayable funds from the public …" Article 1: "For the purpose of this Directive … 1. 'credit institution' shall mean an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account …"

[5] For example, Article 2 of Directive 97/7/EC (Directive on distance contracts) provides that the directive applies to certain contracts concluded between a supplier and a consumer. "Supplier" means "any natural or legal person who … is acting in his commercial or professional capacity".

[6] See, for example, Article 1 of Directive 83/349/EEC (Seventh Company Law Directive).

[7] Küting K, Gattung A, Konzerntheorien in der nationalen und internationalen Konzernrechnungslegung, ZVglRWiss 102 (2003) pp 505–527.

[8] Paragraph 24 of the Basel II Framework.

[9] Articles 101 and 102 of the Treaty on the Functioning of the European Union.

[10] Case C-90/09 P, General Química and others v Commission, paragraph 34.

[11] Case C-90/09 P, General Química and others v Commission, paragraph 35.

[12] For subsdiaries, see Case C-97/08 P, Akzo Nobel and others v Commission [2009] ECR I–8237, paragraph 58. For merger control, see Article 5(4) of Regulation 139/2004 (EC Merger Regulation).

Legal entities are tools used by firms. This brings MBCL closer to continental European legal tradition and "legal realism" (Sect. 5.2.4).[13]

Not the market. The firm does not mean the market. This separates MBCL from the set-of-contracts theory of the firm according to which the firm does not exist and the "behaviour" of the firm is like the behaviour of the market.[14] In commercial law, the "perspective of the market" tends to mean a "norm-based" approach to commercial law (see Sect. 3.2).[15]

Exclusion of certain economic theories. While the firm is not used as a normative concept in MBCL, it cannot be used a purely economic concept either. This is because of the existence of many different economic theories of the firm, and because most of them are not aligned with existing laws.

For legal reasons, it is necessary to exclude the set-of-contracts theory and the property rights theory of the firm. First, these theories cannot be aligned with the separate legal existence of companies. Second, the set-of-contracts theory of the firm is not made up of contracts that are enforceable in the legal sense. For example, the employees and managers of a limited-liability company do not owe any contractual duties to the company's shareholders or creditors. They owe their contractual duties to the legal entity. Third, the property rights of the property rights theory are not necessarily enforceable in the legal sense. For example, the assets of a limited-liability company are owned by the legal entity. They are not owned by the entity's shareholders.

Organisational construction. We can now turn to how the firm can be defined in MBCL. To begin with, the theory of MBCL is based on the hypothesis that firms exist. Firms consist of people working as organised teams. The firm can thus be regarded as a particular kind of organisational construction competing against other teams in the market.[16]

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[13] See also Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) pp 1504–1505 (on Chief Justice Marshall's opinion in Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819)): "Since the corporation is not a natural person it has no ability to formulate its own purposes and follow them. Less than a person, it is only a means to prescribed ends." Traces of this approach can also be found in Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) pp 550–551: ". . . director primacy treats the corporation as a vehicle by which the board of directors hires various factors of production." Other examples include Mäntysaari P, The Law of Corporate Finance Volume 1. Springer, Berlin Heidelberg (2010) PI and Robé JP, The Legal Structure of the Firm, Acc Econ L 1(1) (2011).

[14] Jensen MC, Meckling WH, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J Fin Econ 3 (1976) p 311.

[15] Compare Goode RM, Commercial Law in the Next Millenium. The Hamlyn Lectures. Forty-ninth Series. Sweet & Maxwell, London (1998) p 4: "Commercial law is about problem-solving, about fashioning the contract structures and other legal tools by which the legitimate needs of the market can be met." This definition is designed to lead to a rule-based approach to commercial law.

[16] Coase RH, The Nature of the Firm, Economica, New Series 4(14) (1937) pp 386–405; Alchian AA, Uncertainty, Evolution, and Economic Theory, J Pol Econ 58 (1950) pp 211–221; Arrow KJ, The Limits of Organization. Fels Lectures on Public Policy Analysis. Norton, New York (1974);

The firm has a value as an organisational construction. According to econonomics, it has a value as a mechanism to manage information, reduce transaction costs, and handle incentive and adaption problems. (a) The organisation of the firm is a way to handle *information*.[17] For individual members of the organisation and the firm, the designing of internal communication channels and investment in information are acts of irreversible investment. Each firm has its own "code". If the firm is broken up, such investments will be lost. If the firm is merged with another firm, new investment becomes necessary. (b) According to *transaction cost economics*, all complex contracts are unavoidably incomplete. The firm is regarded as an alternative mode of governance and as a way to handle this problem.[18] The firm can thus not always be replaced by the market without a cost. (c) Neither can the firm always be merged with another firm without a cost. This is because of the *costs of bureaucracy*. Large firms must find ways to mitigate the *incentive* and *adaptation* problem caused by an increase in firm size.[19] For example, the firm will try to manage its internal agency relationships, information flows, and decision-making processes. Changing the size of the organisation may affect the incentive and adaptation problem in many ways. Reducing firm size can reduce the problem. Merging the firm with another firm can increase the problem. An outsourcing network can enable the firm to grow while managing such problems.

The firm has a value also in MBCL. According to MBCL, members of the firm's organisation manage the firm's *cash flow and exchange of goods and services*, *risk*, *agency relationships*, and *information*. If the firm is broken up, the firm's investment in the particular tools and practices to handle these aspects will be lost. If the organisation is changed, the particular ways to handle them may have to be changed as well.

In practice, firms form the economically most important category of self-interested users of commercial law. One can regard firms – such as Facebook, Steiff, the small Othello bakery in the town of Vasa, Crédit Agricole, Goldman Sachs, FC Barcelona, Slaughter and May, and Ikea – as the most important market participants in capitalism (Weber 1922). Most goods and services are produced by firms, and most people in Western countries earn their living as their employees.[20]

Simon HA, Organizations and Markets, J Econ Persp 5(2) (1991) pp 25–44; Williamson OE, The Economic Institutions of Capitalism. The Free Press, New York (1985); Alchian AA, Demsetz H, Production, Information Costs, and Economic Organization, Am Econ Rev 62 (1972) pp 777–795; Holmström B, Moral Hazard in Teams, Bell J Econ 13 (1982) pp 324–340; Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88(2) (1980) pp 288–307; Fama EF, Jensen MC, Separation of Ownership and Control, J Law Econ 14(2) (1983) pp 301–325; Fama EF, Jensen MC, Agency Problems and Residual Claims, J Law Econ 14(2) (1983) pp 327–349.

[17] Arrow KJ, The Limits of Organization. W. W. Norton & Company, New York (1974) pp 53–55.

[18] See, for example, Williamson OE, The Economic Institutions of Capitalism. Free Press, New York (1985) pp 30–31.

[19] Williamson OE, The Incentive Limits of Firms: A Comparative Institutional Assessment of Bureaucracy, Rev World Econ 120(4) (1984) pp 736–763.

[20] See also Simon HA, Organizations and Markets, J Econ Persp 5(2) (1991) pp 25–44.

The survival and growth of firms is very important for a very large number of stakeholders and society at large.[21]

4.3 The Rational Decision-Making of the Firm

It is assumed here that the firm's decision-making should be rational. But "the firm" has neither brains nor a mind of its own as a mere governance structure or organisational construction. Can the firm's decision-making be rational? The answer is yes, to the extent that human decision-making can be rational in the first place (bounded rationality, Simon 1957).

We assumed that firms are organisational constructions or teams competing against other teams in the market. The people that belong to the firm's organisation can take more or less rational decisions on the firm's behalf. Because of patterns of human behaviour, this is what managers and employees normally do unless the firm is governed by a pathological corporate of social culture.

It is customary for people to comply with social expectations. The behaviour of people is, in general, influenced by their instinctive need to belong to groups or teams.[22] Once they have become members, it is also influenced by the expectations of other team members. Team membership can influence the behaviour of its members for the better or for the worse (Freud 1921; Simon 1991).[23]

Some teams will survive in the short term, and a small number of teams even longer. A firm will not be able to survive unless its employees and managers voluntarily try to further its interests in a rational way. Firms try to hire such people. Firms generally do not want to hire people that are expected to act randomly (in any way whatsoever), to further nobody else's interests but their own, or to further the interests of somebody else instead of those of the firm.

4.4 The Ultimate Goal of the Firm

But what is rational in this context? What is the ultimate goal of the firm's decision-making, the Grundnorm (Kelsen) of business organisations?

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[21] For the stakeholder concept, see Freeman RE, Strategic Management. A Stakeholder Approach. Cambridge U P, Cambridge (originally published in 1984) pp 25, 31–33, and 46.

[22] Freud S, Massenpsychologie und Ich-Analyse. Internationaler Psychoanalytischer Verlag, Wien (1921), Chapter IX pp 98–99: "Getrauen wir uns also, die Aussage Trotter's, der Mensch sei ein Herdentier, dahin zu korrigieren, er sei vielmehr ein Hordentier, ein Einzelwesen einer von einem Oberhaupt angeführten Horde." Freud discusses even Gustave Le Bon's Psychologie des foules (1985), William MacDougall's The Group Mind (1920), and Charles Darwin's The Descent of Man, and Selection in Relation to Sex (1871).

[23] See Freud S, *supra*, Chapter III pp 33–35 (discussing when the behavior of the group can change for the better according to McDougall).

If we assume that firms exist, that they can take rational decisions in one way or another, and that they can have their own objectives, the highest objective of a firm must be its own survival. The choice of efficient ways to ensure the long-term survival of the firm in a competitive environment is likely to increase the firm's long-term survival chances compared with choices that do not serve that purpose.[24]

Depending on the circumstances, different methods may help the firm to survive. It is nevertheless clear that most firms must make a profit and create value over a long period of time in order to survive.[25] Profitability requires investments, operational efficiency, risk-taking, and growth. Few firms can rely on the benevolence of a sponsor who can be expected to cover losses in the long term, although there may be firms whose business model can temporarily be based on access to such funding (football clubs, state-owned companies, non-profit organisations sponsored by billionaires, banks sponsored by taxpayers).

4.5 The Legal Objectives of the Firm

It is not enough to choose the perspective of the firm as the user of law. The perspective of the firm should also be defined. What does the perspective of the firm mean in the context of MBCL?

To begin with, it seems reasonable to assume that the firm has the same rational approach to non-legal and legal decision-making. Firms are not interested in legal aspects as such. One could also say that there is no such thing as non-legal decision-making. The firm's rational decision-making always incorporates the legal point of view.

In the financial sense, rational decision-making is based on *expected return and perceived risk*. Typically, return and risk should be quantifiable for the purposes of financial decision-making. There is also *a social dimension*. The firm expects members of its organisation, its contract parties, and many other parties to further its interests in various ways. These relationships can be described as *principal-agency* relationships. There is a large number of relationships with the firm as principal and many other parties as the firm's agents.[26] For example, employees are

[24] Alchian AA, Uncertainty, Evolution, and Economic Theory, J Pol Econ 58 (1950) pp 211–221. See also Freeman RE, Strategic Management. A Stakeholder Approach. Cambridge U P, Cambridge (originally published in 1984) p 33.

[25] Alchian AA, *supra*; Friedman M, The Social Responsibility of Business is to Increase its Profits, The New York Times Magazine, September 13, 1970.

[26] For principal-agent relationships, see Jensen MC, Meckling WH, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J Fin Econ 3 (1976) pp 305–360; Alchian AA, Demsetz H, Production, Information Costs, and Economic Organization, Am Econ Rev 62 (1972) pp 777–795; Fama EF, Jensen MC, Separation of Ownership and Control, J Law Econ 14 (2) (1983) pp 301–325; Fama EF, Jensen MC, Agency Problems and Residual Claims, J Law Econ 14(2) (1983) pp 327–349.

agents that belong to the firm's internal organisation. Suppliers, customers, investors, and stakeholders are examples of external agents. Outsource providers can have the characteristics of both internal and external agents. Moreover, rational decision-making is always based on *information*.[27]

It would be rational and reasonable for the firm to manage such aspects. The use of legal tools and practices is an important way to manage them in a market economy that upholds the rule of law.

This leads to the conclusion that all firms regardless of the jurisdiction share the same *generic legal objectives*. Their generic legal objectives consist of the management, by legal tools and practices, of: (1) cash flow and the exchange of goods and services; (2) risk; (3) principal-agency relationships; and (4) information.[28] These four aspects and various related concepts (such as "signalling") have been defined in economics and management sciences and are thus based on imported theories.

4.6 The Legal Tools and Practices of the Firm

We have identified one general goal and four generic objectives for the firm's rational decision-making. The firm will try to manage the four issues in some way or another.

All firms use legal tools and practices to reach their generic legal objectives. Legal tools and practices belong to "institutions" in the broad sense, that is, rules, norms, and strategies used by humans in repetitive situations. Such legal tools and practices can be classified as institutions in various ways (North 1990; Ostrom and Crawford 2005).[29]

For our purposes, we can identify five generic legal tools and practices used simultaneously in most transactions in one way or another: (a) choice of a business form (which facilitates the organising of production within the firm and helps to regulate asset ownership and other matters); (b) contracts (promises complemented by a particular sanction system enforceable by the state); (c) regulatory compliance and organisation of the firm's internal activities[30]; (d) generic ways to manage

[27] For a historical survey, see Stiglitz JE, Information and the change in the paradigm of economics, Am Econ Rev 92 (2002) pp 460–501.

[28] See, for example, Mann RJ, Explaining the Pattern of Secured Credit, Harv L Rev 110 (1997) pp 625–680.

[29] North DC, Institutions, Institutional Change and Economic Performance. Cambridge U P, Cambridge (1990) pp 3–4; Ostrom E, Crawford S, Classifying Rules. In: Ostrom E, Understanding Institutional Diversity. Princeton U P, Princeton Oxford (2005), Chapter 7, pp 190–191 (rules can be position, boundary, choice, aggregation, information, payoff, or scope rules).

[30] For regulatory compliance as a legal tool, see, for example, Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 52–62. For the statutory regulation of the firm's processes as a corporate governance tool, see Merkt H, Die Zukunft der privatrechtlichen Forschung im Unternehmens- und Kapitalmarktrecht, ZGR 4/2007 pp 535–536; Binder JH, „Prozeduralisierung" und Corporate Governance, ZGR 5/2007 pp 745–788.

principal-agency relationships[31]; and (e) generic ways to manage information.[32] This means, for example, that all commercial contracts are ways to manage cash flow and the exchange of goods and services, risk, agency, and information at different levels of the decision-making of the firm.[33] Contracts work in this way because of the existence of contract-enforcement institutions.[34]

Many tools can be used actively or passively. There is a trend of increasing active use of legal tools and practices by firms (self-regulation by each firm), increasing use of non-state rule-making (in particular, industry self-regulation and routinised practices), and decreasing reliance on state law. This is caused by many factors which have increased legal risk, made the management of risk more important, or made the management of risk easier. Such factors include: the globalisation of business and firms; the need to adapt the firm's business to a multitude of jurisdictions and cultures; various information related-questions (global reach of information, global access to information, digitalisation, the Internet); increased regulation that forces firms to adapt; increased sophistication of financial markets; and increased legal sophistication of so-called global players.

4.7 Levels of Decision-Making

The firm tries to reach its legal objectives at the strategic, operational, and transaction level.[35] Strategic management typically includes issues that relate to: strategic direction; strategic programme formulation; budgeting; control; as well as structures and systems.[36] At the operational level, the firm typically manages its business processes.

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[31] For legal ways to manage agency, see Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 99–114.

[32] For legal ways to manage information, see *ibid*, pp 335–469.

[33] Generally, see Mäntysaari P, The Law of Corporate Finance. Volume II. Springer, Berlin Heidelberg (2010). For example, it would be easy to apply the principles even to "the interprofessional agreement of 1988 on the market for cattle above 6 months old" discussed in Mazé A, Ménard C, Private ordering, collective action, and the self-enforcing range of contracts, Eur J Law Econ 29 (2010) p 143, Table 1.

[34] See, for example, Greif A, Commitment, coercion, and markets: The nature and dynamics of institutions supporting exchange. In: Menard C, Shirley MM (eds), Handbook of New Institutional Economics. Springer, Dordrecht (2005) p 730.

[35] See, for example, Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 48, 120, and 123. For a different research stream on "legal strategies", see Masson A, Shariff MJ, Through the Legal Looking Glass: Exploring the Concept of Corporate Legal Strategy, EBLJ 2011 pp 51–77.

[36] See Freeman RE, Strategic Management. A Stakeholder Approach. Cambridge U P, Cambridge (originally published in 1984) p 44. Strategic direction: "What is the direction or mission of the organization?" Strategic programme formulation: "What paths or strategies will achieve such a mission?" Budgeting: "What resource allocations or budgets must be made for the strategies to be

This can be illustrated with the following situations. (a) The choice of the *business form* can be a strategic choice or an operational decision. For example, corporate structure (one entity or several entities), the place of incorporation of the parent (say, Russia, Finland, or the US) and the business form of the parent (co-operative, partnership, public limited-liability company) belong to the most important legal decisions at the strategic level. The choice of business form and corporate structure will also influence the firm's administrative costs and tax burden (cash flow) at the operational level, and influence the firm's exposure to risk. Special purpose vehicles are often used as risk management tools at the operational level (they are employed to ring-fence assets or to make them bankruptcy remote). (b) Like the business form, *contracts* can be used at different levels of corporate decision-making. Outsourcing contracts with outsource providers can be a way to manage principal-agent, information, and cost problems caused by large firm size. This can be an operational decision or a strategic choice.[37] (c) The third illustration relates to *compliance and organisation* in the field of emission regulation. Future restrictions on CO^2 emissions may force the firm to mitigate risk by changing its business areas (strategic level). The firm may adopt internal guidelines for its contracts for trading in emission rights (operational level). The firm may also insist on a certain contract term to be included in a particular contract for the purchase of emission rights in order to give its contract party an incentive to fulfil its obligations (transaction level).

4.8 Branches of Management-Based Commercial Law

The choice of the perspective of the firm, the study of the legal objectives of the firm, the study of the legal tools and practices used to reach those objectives, and the distinction between various levels of management are characteristic of *general MBCL*. Such aspects are taken into account by firms generally, that is, regardless of the nature of the transaction. In addition, one can distinguish between

implemented?" Control: "How can we be sure the strategies are on track or in control?" Structure and systems: "What are the macro-systems and structures necessary for implementation?"

[37] Geis GS, The Space Between Markets and Hierarchies. Virginia L Rev 95 (2009) pp 99–154: ". . . I argue that business outsourcing . . . can add value . . . by allowing firms to fashion an efficient governance compromise between markets and hierarchies. This can be true for four reasons. First, business outsourcing helps firms reintroduce some market discipline into production decisions. Second, it can reduce the hold-up problem that arises with market transactions. Third, it can mitigate the corporate agency cost problem. And fourth, it can allow firms to better attune their capital structures to underlying asset characteristics. The decision to pursue a hybrid outsourcing transaction can therefore be seen as an attempt to compromise among each (or all) of these four dimensions."

general MBCL and particular *branches of MBCL*. The branches of MBCL are functional.[38]

Functional questions depending on the commercial context. The firm will manage cash flow and the exchange of goods and services, risk, principal-agency relationships, and information in some way or another regardless of the transaction, but the particular payments, goods, services, risk, principal-agency relationships, and information-related issues that firms tend to manage depend on the commercial *context*. Furthermore, the firm will use the generic legal tools and practices regardless of the transaction in some way or another, but the particular manner of using them depends again on the context. As virtually any legal norm can influence the behaviour of firms in some way or another in a market economy that enforces the rule of law, the firm can also use a large number of particular legal tools and practices depending on the context.

If one identifies a particular commercial context, the particular aspects of the objectives of firms, the particular manner of reaching them with generic legal tools and practices, and the particular legal tools and practices used by firms in that context, one can identify a functional branches of MBCL.

This can be illustrated by the law of corporate finance. Obviously, the firm must manage its finances. We can therefore identify a commercial context. The firm must address four fundamental issues in this context: How should the firm invest (the investment decision)? How should the firm raise funding (the funding decision)? How should funds be returned to investors (the exit decision)? How should the firm manage situations that threaten its existence (the existential decision)? The study of the management of the particular legal aspects of investment, funding, exit, and existential decisions from the perspective of the firm can be called *the law of corporate finance*.

Like the law of corporate finance, the law of corporate governance can be defined as a functional branch of MBCL. This will be done in Chap. 7. Both will influence corporate law theory. This will be discussed in Chap. 8.

Generic objectives and generic legal tools and practices v branches of MBCL. One can ask whether the generic legal objectives (such as risk management) or the generic legal tools and practices (such as the use of contracts or the particular ways to manage information) can be regarded as branches of MBCL.

Of course, this is a matter of taste. However, the former are functional as objectives, and the latter are functional as ways to reach those broad objectives. It is, in both cases, possible to define the particular aspects that will need to be managed by the firm. One could therefore define the management of each of

[38] For functional branches of commercial law, see Eidenmüller H, Forschungsperspektiven im Unternehmensrecht, ZGR 4/2007 p 486; Fleischer H, Gesellschafts- und Kapitalmarktrecht als wissenschaftliche Disziplin – Das Proprium der Rechtswissenschaft. In: Engel C, Schön W (eds), *op cit*, p 50; Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 1 and 165.

those generic legal objectives and the use of each of the generic legal tools and practices as broad branches of MBCL. Collectively, they form the general MBCL.

4.9 Management-Based Commercial Law and Transaction Cost Economics

As a branch of legal science, MBCL is clearly different from neoclassical economics. However, there are some similarities between MBCL and the new institutional economics, in particular transaction cost economics (TCE). For example, MBCL uses partly the same terminology when discussing the management of agency and information and generally the organisation of the firm. The similarities and differences can help to understand the nature of MBCL better.

The following are probably the most important *similarities*. First, whereas neoclassical economics describes the firm as a production function (which is a technological construction), TCE describes the firm as a *governance structure* (which is an organisational construction). So does MBCL. This helps to paint a more realistic picture of the firm compared with neoclassical economics.[39] Second, TCE maintains that the *transaction* is the unit of analysis and insists that *organisation form* matters.[40] Both are important in MBCL as well. Third, TCE studies economic phenomena through the lens of *contract*, and contracts belong to the generic legal tools used by the firm according to the theory of MBCL.[41] Fourth, TCE and MBCL have partly similar approaches to *rationality*. Whereas neoclassical economics maintains a "maximising orientation", TCE relies on the cognitive assumption of "bounded rationality".[42]

There are also important *differences* between MBCL and TCE. Simply put, MBCL and TCE answer different questions.

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[39] Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) p 1481.

[40] Williamson OE, The Economic Institutions of Capitalism. The Free Press, New York (1985) p 18.

[41] *Ibid*, pp 17–18: "As compared with other approaches to the study of economic organization, transaction cost economics (1) is more microanalytic, (2) is more self-conscious about its behavioral assumptions, (3) introduces and develops the economic importance of asset specificity, (4) relies more on comparative institutional analysis, (5) regards the business firm as a governance structure rather than a production function, and (6) places greater weight on the ex post institutions of contract, with special emphasis on private ordering (as compared with court ordering)." Williamson OE, Transaction Cost Economics: How It Works; Where It Is Headed, De Economist 146 (1998) pp 23–58; Williamson OE, Transaction Cost Economics. In: Menard C, Shirley MM (eds), Handbook of New Institutional Economics. Springer, Dordrecht (2005) pp 51–65.

[42] Williamson OE, The Economic Institutions of Capitalism. The Free Press, New York (1985) p 44: "Three levels of rationality are usefully distinguished. The strong for contemplates maximizing. Bounded rationality is the semistrong form. The weak form is organic rationality."

First, whereas TCE studies economic phenomena, MBCL focuses on legal phenomena, that is, the attainment of relevant objectives by legal tools and practices.

Second, MBCL distinguishes more clearly between the firm and the legal entity. Legal entities are legal tools used by firms and other market participants.

Third, MBCL studies a wider range of behaviour. In TCE, the underlying viewpoint is that transaction costs are economised by assigning transactions to governance structures in a discriminating way.[43] In MBCL, the firm is assumed to manage not only costs (cash flow and the exchange of goods and services) but even risk, principal-agency relationships, and information (which all can even be sources of transaction costs).

Fourth, MBCL studies a wider range of legal tools and practices. Whereas both the neoclassical theory of the firm and TCE study economic phenomena through the lens of contract,[44] MBCL identifies five categories of generic legal tools and practices of which contracts are one. MBCL takes into account even special legal tools and practices depending on the commercial context of firms.

Fifth, MBCL tries to be even more micro-analytic. Whereas TCE explains the assigning of transactions to governance structures in general (the make or buy decision), MBCL tries to explain the detailed terms of transactions and the contents of governance structures.

Sixth, there are differences regarding rationality. Whereas TCE is limited to what is rational in a technical or mathematical way (Zweckrationalität), MBCL takes into account also what is reasonable (Wertrationalität).[45]

Seventh, such and other differences regarding rationality are connected to differences regarding the choice of the relevant actors and their self-interest orientation. Although both TCE and MBCL rely on the cognitive assumption of bounded rationality, the relevant actors are "intendedly rational"[46] in slightly different ways, because TCE and MBCL focus on the rational decision-making of different actors and MBCL places greater weight on what is reasonable. (a) MBCL studies the decision-making of the firm. It is assumed that the firm can have a self-interest orientation. [47] The most fundamental objective of the firm is its own long-term survival in a competitive environment. It is also assumed that firms that adapt to their competitive environment by doing whatever it takes to survive in the long term are more likely to survive than firms that do other things. For example, the firm

[43] *Ibid*, p 18.

[44] See, for example, Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) pp 1480–1482.

[45] See, for example, Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 165.

[46] According to Simon, economic actors are assumed to be "intendedly rational, but only limitedly so".

[47] For a contrary view, see Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88 (2) (1980) pp 288–307 (arguing that the firm is just a set of contracts, a market).

should make a profit.[48] For such reasons, the relative importance of "organic rationality" is higher in MBCL compared with TCE.[49] (b) In TCE, transaction costs are economised by assigning transactions to governance structures in a discriminating way.[50] Although it is recognised that the firm exists as a governance structure, it is not necessary for TCE to assume that the firm would have any particular objectives of its own. Only its "constituencies",[51] that is, non-firm actors have objectives. They are defined in relation to the firm and as three levels of self-interest seeking (opportunism, simple self-interest seeking, and obedience).[52]

4.10 Management-Based Commercial Law and Traditional Branches of Law

The use of legal tools and practices to reach the firm's legal objectives is a legal exercise that requires specialised legal know-how. For this reason, MBCL can be regarded as a field of law rather than a particular area of management science or economics. Typically, business consultants and investment bankers who have received an education in management or economics do not possess the necessary legal know-how but turn to external law firms or in-house counsel for advice. On the other hand, economic objectives are the cause of commercial transactions, and economic arguments can help to choose between alternative legal tools and practices.[53]

There are fundamental differences between MBCL and the traditional research approaches and branches of norm-based commercial law. They have already been discussed above but can be summed up here.

Research approaches. Whereas *legal norms* (state law and non-state law) applied by the court are the starting point of the mainstream research approaches,

[48] Alchian AA, Uncertainty, Evolution, and Economic Theory, J Pol Econ 58 (1950) p 213: "Realized positive profits, not *maximum* profits, are the mark of success and viability. It does not matter through what process of reasoning or motivation such success was achieved. The fact of its accomplishment is sufficient. This is the criterion by which the economic system selects survivors: those who realize *positive profits* are the survivors; those who suffer losses disappear."

[49] Williamson OE, The Economic Institutions of Capitalism. The Free Press, New York (1985) p 47.

[50] *Ibid*, p 18.

[51] *Ibid*, p 298: "labor, capital, suppliers, customers, the community, and management".

[52] *Ibid*, p 47: "The strongest form, the one to which transaction cost economics appeals, is opportunism. The semistrong form is simple self-interest seeking. Obedience is the weak (really null) form."

[53] See already Holmes OW, The Path of the Law, Harv L Rev 10 (1897) pp 457–490: "For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics."

the management-based research approach has as its starting point the *management objectives* of firms.

As management objectives can be determined functionally, the management-based research approach is related to the functional approach used in *comparative law*.[54] This means also that studies based on the management-based research approach can be useful in comparative legal research. In practice, some comparative lawyers have found client memos and articles written by practicing lawyers surprisingly useful compared with academic studies written by law professors.

The management-based research approach often studies functional questions that are studied even in economic sciences,[55] but it is separate from *law and economics*. Simply put, it does not ask: "Why should lawyers study economics? Why should economists study law?"[56] Instead, it asks: "Why should managers study law?"[57]

The management-based research approach incorporates *doctrinal analysis*. Obviously, management can use legal rules better if it has information about them. However, it is more than doctrinal analysis, because it contains more layers of analysis.[58] One could also say that there is a difference between legal research which is doctrinal with a functional twist[59] and legal research which is management-based and functional by definition. Doctrinal research cannot be perfectly functional, because the legal tools and practices employed by firms to achieve a certain objective are to a very large extent chosen and designed by firms rather than the state or other external rule-makers.

Branches of commercial law. One can also distinguish special *branches* of MBCL on the basis of the *functional* questions that must be addressed by firms depending on the context. The branches of MBCL are thus functional and modern rather than dogmatic and traditional.

The traditional branches of traditional commercial law are a loose bunch and do not necessarily have much in common. This is because state law reflects the preferences of the legislator and is designed to further various public policy

[54] See Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) pp 16 and 30; Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 165 (for the definition of corporate governance as an example of the similarities of the functional method and MBCL).

[55] See also Mattei U, Comparative Law and Economics. U Michigan P, Ann Arbor (1997) p ix: "... comparative law may gain theoretical perspective by using the kind of functional analysis employed in economic analysis of law."

[56] See Cooter R, Ulen T, Law and Economics. 5th International Edition. Pearson/Addison-Wesley, Boston, Mass. (2007).

[57] For an example of this approach, see Bagley CE, Winning Legally. Harv Bus School P, Boston, Mass. (2005).

[58] JP Morgan (1837–1913) famously put it this way: "I don't ... want a lawyer to tell me what I cannot do. I hire him to tell me how to do what I want to do."

[59] For an example of such an approach, see Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008).

objectives.[60] Typically, rules that belong to different areas of state law have been designed to further different public policy objectives. Furthermore, the choice of the branches of commercial law and the scope of each branch are both jurisdiction-specific and path-dependent: they are influenced by the legal family to which the jurisdiction belongs, convention, other areas of law, and other things. Although it may be beneficial to call the loose bunch of certain branches of law "commercial law" for educational purposes or to identify those branches of law that are particularly important for firms, one could just as well regard them as independent branches of law. The existence or absence of a particular commercial law code is unlikely to change this.[61]

The branches of MBCL have more in common. By definition, the branches of MBCL should choose the firm (rather than the court) as the user of legal tools and practices, and branches of MBCL can be defined on the basis of the firm's management objectives or functions (rather than on the basis of public policy objectives).

Unlike the branches of traditional commercial law, the branches of MBCL do not have to be jurisdiction-specific. Firms are – at least at a very high level of generality – relatively homogeneous regardless of the jurisdiction. Typically, firms tend to have similar generic objectives when managing legal questions in similar commercial contexts.

The choice of the perspective of the firm as the user of legal norms also means that the distinction between private law and public law, or between any traditional branches of law, is basically irrelevant in MBCL. Obviously, when a firm tries to design a proper legal framework in order to make a profit and survive, it is not interested in law professors' rather philosophical discussions about the structure of the legal system.

Because of fundamental differences in the perspective, the branches of traditional commercial law do not "belong" to MBCL. For example, "company law" cannot be regarded as a branch of MBCL, although some branches of MBCL such as the law of corporate finance or the law of corporate governance can address many traditional questions of company law and the tools used by firms are governed by rules belonging to traditional branches of commercial law. The same can be said of all the other branches of traditional norm-based commercial law.

Management-based commercial law and "law". Firms are not interested in the definition of "law" as such, or on the jurisdictional foundations of "law". From the perspective of the firm, the distinction between various categories of "law" (various categories of state law, non-legal institutionalised normative systems, or the firm's own self-practices) is irrelevant, unless there is a difference in the perceived

[60] For the reasons of regulation, see, for example, Goode RM, Commercial Law in the Next Millenium. The Hamlyn Lectures. Forty-ninth Series. Sweet & Maxwell, London (1998) p 44–47.

[61] Compare *ibid*, p 102 (arguing that a code "integrates … a disparate collection of statutes, unconnected to each other, replacing them with provisions which cover the field as a whole, in which each part is linked to the others and which are bedded down on a set of general provisions governing all transactions to which the code applies").

usefulness (information, content, addressee, impact, cost, risk) of norms belonging to different categories. Typically, the firm can use many overlapping "legal" layers to regulate the same context.

4.11 Concluding Remarks

It takes a theory to beat a theory.[62] However, there is hardly any commercial law theory to beat, because the mainstream research paradigm makes it virtually impossible to design one. Changing the research paradigm from norm-based to management-based makes it easier to formulate a theory for global use.

One can distinguish between general management-based commercial law and its branches.

At the general level, the theory of MBCL recognises the existence of firms that try to increase the likelihood of their own long-term survival in a competitive environment. For this reason, they have legal objectives. Their legal objectives consist of the management, by legal tools and practices, of: (1) cash flow and the exchange of goods and services; (2) risk; (3) principal-agency relationships; and (4) information. They always use five categories of legal tools and practices: (1) choice of the business form; (2) contracts; (3) regulatory compliance and organisation of internal processes; (4) particular legal ways to manage agency relationships; and (5) particular legal ways to manage information. The objectives are managed by the legal tools and practices at all three levels of corporate decision-making: (1) the strategic level; (2) the operational level; and (3) the transaction level.

One can also distinguish particular branches of management-based commercial law on the basis of the functional questions that must be addressed by firms in different commercial contexts. The branches are therefore functional rather than dogmatic.

[62] Kuhn TS, The Structure of Scientific Revolutions, Second Edition. U Chicago P, Chicago (1970) p 77.