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Organising the Firm

Theories of Commercial Law, Corporate Governance and Corporate Law

Springer

Chapter 5
Theories of Corporate Law and Corporations: Past Approaches

5.1 Introduction

We can now move on to theories of corporate law. Corporate law belongs to the traditional branches of commercial law in continental Europe. Both the Napoleonic Code de commerce and the German Handelsgesetzbuch address company law issues. Whereas norm-based commercial law is largely untheorised as a much too heterogenic branch of law, there is more discussion on the theoretical foundations of corporate law. The purpose of this chapter is to explain the main theories and explain why they are unsatisfactory. A new theory will be proposed in Chap. 8 after analysing corporate governance theory in Chaps. 6 and 7.

Legal theories v economic theories. To begin with, it is important to keep in mind that there is a fundamental difference between legal theories and economic theories such as theories of the firm.

Law is normative. As a normative discipline, law must be applied, and it must be complied with by a very large number of real firms and real people. Its contents should be predictable and regarded as fair and reasonable (Rawls 1971). This also means that law and legal theories tend to be conservative. Legal theories face a reality check every day when enforced in practice. As a result of the connection between law and real life, law can also give valuable information about the behaviour of real people and firms and about how society works.

Economic theories are not law. It should take some time before an economic theory of the firm can be accepted in corporate law, and the number of theories that can be accepted is limited. One should think twice before aligning legal norms designed to be applied by real people and firms with an economic theory based on a few aspects of fictive people or firms.

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Economic theories of the firm have nevertheless influenced theories of corporate law.[1] The role of the former depends on the nature of the latter. There are different kinds of corporate law theories.

Theory of corporate law, theory of corporations. A legal theory may broadly address questions relating to language, existence, scope, contents, structure, and interaction.[2] For the purposes of this book, these aspects can relate to corporate law or corporations. One can therefore distinguish between legal theories of corporate law and legal theories of corporations.[3]

Theory of corporate law. A legal theory of corporate law can seek to define corporate law. This may require a common language, that is, common concepts and terminology. The theory could explain the existence, purpose, contents, scope, and effects of corporate law. It could provide a structural framework that helps to describe and analyse its contents. It could also explain the relationship of corporate law and other areas of law or society.

Theory of corporations. A legal theory of corporations can address similar questions in the more limited context of corporations. It can provide a common language. It can try to define corporations. It can explain their existence and purpose, their structure and organisation, and their interaction with corporate insiders and third parties.

Dogmatics v economics. Existing legal theories of corporate law and corporations have addressed all such questions.

The earliest theories were theories of corporations. In Europe, legal theories of corporations still predominate. This is partly caused by the dogmatic nature of mainstream European research in corporate law. Legal theories of corporations are jurisdiction-specific, connected to the normative purpose of corporate law, and applied in the context of the interpretation of legal rules.

A need for theories of corporate law emerged at a later stage. There is more demand for theories of corporate law in the US compared with Europe. This is partly caused by the more prominent role of economic sciences in US legal

[1] See Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) pp 1471–1527.

[2] Von der Pforten distinguishes between the following characteristics of "something": (1) Reale, mereologische, raumzeitliche Bestimmung. (2) Kausale Bestimmung. (3) Funktionale Bestimmung. (4) Qualitative Bestimmung. (5) Begriffliche Bestimmung. (6) Sprachlich-semantische Bestimmung. (7) Intentionale Bestimmung. In short: real (something in space and time); causal; functional; qualitative, conceptual, linguistic, and intentional. See von der Pforten D, Was ist Recht? Eine philosophische Perspektive. In: Brugger W, Neumann U, Kirste S (eds), Rechtsphilosophie im 21. Jahrhundert. Suhrkamp Verlag, Frankfurt am Main (2008) pp 261–285.

[3] Compare Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) p 1474. Bratton distinguishes between "traditional legal theories of the corporate firm", "managerialism", and "the new economic theory of the firm". Traditional legal theories of the corporate firm are here regarded as examples of theories of corporations. Managerialism and the new economic theory of the firm are examples of theories of corporate law.

research. It is customary to apply theories developed in economic sciences even when interpreting provisions of corporate law in US courts.

Differences. There are characteristic differences between theories of corporate law and theories of corporations caused by the choice of perspective and the level of abstraction. Like theories of the firm, theories of corporate law or corporations tend to be limited to certain aspects. Theories of corporations tend to be based on existing corporate forms (inductive reasoning). This makes them more detailed and concrete. Theories of corporate law are based on general concepts (deductive reasoning). As a result, there is a risk that they fail to connect with the existing regulation of corporations.

5.2 Legal Theories of Corporations

5.2.1 General Remarks

Legal theories of corporations tend to be limited to certain aspects of the corporation. They are not designed to show the whole picture. As a result, the 1976 view was that "the general principles governing the legal structure of the corporation have never been well articulated".[4]

The most common legal theories of corporations focus on: the formation and general nature of corporations; the listing of the characteristics of corporations; the legal personality of corporations; their capacity; their purpose and objects; and the separation of corporate functions. Theories of supranational or international corporate forms focus on the particular legal aspects of such corporate forms.

5.2.2 Formation and General Nature

Theories on the formation and general nature of corporations seek to explain how corporations come to existence and how corporations are classified in the legal system.

Numerus clausus or party freedom. To begin with, one may ask whether only certain types of corporations should be permitted to exist (numerus clausus) or whether parties should have discretion to design corporations as they wish.

[4] Eisenberg MA, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) p 1. See nevertheless Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) p 1508: "By 1976, traditional theory of the firm concepts had fallen so far from view that theoretically ambitious works on corporate structure omitted any mention of them."

The main rule is that there is a numerus clausus of corporations in substantive law[5] but not in international private law.[6]

The founding of corporations. Corporations can nevertheless be created in different ways. In substantive law, the founding of a corporation can require: a contract; filing of the corporation with a registry; a charter or a similar authorisation; a statute; or a treaty. A corporation can thus be regarded as a contract, a private law entity, a public law entity, or an international law entity in legal dogmatics.

One can also distinguish between concession systems (the concession theory), normative systems as intermediate systems, and contractual systems as the opposite of concession systems.

A *concession* system means that the incorporation of a company requires consent by the state. There can be various degrees of the concession system. (a) First, the existence of a corporation can be in the discretion of the state (stronger form). This form of concession system was common in the past. For example, the Bubble Act prohibited incorporation without a Royal Charter or Act of Parliament in English law.[7] The Bubble Act was replaced by the 1844 Act. In the German Reich, incorporation was not liberalised until 1870.[8] (b) Second, incorporated entities may need a concession to do business (weaker form).[9] This system is likely to be found in branches that are regulated in the public interest, economies that are controlled by a state bureaucracy, and dictatorships.

A *normative* system means that the incorporation of a company and the carrying out of business is a legal right provided that all the legal requirements are met.[10]

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[5] See, for example, Article 530(2) of the Swiss Code of Obligations (OR). If an entity cannot be regarded as a corporation, it is deemed to be a partnership.

[6] See Article 150(2) of the Swiss Federal Act on Private International Law (IPRG). See Guillaume F, The Law Governing Companies in Swiss Private International Law. In: Sarcevic P, Volken P, Bonomi A, Yearbook of Private International Law, Volume 6 (2004). Sellier, München / Staempfli Publishers, Berne / Swiss Institute of Comparative Law (2005) pp 253–255.

[7] In the US, Chief Justice Marshall's opinion on the nature of the corporation in the famous corporate law case of Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819) reflects the concession theory: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."

[8] Article 208 of Allgemeines Deutsches Handelsgesetzbuch: "Aktiengesellschaften können nur mit staatlicher Genehmigung errichtet werden …" Article 249: "Den Landesgesetzen bleibt vorbehalten, zu bestimmen, daß es der staatlichen Genehmigung zur Errichtung von Aktiengesellschaften im Allgemeinen oder von einzelnen Arten derselben nicht bedarf …"

[9] Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) p 1475. See also pp 1483–1484 (for American corporate law's special charter phase).

[10] See, for example, Priester HJ, Beginn der Rechtsperson – Vorräte und Mäntel, ZHR 168 (2004) p 255.

In English company law, for example, the Act of 1844[11] represented a shift from the privilege of incorporation to the right of incorporation provided that the statutory conditions were fulfilled.[12] The normative system is the default system in the EU[13] and the system likely to be found in countries that enforce the rule of law and have a low level of corruption.

The *contractual* system means that individuals should have a right to incorporate entities and carry out business without state interference.[14] This system is rather rare in developed countries.

The regulation of corporations. There can also be a connection between the general nature of corporations and the regulation of corporations, in particular the balance between mandatory and dispositive provisions of law. If one wants to increase the discretion of the parties and limit the scope of state regulation, one can regard the corporation as something similar to a contract and argue that freedom of contract should prevail. Alternatively, one can argue that the corporation is not a contract and that mandatory standardisation reduces transaction costs and benefits the society as a whole.

5.2.3 Characteristics of the Corporation

The characteristics of the corporation depend on its general nature. For example, a corporation based on a statute or a treaty shares some of its characteristics with capitalist limited-liability corporations, but not necessarily all characteristics.

In substantive law, it is nowadays customary to describe the structural characteristics of capitalist limited-liability corporations roughly as follows: (1)

[11] The Joint Stock Companies Act of 1844 and the Limited Liability Act of 1855.

[12] Hurst JW, The Legitimacy of the Business Corporation in the Law of the United States 1780–1970. The U P of Virginia, the USA (1970) pp 5–6: "The shift in English policy from a focus upon political considerations to a focus upon economic utility anticipated a much later analogous course of policy in the United States."

[13] Article 10 of Directive 68/151/EEC (First Company Law Directive): "In all Member States whose laws do not provide for preventive control, administrative or judicial, at the time of formation of a company, the instrument of constitution, the company statutes and any amendments to those documents shall be drawn up and certified in due legal form." Article 3(1): "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." Article 2(1): "Member States shall take the measures required to ensure compulsory disclosure by companies of at least the following documents and particulars: (a) The instrument of constitution, and the statutes if they are contained in a separate instrument . . ."

[14] Bratton WW, *op cit*, p 1475: "The contractual response locates the source of all firms' economic energy in individuals. Stated most strongly, this view holds that the individuals' freedom of contract implies a right to do business as a corporation without state interference. A variant of this discussion suggests that the corporation is not a suitable subject for regulation because its activities have a 'private' rather than a 'public' nature."

legal personality; (2) indefinite duration; (3) the limited liability of shareholders; (4) freely transferable shares; (5) the separation of functions between corporate bodies; (6) majority rule; and (7) profit orientation.

Examples of studies that discuss such structural characteristics include Bergström and Samuelsson (1997),[15] Clark (1986),[16] and Kraakman et al. (2004).[17] There have also been much earlier attempts to describe the characteristics of the corporation. In the US, Angell and Ames (1871) defined the corporation by drawing on definitions from prominent earlier works.[18]

We can take a closer look at the structural characteristics of corporations and start with legal personality.

5.2.4 Legal Personality

Theories on legal personality focus on one of the most fundamental aspects of corporations. Although these theories are important and have influenced corporate law in surprisingly many ways, they have a narrow scope. There are issues relating to legal personality in substantive law and in international private law. We can first have a look at developments in substantive law.

Substantive law – fiction or realist theory. In Europe, the most important early theories were the nineteenth century realist theory of Otto von Gierke and the fiction theory of Friedrich Carl von Savigny and Bernhard Windscheid. The question was which of the theories should prevail. Is a legal person just a fiction (von Savigny and Windscheid)? Or should one assume that it exists and apply, by analogy, rules applicable to actions by individuals (von Gierke)?[19]

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[15] Bergström C, Samuelsson P, Aktiebolagets grundproblem. En rättsekonomisk analys. Nerenius & Santérus Förlag, Stockholm (1997) p 48.

[16] Clark RC, Corporate Law. Little, Brown & Co., Boston, Mass (1986). For an analysis of Clark's theory, see Klausner MD, The Contractarian Theory of Corporate Law: A Generation Later, J Corp L 31 (2006) pp 779–797.

[17] According to Kraakman et al., the characteristics are: (1) legal personality; (2) limited liability; (3) transferable shares; (4) centralised management under a board structure; and (5) shared ownership by contributors of capital. Kraakman R, Davies P, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB, The Anatomy of Corporate Law: A Comparative and Functional Approach. OUP, Oxford (2004) p 5.

[18] Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) pp 1502–1503: "One definition came from Kent's Commentaries, but had origins going as far back as the writings of Pope Innocent. The second came from Kyd's late eighteenth century British treatise on corporate law. The third was the famous description of the corporation in Chief Justice Marshall's opinion in the Dartmouth College case."

[19] This discussion was relevant even in the US. See Bratton WW, *op cit*, p 1475: "Here one line of responses holds the corporation to be at most a reification—a construction of the minds of the persons connected with the firm and those who deal with them and their products. A conflicting line holds the corporate firm to be a real thing having an existence, like a spiritual being, apart from the separate existences of the persons connected with it."

The latter theory (von Gierke) was adopted by German law and in continental Europe.[20] This explains, for example, why continental European companies have traditionally been represented by their "organs" (the organic theory).[21] German legal science also distinguishes between the legal entity and the firm. The firm (das Unternehmen) has interests (Unternehmensinteresse, see below) and belongs at law to a legal entity that acts as the "carrier of the firm" (Unternehmensträger).[22] This makes it also easier to recognise that the business of modern firms is not limited to the confines of one legal entity. For example, the regulation of company groups (Konzernrecht) and the duties of good faith ("Treu und Glauben", § 242 BGB) between group members make it easier to manage a firm that uses a fleet of legal entities.[23] In France, the "Rozenblum" doctrine serves the same purpose.[24]

English law chose a different path. In English law, the question of legal personality was discussed in the landmark case of *Salomon v Salomon*.[25] After this case, the question of legal personality has customarily been discussed in the context of the limited liability of shareholders.[26] It is rare to discuss the nature of legal personality or the relationship between the company and the firm. As a result, the company and the firm are terms that tend to be used interchangeably in corporate law scholarship (such as Keay 2008). This is reflected in the absence of group law.

[20] See Larenz K, Allgemeiner Teil des deutschen Bürgerlichen Rechts, Ein Lehrbuch. 7. Auflage. Verlag C.H. Beck, München (1988) § 9 I; Teubner G, Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person, Am J Comp L 36 (1988) pp 130–155; Foster NHD, Company Law Theory in Comparative Perspective: England and France, Am J Comp L 48 (2000) pp 573–621; Mäntysaari P, The Law of Corporate Finance. Volume II. Springer, Berlin Heidelberg (2010) p 193.

[21] See also Article 10 of Directive 2009/101/EC, previously Article 9 of Directive 68/151/EEC (First Company Law Directive).

[22] One can see evidence of this also in § 3(1)(2) GmbHG and § 23(2)(2) AktG. See, for example, Priester HJ, Beginn der Rechtsperson – Vorräte und Mäntel, ZHR 168 (2004) p 252.

[23] Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) p 363.

[24] See Hofstetter K, Parent Responsibility for Subsidiary Corporations: Evaluating European Trends, ICLQ 39 (1990) pp 576–598.

[25] Salomon v A Salomon & Co Ltd [1897] AC 22.

[26] Easterbrook and Fischel regard limited liability as *the* distinguishing figure of corporate law in the US. Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harvard U P, Cambridge, Mass. (1991) p 40. Blair nevertheless provides a very different view. Blair argues: "While [the ability to amass large amounts of capital, limited liability, and the centralization of control] were important in many situations, it was a fourth factor that turned out to be the critical advantage of the corporate form: the ability to commit capital, once amassed, for extended periods of time … [T]he chartering of a corporation legally transformed the business enterprise in ways that would have been impossible or extremely difficult to achieve through … contract law … The first way was that incorporation gave the enterprise 'entity' status under the law, and the second was that incorporation required governance rules that legally separated business decisionmaking from contributions of financial capital." Blair MM, Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, UCLA L Rev 51 (2003) p 390.

Different companies do not belong to the same firm. Each company is expected to pursue its own interests.[27]

In the US, von Gierke's theory – the theory adopted in German law – inspired a theory called corporate realism. Its most prominent advocate was Ernst Freund.[28] Corporate realism survived into the 1920s as the theory that, unlike the classical model with an owner-manager-entrepreneur, could describe complex, capital-intensive corporate entities, offered a theory of groups, and suited the interests of the management.[29] Corporate realism and the management corporation rose together.[30] Corporate realism disappeared in the mid 1920s as managerialist concepts made popular by Berle and Means (1932) prevailed in legal research:[31] the "enduring ideas came from contemporary American economics rather than from nineteenth century European jurisprudence".[32] The classical model lived longer in economic theories of the firm.[33]

International private law – recognisability. In international private law, the question of legal personality can be rephrased, in a situation that has connections to two or more jurisdictions, as a question of (a) the governing law and (b) whether entities are recognised as legal entities.[34] States customarily apply a system of rules grounded in the real seat theory, the incorporation theory, or a combination of both theories.[35] Case-law of the European Court of Justice[36] in effect forces Member

[27] See, for example, Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) p 217.

[28] Freund E, The Legal Nature of Corporations. U Chicago P, Chicago (1897) § 6 pp 13–14 (discussing von Gierke's organic theory).

[29] Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) pp 1490–1491 (with references in footnote 90).

[30] *Ibid*, p 1511 commenting on Horwitz MJ, Santa Clara Revisited: The Development of Corporate Theory, W Virginia L Rev 173 (1986) pp 173–224.

[31] *Ibid*, pp 1490–1491; Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) pp 549 and 561–563. For a critique of the theory, see Dewey J, The Historic Background of Corporate Legal Personality, Yale L J 35 (1926) p 672: "... the entire discussion of personality, whether of single or corporate personality, is needlessly encumbered with a mass of traditional doctrines and remnants of old issues."

[32] Bratton WW, *op cit*, p 1512.

[33] See Alchian AA, Demsetz H, Production, information costs, and economic organization, Am Econ Rev 62(5) (1972) p 794.

[34] See, for example, Großfeld B, Zur Geschichte der Anerkennungsproblematik bei Aktiengesellschaften, RabelsZ 38 (1974) pp 344–371; Zimmer D, Grenzüberschreitende Rechtspersönlichkeit, ZHR 168 (2004) pp 355–368; Roth WH, From Centros to Überseering: Free Movement of Companies, Private International Law, and Community Law, ICLQ 52 (2003) pp 177–208.

[35] For the benefits of the real seat doctrine, see Schmidt K, Sitzverlegungsrichtlinie, Freizügigkeit und Gesellschaftsrechtspraxis. Grundlagen, ZGR 1999 pp 23–24.

[36] Case C-212/97 Centros [1999] ECR I–459; Case C-208/00 Überseering [2002] ECR I–9919; Case C-167/01 Inspire Art [2003] ECR I–10155; Case C-411/03 SEVIC Systems [2005] ECR I–10805; Case C-196/04 Cadbury Schweppes [2006] ECR I–7995; and the opinion of advocate general Poiares Maduro in Case C-2010/06 Cartesio.

States of the EU to apply, in a non-discriminatory way, the incorporation theory to EU companies.[37]

5.2.5 Capacity

A distinction can be made between legal personality (Rechtspersönlichkeit, personnalité juridique) and legal capacity (Handlungs- und Geschäftsfähigkeit, capacité juridique). A company that is regarded as a legal person customarily possesses legal capacity. Entities can nevertheless possess legal capacity without being regarded as legal persons,[38] and the legal capacity of an entity may be limited although the entity is regarded as a legal person. The common law doctrine of ultra vires is an example of the latter (see below).

5.2.6 Purpose and Object

Even where a corporation is regarded as a legal person, its actions may be constrained by its purpose or objects. Theories on the purpose and objects of corporations can be connected with other theories.

First, they can be connected with theories on the *capacity* of the corporation. (a) The doctrine of ultra vires provides an example. This doctrine used to pay an important role in common law systems. It meant that actions that fell outside the company's objects clause were "ultra vires" and not binding on the company.[39] As a result, the objects clause used to be very detailed and cover a long list of activities. The ultra vires doctrine has lost much of its relevance due to EU company law,[40] the UK Companies Act of 2006,[41] and developments in US company law.[42] (b) Like

[37] Articles 49 and 54 TFEU.

[38] Fleischer describes one such case. Fleischer H, Supranational Corporate Forms in the European Union: Prolegomena to a Theory on Supranational Forms of Association, CMLR 47 (2010) p 1704: "Article 1(2) EEIG Regulation grants legal personality . . . to the EEIG, while Article 1 (3) leaves it up to each Member State to decide whether or not groups registered there will have legal personality. In most Member States – the marked exceptions being Germany and Italy – the EEIG is a legal person, although in the United Kingdom it is generically classified as a body corporate." For the German version of this paper, see Fleischer H, ZHR 174 (2010) pp 385–428.

[39] Ashbury Railway Carriage and Iron Co Ltd v Riche (1875) LR 7 (House of Lords) 653.

[40] Originally Article 9 of Directive 68/151/EEC (First Company Law Directive), now Article 10 of Directive 2009/101/EC.

[41] Section 31(1) of Companies Act 2006: "Unless a company's articles specifically restrict the objects of the company, its objects are unrestricted." Section 39(1): "The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution." The doctrine's relevance was reduced already by section 35A of the Companies Act 1985 inserted by the Company Act 1989.

[42] § 3.01(a) of the Revised Model Business Corporation Act: "Every corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is

the doctrine of ultra vires, the French doctrine of spécialité statutaire has lost much of its earlier importance due to EU company law.[43]

Second, they can be connected with the *interests* to be served. The purpose of the corporation can influence the legal duties of corporate bodies and the allocation of power between shareholders and corporate bodies. This question will be discussed in Sect. 6.3.

Third, they can also be connected with theories on the *separation* of corporate functions (see below).

5.2.7 Separation

Theories on the separation of corporate functions have long roots. The leading countries are Germany and the US.

In Germany, the separation of corporate functions with a management board, supervisory board, and general meeting of shareholders was made mandatory for large companies by the Commercial Code of 1897.[44] Rathenau (1917a) described how share ownership had changed in large companies, how the responsibility for the affairs of the firm had moved from the supervisory board to the management board, and how the new structures contributed to conflicts between the general meeting and management.[45]

set forth in the articles of incorporation." Compare this with Chief Justice Marshall's opinion in the famous corporate law case of Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819) on the nature of the corporation: "Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."

[43] Zimmer D, Internationales Gesellschaftsrecht. Schriftenreihe Recht der Internationalen Wirtschaft. Band 50. Verlag Recht und Wirtschaft GmbH, Heidelberg (1996), Dritter Teil C I 1 b at pp 243–244.

[44] § 239 HGB 1897 and § 246 HGB 1897. There were exemptions for small companies – GmbH – combined with restrictions on the transferability of shares and an increased liability of shareholders. See, for example, Cosack K, Lehrbuch des Handelsrechts. Sechste Auflage. Verlag von Ferdinand Enke, Stuttgart (1903) § 122.

[45] Rathenau W, Vom Aktienwesen. Eine geschäftliche Betrachtung. Berlin (1917) p 13; Riechers A, Das "Unternehmen an sich". Die Entwicklung eines Begriffes in der Aktienrechtsdiskussion des 20. Jahrhunderts. Beiträge zur Rechtsgeschichte des 20. Jahrhunderts 17. Mohr Siebeck, Tübingen (1996); Laux F, Die Lehre vom Unternehmen an sich. Walther Rathenau und die aktienrechtliche Diskussion in der Weimarer Republik. Schriften zur Rechtsgeschichte RG 74. Duncker & Humblot, Berlin (1998) p 7.

In the US, the separation of ownership and control was recognised as a modern phenomenon in the 1920s.[46] It was later made popular by Berle and Means (1932) who explained that the separation of ownership from control is one of the characteristics of the modern corporation.[47] The work of Berle and Means was influential (see below).

Eisenberg (1976) builds on the work of Berle and Means. He discusses both closely-held and publicly-held corporations.

Eisenberg analyses the separation of functions in *closely-held* corporations on the basis of the fair expectations of "owners". He argues that there are matters that "owners" would expect to decide by themselves, and matters they would expect the managers to decide.[48] However, he does not explain on what grounds "owners" can be assumed to have such expectations, and he discusses their expectations only in the context of the founding of the company.

In *publicly-held* corporations, he distinguishes between different categories of decisions. *Structural changes* should be decided on by shareholders, because, first, "management is likely to be deeply self-interested in structural decisions"[49] and, second, neither judicial review nor approval by a government agency would work as alternative decision-making mechanisms.[50] Managers should take care of most *management matters*. Eisenberg argues that the main function of the board of a publicly-held corporation is the selection and removal of the *chief executive*.[51] He discusses boards composed of independent directors, boards with a clear majority of independent directors, the statutory two-tier system, and de facto two-tier systems of American corporations.[52]

5.2.8 Supranational or International Corporate Forms

Some corporate forms can be regarded as supranational or international. International companies are founded on the basis of a private or public law treaty between

[46] Brandeis LD, On Industrial Relations (testimony before the United States Commission on Industrial relations, January 23, 1915, see Bruner CM, The Enduring Ambivalence of Corporate Law, Alabama L Rev 59 (2008) p 1390); Veblen T, Absentee Ownership and Business Enterprise in Recent Times: The Case of America. B.W. Huebsch, New York (1923); Riechers A, *op cit*, p 183.

[47] Berle AA, Means GC, The Modern Corporation and Private Property. Transaction Publishers, New Brunswick, New Jersey (1968). Originally published in 1932. See also Mark Roe, Strong Managers, Weak Owners (1994). According to Roe, the emergence of dispersed share ownership was not entirely dictated by economics.

[48] Eisenberg MA, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) pp 12–13, 16.

[49] *Ibid*, p 33.

[50] *Ibid*, pp 34–36.

[51] *Ibid*, pp 162–170.

[52] *Ibid*, pp 172–185.

several States.[53] Supranational corporate forms are different. In the EU, supranational corporate forms include the European Economic Interest Grouping (EEIG),[54] the European Company (Societas europaea, SE),[55] and the European Cooperative Society (Societas cooperativa europaea, SCE),[56] and may include the European Private Company (Societas privata europaea, SPE) in the future.[57]

It is characteristic of such corporate forms that they are not created by a national legislator. A theory of supranational or international corporate forms must therefore explain their creation and the interaction of international/supranational law and national law.[58] Such corporate forms nevertheless share most of their characteristics with similar national corporate forms. Their cross-border nature does not really set them apart from national corporate forms as the business of firms has become increasingly international or global.[59] In principle, supranational or international corporate forms could nevertheless have characteristic elements not shared by other corporate national corporate forms.

5.2.9 Problems

Existing theories of corporations raise certain problems. First, a list of characteristics does not explain why the company has exactly those and not other characteristics. Neither does it explain the relationship between the different characteristics. This could be achieved by identifying the bigger idea behind all the characteristics, that is, the main objectives of the legal framework that governs corporations, and the particular functions that must be regulated. In practice, such

[53] Fleischer H, Supranational Corporate Forms in the European Union: Prolegomena to a Theory on Supranational Forms of Association, CMLR 47 (2010) pp 1680–1681 citing, in particular, Marty G, Les Sociétés Internationales, RabelsZ 27 (1962) pp 73–88; Wiedemann H, Gesellschaftsrecht. Vol. I. C.H. Beck, München (1980), § 15 IV p 881.

[54] Regulation 2137/85 (EEIG Regulation).

[55] Regulation 2157/2001 (SE Regulation).

[56] Regulation 1435/2003 (SCE Regulation).

[57] Commission, Proposal for a Council Regulation on the Statute for a European private company, COM(2008) 396 final. See, for example, Bormann J, König DC, Der Weg zur Europäischen Privatgesellschaft, RIW 3/2010 pp 111–119; Teichmann C, Die Societas Privata Europaea (SPE) als ausländische Tochtergesellschaft, RIW 3/2010 pp 120–127.

[58] Fleischer H, Supranational Corporate Forms in the European Union: Prolegomena to a Theory on Supranational Forms of Association, CMLR 47 (2010) p 1717: "As far as the interaction of supranational and national law is concerned, two types of legislative techniques may be distinguished: the referential model (paradigm: the SE Regulation) and the complete statute (paradigm: the draft SPE Regulation)."

[59] *Ibid*, p 1717 (on a theory of European supranational corporate forms): "Some distinguishing features which may play a role in furthering the doctrinal assessment of European corporate law are: legal personality; corporate purpose and company object; cross-border involvement; registered and head offices; and company members from third countries."

theories must be complemented by theories of corporate law (see below) or other theories. Second, although separate legal personality and the separation of functions are characteristic of companies, there must be other factors explaining the details of corporate law. For example, what are the factors explaining how functions are separated?

5.3 Legal Theories of Corporate Law

5.3.1 General Remarks

The most important theories of corporate law are probably the contractarian theory of corporate law, applications of the agency theory, and the team-production theory of corporate law.[60]

5.3.2 Contract

The *contractarian* theory of corporate law was the next big thing after Berle and Means (1932) in mainstream corporate law research. It is still the mainstream approach in Anglo-American legal science. This theory analyses corporate law as a set of standard form contracts. The "corporate contract" consists of the terms of a corporation's articles of association (charter) and the corporate law the firm selects by virtue of incorporating in a particular jurisdiction.

The contractarian theory of corporate law is influenced by the set-of-contracts theory of the firm but it has much longer historical roots in English company law.[61] English law treats articles of association as a "statutory contract".[62] American law was greatly influenced by English law,[63] and economic sciences were influenced by the existing legal framework (path dependency). One could say that the set-of-contracts theory of the firm "confirms and repeats legal history" when it asserts that the corporation is a contract.[64]

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[60] See, for example, Bruner CM, The Enduring Ambivalence of Corporate Law, Alabama L Rev 59 (2008) p 1396.

[61] See already Berle AA, Means GC, The Modern Corporation and Private Property (1932), Chapter IV.

[62] Section 33 of the Companies Act 2006; section 14 of the Companies Act 1985. See also Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) pp 105–113.

[63] See Berle AA, Means GC, *op cit*, Book Two, Chapter I.

[64] Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) p 1513.

As a result, it was relatively easy to adopt the set-of-contracts theory of the firm in American economic sciences,[65] and it is relatively easy to explain the theory's success in corporate legal theory in common law countries.[66]

The contractarian theory of corporate law contains a political agenda. The representatives of this theory argue: that the corporation is a set of contracts; that the main principle in contract law is party autonomy; and that company law should, therefore, be enabling and without mandatory provisions. This means that the contractarian theory does not reflect existing corporate law.[67] Although not its originators, Easterbrook and Fischel belong to the best-known modern representatives of the set-of-contracts theory in corporate law.[68]

In economic sciences, the set-of-contracts theory of the firm is complemented by the property rights approach. This has led to attempts to describe the *proprietary* foundations of corporate law.[69]

The set-of-contracts theory of corporate law is very problematic.[70] It cannot help to define corporate law and its relevant issues. The most fundamental problems are caused by its failure to reflect the contents of the law.[71]

First, the set-of-contracts theory of corporate law relies on fictive rather than legal contracts. Whereas legal contracts (the real contracts) are legally enforceable, the fictive contracts of economic theory and the set-of-contracts theory of corporate law are not. This is recognised even by its representatives.[72] There is also a difference between the "statutory contract" created by English company law and contracts governed by contract law: the statutory contract binds members in their capacity as members only; normal remedies for breach of contract do not

[65] See Fama EF, Jensen MC, Separation of Ownership and Control, J Law Econ 26 (1983) pp 301–325.

[66] Bratton WW, *op cit*, p 1473.

[67] See also *ibid*, p 1517: "While the doctrinal theory always takes cognizance of contractual elements, it never makes contract the essence. The doctrinal theory balances contract against the corporate entity and a sovereign presence . . . Selection of the applicable theoretical paradigm—managerialist or contractual—will occur in the particular context as a quasi-political decision."

[68] See Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harvard U P, Cambridge, Mass. (1991) p 15.

[69] Armour J, Whincop MJ, The Proprietary Foundations of Corporate Law, OJLS 27 (2007) pp 429–465 (http://ssrn.com/abstract=1150625).

[70] See Clark RC, Corporate Law. Little, Brown & Co, Boston, Mass. (1986); Clark RC, Contracts, Elites, and Traditions in the Making of Corporate Law, Columbia L Rev 89 (1989) pp 1703–1747; Klausner MD, The Contractarian Theory of Corporate Law: A Generation Later, J Corp L 31 (2006) pp 779–797.

[71] See also Bratton WW, *op cit*, p 1513: "This absolute contractualism makes problematic the new theory's practical application in the law." See also p 1517: "Contractual notions will be entertained, but any move to foreclose wider discussion by the assertion that contract should govern as a function of the intrinsic nature of the corporation will fail."

[72] Demsetz H, The Structure of Ownership and the Theory of the Firm, J Law Econ 26(2) (1983) p 377; Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harvard U P, Cambridge, Mass. (1991) pp 15–16.

necessarily apply; and the statutory contract can be altered by special resolution. Such "statutory contracts" are thus fictive rather than real.

Second, the set-of-contracts theory of corporate law is not compatible with separate legal personality, one of the most fundamental characteristics of corporations. For example, an employee does not owe any real contractual duties to a shareholder. An employee owes contractual duties to the employer, the legal entity. A CEO seldom owes contractual duties to a shareholder but does customarily owe them to the legal entity.

Third, freedom of contract is not characteristic of corporate law in the broad sense. There is an extensive *mandatory* regulatory regime for securities markets and corporate insolvency, there is an extensive *mandatory* regulatory regime for the disclosure of financial information, and there is an increasing amount of *mandatory* regulation of corporate governance. It is fair to assume that the regulation of securities markets, corporate insolvency, disclosure of financial information, and corporate governance can fall within the scope of corporate law in the broad sense.[73] The political agenda of the contractarian theory of corporate law has clearly failed.

5.3.3 Agency

The contractarian theory is combined with the agency theory. Of course, corporate law does not have its roots in the agency theory. Corporate law has existed for hundreds of years (or longer),[74] but the origins of the agency theory can be traced to the 1960s and early 1970s.[75] The agency theory nevertheless became the most popular theory in corporate governance research (see below) and started to influence corporate law scholarship in general. It has very slowly started to influence even other areas of law. That its penetration of legal science is very slow in Europe can be illustrated by a 2006 book published by the Stockholm Institute for

[73] Klausner MD, The Contractarian Theory of Corporate Law: A Generation Later, J Corp L 31 (2006) p 785. The scope of "corporate law" or "company law" can also have normative implications. See, for example, Case C–167/01 Inspire Art [2003] ECR I–10155, paragraph 138; Article 1(2)(f) of Regulation 593/2008 (Rome I).

[74] Malmendier U, Roman Shares. In: Goetzmann WN, Rouwenhorst KG (eds), *op cit*, p 32: "While the idea of offering shares in enterprises may date back further, most papers and monographs on the history of the corporation identify the East and West India Companies, which emerged during the early seventeenth century as the world's first business corporations . . . I argue that over two thousand years earlier the Roman *societas publicanorum*, or 'society of publicans' anticipated the modern corporation and, in particular, the use of fungible shares with limited liability."

[75] Wilson R, On the Theory of Syndicates, Econometrica 36 (1968) pp 119–132; Arrow KJ, Essays in the Theory of Risk-Bearing. Markham Publishing Co., Chicago (1971); Ross SA, The Economic Theory of Agency: The Principal's Problem, Am Econ Rev 63(2) (1973) pp 134–139; Jensen MC, Meckling WH, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J Fin Econ 3 (1976) pp 305–360.

Scandinavian Law which contained 25 articles on "a proactive approach" in law without mentioning the agency theory even once.

In their book "Aktiebolagets grundproblem" (The Fundamental Problems of the Corporation), Bergström and Samuelsson study the characteristics of the corporate form and how Swedish company law regulates conflicts of interest between managers and shareholders, between majority and minority shareholders, and between shareholders and creditors.[76] In their book "The Anatomy of Corporate Law. A Comparative and Functional Approach", a number of leading corporate law scholars (Kraakman et al. 2004) suggest that the central issue for corporate law in every jurisdiction is how to mediate such agency conflicts. In addition, the authors develop a typology of ten different strategies divided by operational and temporal criteria.[77] The authors then apply their scheme to related party transactions, control transactions, investor protection, and a variety of other key corporate law issues. This book has gained much influence.[78]

The mainstream agency model or "anatomy model" is nevertheless problematic. Like the contractarian theory, it fails to reflect the contents of existing law. Moreover, it fails to explain fundamental questions. The core failings of the anatomy model are: (1) that it does not explain why the limited-liability company has many of its basic legal characteristics (such as separate legal personality and shareholders with limited liability and freely transferable shares); [79] (2) that it does not explain why something should be done in the first place;[80] and (3) that there are various categories of potential principals with potentially conflicting interests.

The last of the three issues partly contributes to the other two issues. If shareholders, minority shareholders, and various kinds of third parties can all be

[76] Bergström C, Samuelsson P, Aktiebolagets grundproblem. En rättsekonomisk analys. Nerenius & Santérus Förlag, Stockholm (1997).

[77] Kraakman R, Davies P, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB, The Anatomy of Corporate Law: A Comparative and Functional Approach. OUP, Oxford (2004) p 23.

[78] See Skeel DA Jr., Corporate Anatomy Lessons, Yale L J 113 (2004) pp 1519–1577; Wiedemann H, Auf der Suche nach den Strukturen der Aktiengesellschaft. The Anatomy of Corporate Law, ZGR 2006 pp 240–258.

[79] Kraakman R, Davies P, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB, *op cit*, pp 1–2: "These characteristics are . . . induced by the economic exigencies of the large modern business enterprise. Thus, corporate law everywhere must, of necessity, provide for them. To be sure, there are other forms of business enterprise that lack one or more of these characteristics. But . . . almost all large-scale business forms adopt a legal form that possesses all five of the basic characteristics . . . Self-evidently, a principal function of corporate law is to provide business enterprises with a legal form that possesses these five core attributes." Kraakman et al. nevertheless fail to explain why the limited-liability company has its basic legal characteristics. See also Williamson OE, The Modern Corporation: Origins, Evolution, Attributes, J Econ Lit 19 (1981) pp 1538–1539 (on the focus of the essay): "Key legal features of the corporation – limited liability and the transferability of ownership – are taken as given. Failure to discuss these does not reflect a judgment that these are either irrelevant or uninteresting. The main focus of this essay, however, is on the internal organization of the corporation."

[80] Skeel DA, Jr., Corporate Anatomy Lessons, Yale L J 113 (2004) pp 1543–1544.

regarded as principals depending on the circumstances, whose interests should prevail and why?[81] This argument is customarily used against stakeholder theories (Sect. 6.3). The mainstream view attempts to solve this problem by choosing shareholders as the most important principal. However, it uses weak arguments (Sect. 6.4).

Generally, the mainstream view defends the choice of shareholders as the most important principal by weak moral arguments,[82] arguments that should rather apply to other principals (shareholders are not the main source of capital, shareholders do not necessarily have the biggest risk exposure), or arguments that can make sense only in economic theory (the firm of economic theory exists only in economic theory;[83] it is clear that shareholders do not own the assets of a separate legal person;[84] and there is a difference between legally enforceable contracts and the fictional contracts of economic theory).

The choice of shareholders as the most important principal does not explain their existence as a class. Why are there claimants called shareholders in the first place? For example, the limitation of investors' liability cannot explain the existence of shareholders, because the limited liability of investors is "an attribute of most investment, not just of corporate law".[85] And if the cause of their existence could be explained, the choice of real shareholders as the principal would still be particularly problematic. Real shareholders can have different interests and are most likely to have very different interests in a company with a dispersed share ownership structure.[86] What are the real interests of a corporation's real shareholders? Of course, one could decide that the interests of real shareholders do not count and use the fictive interests of fictive shareholders instead. But fictive shareholders do not exist, and both corporate law and corporate decision-making must address issues caused by the real interests of shareholders that do exist.

5.3.4 Team Production

The team production theory is one of the attempts to solve the problem caused by the existence of many agency relationships. Blair and Stout (1999) argue that the

[81] An example of this approach is Keay A, Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model, MLR 71(5) (2008) pp 676–677.

[82] Like Berle AA, Property, Production and Revolution. A Preface to the Revised Edition. In: Berle AA, Means GC, *op cit*.

[83] Demsetz H, The Structure of Ownership and the Theory of the Firm, J Law Econ 26(2) (1983) p 377.

[84] For a landmark case in English company law, see Salomon v A Salomon & Co Ltd [1897] AC 22.

[85] Easterbrook FH, Fischel DR, *op cit*, p 40.

[86] For example, they have very different political interests. See Bebchuk LA, Jackson RJ, Corporate Political Speech: Who Decides? Harv L Rev 124 (2010) pp 83–117.

essential economic function of the public corporation is not to address principal-agent problems at all. Instead, they suggest that the unique legal rules governing publicly-held corporations are primarily designed to address the team production problem identified by Holmström (1982). In particular, Blair (2003) points out that corporate law facilitates locking in capital.[87]

The team production problem arises when a number of individuals must invest firm-specific resources to produce a non-separable output. In such situations, team members may find it difficult or impossible to draft explicit contracts distributing the output of their joint efforts, and, as an alternative, might prefer to give up control over their enterprise to an independent third party charged with representing the team's interests and allocating rewards among team members.

According to Blair and Stout, the public corporation is a vehicle through which potential corporate stakeholders can jointly relinquish control over their firm-specific resources to a board of directors. Blair and Stout suggest that directors of public corporations should seek to maximise the joint welfare of all the firm's stakeholders who contribute firm-specific resources to corporate production.

Blair and Stout thus regard the firm as a production function. What makes their model problematic is that it gives little guidance on what should be done and how. There is a long list of potential contributors of firm-specific resources. How should the contributors of firm-specific resources be chosen? Is there a way to measure their joint welfare in any reasonable way? Whose interests should prevail?

5.4 Summary

One can distinguish between theories of corporations and theories of corporate law. These theories tend to be limited to certain questions. Of the two categories, theories of corporations tend to be narrower. Because of their inductive nature, they also tend to reflect the regulation of corporations better. The broader theories of corporate law seem to be problematic and flawed. In particular, they do not seem to reflect the reality of the regulation of corporations. This can partly be explained by their deductive nature.

[87] Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virginia L Rev 85 (1999) pp 247–328; Blair MM, Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, UCLA L Rev 51(2) (2003) pp 433–434; Holmström B, Moral Hazard in Teams, Bell J Econ 13(2) (1982) pp 324–340.