Petri Mäntysaari

Organising the Firm

Theories of Commercial Law, Corporate Governance and Corporate Law

Springer

Chapter 6
Legal and Economic Theories of Corporate Governance: Past Approaches

6.1 Introduction

Theories of the firm and theories of corporate law or corporations provide the basis for the study of corporate governance. One can say that all such theories address at least some questions that are interesting in this context. The purpose of this chapter is to provide a critique of the existing theories. A new theory will be proposed in the next chapter.

Theories of corporate law/corporations, theories of corporate governance. One should make a distinction between theories of corporate law/corporations and theories of corporate governance. They describe different phenomena.

Unlike corporate law, corporate governance is not a normative system consisting of legal rules. Corporate governance tends to be defined in various ways and studied in various disciplines in social sciences. It can be regarded as an economic, social, or organisational phenomenon (something happening), or as an organisational or management function (something to be organised or managed). There are many theories of corporate governance in economics and management science.

Corporate governance can also be regarded as a context that raises legal questions. There could therefore be one or more legal theories of corporate governance.

However, the mainstream approaches are typically applications of the mainstream theories of the firm (economic approaches) and corporate law/corporations (legal approaches). For this reason, one could say that there are not really any mainstream theories of corporate governance in particular.

Economic and legal theories of corporate governance. There is no clear dividing line between economic and legal theories of corporate governance, because economic theories have been influenced by legal theories and vice versa. In the following, legal and economic theories are therefore discussed generally as theories of corporate governance.

Four big questions. Unfortunately, the existing theories are rather narrow and fail to explain even the most fundamental issues of corporate governance.

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A general theory of corporate governance should be able to answer at least four fundamental questions: (1) Why is the *legal entity* with its characteristic governance model chosen in the first place? (2) Whose *interests* should the people acting as or on behalf of the legal entity further? (3) Why does a legal entity have a *board*? (4) Why does a legal entity have *shareholders*? For example, one cannot explain the function of shareholders and the board unless one can explain why they exist and the general objective of their activities.

Most research approaches take the existence of a legal entity for granted and assume that a legal entity has shareholders and a board. Typically, most of them discuss just the second question: the corporate objective.[1] We can nevertheless study the question of choice first.

6.2 Choice of Business Form and Governance Model

The corporate governance model used by firms is governed and constrained by the external legal framework. On the other hand, the external legal framework that provides for the default corporate governance model is not static. The legal framework and the default model depend on several choices.

The choices relate to: the governing law (the legal framework of one country rather than the legal framework of another country)[2]; the business form (one business form facilitated by the governing law rather than another business form facilitated by the same governing law); and the combination of business forms (a certain combination of business forms rather than another combination). For example, a German legal entity with a governance model governed by German law can functionally be changed into a French legal entity whose governance model is governed by French law.[3] If this is what one wants, one will also choose between alternative French business forms each with a different legal framework. The governance structure could be based on the use of just one legal entity or a combination of two or more different or similar legal entities.

What explains the choices? A theory of corporate governance should be able to explain why a certain business form and its characteristic governance model are chosen in the first place.

[1] For an example of such an approach, see Keay A, Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model, MLR 71(5) (2008) pp 663–698. Bainbridge S, The New Corporate Governance in Theory and Practice. OUP, Oxford (2008) studies this question and the question why there are boards.

[2] See, for example, Kahan M, Kamar E, The Myth of State Competition in Corporate Law, Stanford L Rev 55 (2002) pp 679–749.

[3] See, for example, Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 86–92.

Although there are examples of research that seek to explain the choices,[4] mainstream research approaches do not seem to recognise the existence of choice. Their corporate governance model is static in the sense that the choice of the governing law and the default governance model (usually that of a large public limited-liability company) are taken for granted.

For example, mainstream approaches do not explain why firms do not move more to jurisdictions whose laws are perceived as “better”,[5] and they do not explain why firms choose incorporation in Delaware.[6] The path dependency of statutory corporate governance models cannot be the explanation.[7] The more discretion market participants have to choose between the corporate governance models of different states and the various corporate governance models available under the laws of a certain state, the less the path dependency of national corporate governance models should matter.

Neither do mainstream approaches explain why firms still use business forms that do not require the existence of shareholders with freely transferable shares. Most firms in the world are small private businesses without freely transferable shares.

6.3 Interests

6.3.1 General Remarks

The interests that the people acting as or on behalf of the legal entity should further depend on the chosen approach. In recent research, it is customary to distinguish between two mainstream approaches: the interests of shareholders (shareholder primacy) and the interests of stakeholders (the stakeholder approach).[8]

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[4] See Aoki M, Jackson G, Understanding an emergent diversity of corporate governance and organizational architecture: an essentiality-based analysis, Ind Corp Change 17 (2008) pp 1–27 (studying equilibrium modes of linkage between assets held by basic stakeholders: managers’ human assets, workers’ human assets, and investor-supplied nonhuman (physical/financial) assets); Christensen JF, Corporate strategy and the management of innovation and technology, Ind Corp Change 11 (2002) pp 263–288 (studying the choice between the U-form and the M-form or various types of the M-form).

[5] See, for example, La Porta R, López de Silanes F, Shleifer A, Vishny R, Investor Protection and Corporate Governance, J Fin Econ 58(1) (2000) pp 3–27; Daines R, Does Delaware Law Improve Firm Value? J Fin Econ 62 (2001) pp 525–558.

[6] Kahan M, Kamar E, The Myth of State Competition in Corporate Law, Stanford L Rev 55 (2002) pp 679–749; Klausner MD, The Contractarian Theory of Corporate Law: A Generation Later, J Corp L 31 (2006) p 787.

[7] For path dependency in general, see Bebchuk L, Roe MJ, A Theory of Path Dependence in Corporate Ownership and Governance, Stanford L Rev 52 (1999) pp 127–170.

[8] Generally, see Freeman RE, Harrison JS, Wicks AC, Parmar BL, de Colle S, Stakeholder Theory. Cambridge U P, Cambridge (2010). Eisenberg assumed that the internal allocation of power and the interests furthered by company law should go hand in hand. He identified three mainstream

As far as the corporate objective is concerned, the most important problems with the mainstream views are: (1) that they fail to give the board and managers sufficient guidance; (2) that they, by design or in effect, force the board and managers to further conflicting interests; and (3) that it is difficult to align them with separate legal personality.

We will now discuss these problems in detail. The approach that can provide the answer will be discussed in Sect. 6.3.6.

6.3.2 Guidance

6.3.2.1 General Remarks

Problems with failing guidance relate not only to the school of thought called managerialism and the stakeholder approach but even to the shareholder primacy approach (Sect. 5.3.3 and 6.3.3). The notion of "efficiency" does not provide the answered.

6.3.2.2 Managerialism

Managerialism means a school of thought according to which managers should run the corporation in the public interest. This is said to require the balancing of several interests. Managerialism is the school of thought advocated, for example, by Berle and Means (1932).[9]

However, managers cannot reasonably be given a duty to maximise general welfare benefits.[10] This would require information managers cannot possess, or third-party acts beyond their control. One of the proposed solutions was that managers should choose growth (instead of profit or general welfare benefits) as the objective and "satisficing" (instead of maximising) as the behaviour pattern.[11]

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approaches: "shareholder democracy" (also known as the shareholder primacy model, shareholders are given the right to decide); "client-group participation" (client-groups are given a formal role); and "managerialism" (management should run the company in the public interest). Eisenberg MA, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) pp 28–29.

[9] Berle AA, Means GC, *op cit*, Book Four, Chapter IV. See also Eisenberg MA, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) p 25.

[10] See also Eisenberg MA, *op cit*, p 25: "... the managerialists seem to greatly exaggerate the inclination and ability of management to serve as instruments of national policy."

[11] Baumol WJ, On the Theory of the Expansion of the firm, Am Econ Rev 52 (1962) pp 1078–1087; Cyert RM, March JG, A Behavioral Theory of the Firm. Prentice-Hall, Inc., Englewood Cliffs, NJ (1963). Cited in Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) pp 1494–1495.

This school of thought largely disappeared from mainstream corporate governance and corporate law research.[12] Instead, it became customary to: question the motivation and incentives of managers; assume that managers are not motivated by profit-seeking, but "by drives for power, prestige, and job security"; and study management performance.[13] Whereas managerialism was based on the idea that the corporation is and should be controlled by its managers, later corporate governance and corporate law research that was influenced by neoclassical economics adopted the view that there is and should be a "market for corporate control" (Manne 1965).[14]

In modern corporate governance research, managerialism has merged with the stakeholder approach and the corporate social responsibility debate (see below).

6.3.2.3 Mainstream Approaches and Efficiency

The mainstream approaches fail to give sufficient guidance even when they seek to foster "efficiency" as the most fundamental paradigm in economics. First, there can be different mainstream approaches based on different notions of economic efficiency. Second, mere economic efficiency is too vague as a regulatory objective in law.[15] Third, the firm's board and managers are not in a position to maximise welfare to the extent that this would require information that they cannot possess or acts beyond their control. Fourth, the mainstream approaches fail to solve the problem of conflicting intrests (Sect. 6.3.3). It is thus unclear what one should take into account when assessing efficiency.

Modern efficiency-based approaches. In modern corporate governance research, the efficiency-based approaches include: the disciplinary approach (the interests that should be served); the knowledge-based approach; and various combinations (synthetic approaches).[16] The choice of the approach influences the choice of the

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[12] Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) pp 549 and 561–563.

[13] Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) p 1494 (citing Means GC, The Corporate Revolution In America. The Crowell-Collier Press, New York (1962) pp 50–51) and pp 1508–1509.

[14] Manne HG, Mergers and the Market for Corporate Control, J Pol Econ 73 (1965) pp 110–120. See also Bratton WW, *op cit*, pp 1518–1521 on the acceptance of Manne's theory and the market for corporate control that appeared after 1980.

[15] See Eidenmüller H, Effizienz als Rechtsprinzip. 3. Auflage. Die Einheit der Gesellschaftswissenschaften. Band 90. Mohr Siebeck, Tübingen (2005); Farber DA, Economic Efficiency and The Ex Ante Perspective. In: Kraus JS, Walt SD (eds), *op cit*, pp 55–86; Kornhauser LA, Constrained optimization. Corporate law and the Maximization of Social Welfare. In: Kraus JS, Walt SD (eds), *op cit*, pp 87–117.

[16] See Charreaux GJ, Corporate Governance Theories: From Micro Theories to National Systems Theories, Working Papers FARGO 1041202, December 2004, http://ideas.repec.org/p/dij/wpfarg/1041202.html.

Table 6.1 Examples of the definition of corporate governance systems (Charreaux 2004)

Governance theories	Disciplinary: shareholder	Disciplinary: stakeholder	Knowledge-based
Theories of the firm:	Mainly agency theory (normative and positive).	Mainly agency theory (normative and positive) extended to numerous stakeholders.	Behavioural theory. Evolutionary theory. Resources and competence theory.
Efficiency criteria:	Shareholder value.	Stakeholder value.	Ability to create a sustainable organisational rent through innovation in particular.
Definition of corporate governance systems:	All mechanisms that secure financial investments.	All mechanisms that maintain the nexus of contracts and optimise the managerial latitude.	All mechanisms possessing the best potential for value creation through learning and innovation.

theory of the firm, efficiency criteria, and the definition of corporate governance systems.

Disciplinary approaches. As Table 6.1 (part of a more complete table published in Charreaux 2004) shows, there are different ideas about the interests that should be served. For example, one can distinguish between: the manager-oriented model; the labour-oriented model; the state-oriented model; stakeholder-oriented models; and the shareholder-oriented model.[17] It is customary to pick either the stakeholder approach or the shareholder primacy model in corporate governance research. We will therefore have a closer look at these two models first.

6.3.2.4 The Stakeholder Approach

Early corporations existed by virtue of a charter or concession granted when incorporation was believed to serve the interests of the crown or the state. The first approach to prevail was thus the *stakeholder* approach. This approach ruled for a long time in the regulation of companies.

For example, incorporation was not liberalised in the German Reich until 1870.[18] After that, the *shareholder* primacy model took over in

[17] Hansmann H, Kraakman R, The End of History for Corporate Law, Georgetown L J 89(2) (2001) pp 439–468.

[18] 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 . . ."

Germany.[19] This was most evident in small limited-liability companies (GmbH).[20] Shareholder primacy was confirmed by the Reichsgericht.[21]

The growing power of shareholders also contributed to social unrest.[22] In the Weimar Republic, the doctrine of the firm in itself - *Unternehmen an sich* - emerged as an alternative to the shareholder primacy model. The most important representative of this doctrine was Walter Rathenau.[23] According to this doctrine, large firms had de facto become an important way to further the interests of the public. This had also contributed to the increased independence of firms from shareholders.[24] The doctrine of the firm in itself was further influenced by the views of several leading American managers who supported social capitalism.[25]

The thinking of Rathenau inspired Berle and Means, who recommended a *stakeholder* approach in the US in 1932.[26] This was to be achieved by increasing public share ownership and making everybody a shareholder in big corporations; management should therefore focus on the distribution of profits to shareholders or all Americans.[27] Riechers (1996) explains that the opposite view was that firms

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[19] See Flume W, Allgemeiner Teil des bürgerlichen Rechts, Band 1. Teil 2. Springer, Berlin Heidelberg (1983) § 2 IV.

[20] Cosack K, Lehrbuch des Handelsrechts. Sechste Auflage. Verlag von Ferdinand Enke, Stuttgart (1903) § 122 I 1: "Die Gesellschaft mit beschränkter Haftung ist zum Teil von der Bevormundung befreit, der die gewöhnliche Aktiengesellschaft unterliegt: keine Kontrolle durch einen Aufsichtsrat oder gar durch Revisoren, Formlosigkeit der Generalversammlung und ihrer Beschlüsse, größere Freiheit bei Aufstellung der Bilanz, geringere Förmlichkeiten bei der Gesellschaftsgründung, Zulassung eines beweglichen, durch Nachschüsse der Gesellschafter gebildeten Geschäftskapitals neben dem starren Grundkapital."

[21] RGZ 107, 72, 202.

[22] See, in particular, Marx K, Das Kapital (1872), Chapter 13.

[23] The term Unternehmen an sich was coined by Fritz Hausmann. Hausmann F, Vom Aktienwesen und vom Aktienrecht, Mannheim 1928 (criticising Rathenau). See, for example, Flume W, *op cit*, § 2 III–IV; Riechers A, *op cit*, pp 8–9 and 16; Laux F, *op cit*; von Hein J, Die Rezeption US-amerikanischen Gesellschaftsrechts in Deutschland. Beiträge zum ausländischen und internationalen Privatrecht 87. Mohr Siebeck, Tübingen (2008) pp 138–140.

[24] Rathenau W, Vom Aktienwesen. Eine geschäftliche Betrachtung. Berlin (1917) pp 38–39: [D]ie Großunternehmung ist heute überhaupt nicht mehr lediglich ein Gebilde privatrechtlichen Interessen, sie ist vielmehr, sowohl einzeln wie in ihrer Gesamtheit, ein nationalwirtschaftlicher, der Gesamtheit angehöriger Faktor, der zwar aus seiner Herkunft, zu Recht oder zu Unrecht, noch die privatrechtlichen Züge des reinen Erwerbsunternehmens trägt, während er längst und in steigendem Maße öffentlichen Interessen dienstbar geworden ist . . .

[25] In particular: Henry Ford; Owen D. Young (General Electric Corporation); Robert S. Brookings; John D. Rockefeller; and Herbert Hoover. See Riechers A, *op cit*, pp 181–182; Brookings RS, Die Demokratisierung der amerikanischen Wirtschaft, Berlin (1925).

[26] Berle AA, Means GC, *op cit*, Book Four, Chapter IV, citing Rathenau W, Von Kommenden Dingen, first published by D. Fischer, Berlin (1917). See also Nörr KW, Ein Gegenstand der Reflexion: Die Aktiengesellschaft in den Schriften Franz Kleins, Rudolf Hilferdings, Walther Rathenaus, ZHR 172 (2008) pp 133–143.

[27] Berle AA, Corporate Powers as Powers in Trust, Harv L Rev 44 (1931) pp 1049–1074; Berle AA, For Whom are Corporate Managers Trustees? Harv L Rev 45 (1932) pp 1365–1372.

provide a "national social service" and management should further the interests of the firm.[28]

The duty to further the interests of not only the company but even the society at large became mandatory for large German companies by virtue of the Aktiengesetz of 1937 which required the two boards of the AG to "direct the company in accordance with the requirements of the enterprise and its working force and the common benefit to the people and the empire".[29]

Since 1965, however, all board members of large German companies have had a duty to act in the interests of *the firm* (Unternehmensinteresse, see below)[30] and not in the interests of stakeholders or society as a whole.

Once again, the stakeholder approach emerged as an alternative in German *Unternehmensrecht* ("enterprise law"). Enterprise law can be described as a theoretical and political programme the purpose of which was to recognise the important role of the workforce and to empower employees in the governance of companies,[31] or as an area of law that is applied to companies but seeks to further interests that fall outside the classic company law "triangle" of shareholders, corporate bodies, and creditors.[32] However, the main rule is that the board must act in the interests of the firm.[33] This is reflected even in the German Corporate Governance Code.[34]

After the Second World War, the work of Berle and Means influenced *théorie institutionelle de l'enterprise* (the institutional theory of the firm) in France. The main representatives of the theory are Durand and Ripert. According to this theory,

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[28] See Dodd EM, For Whom are Corporate Managers Trustees? Harv L Rev 45 (1932) pp 1145–1163; Dodd EM, Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable? University of Chicago Law Review 2 (1935) pp 194–207. See also Riechers A, *op cit*, pp 182–183.

[29] § 70(1) AktG 1937: "… wie das Wohl des Betriebs und seiner Gefolgschaft und der gemeine Nutzen von Volk und Reich es fordern".

[30] § 93(1) AktG. See, for example, Teubner G, Corporate Fiduciary Duties and Their Beneficiaries. In: Hopt K, Teubner G, Corporate Governance and Directors' Liabilities. de Gruyter, Berlin (1994) pp 149–177; Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) p 340.

[31] See Ballerstedt K, GmbH-Reform, Mitbestimmung, Unternehmensrecht, ZHR 135 (1971) pp 479–510; Raiser T, The Theory of Enterprise Law in the Federal Republic of Germany, Am J Comp L 36(1) (1988) pp 111–129; Klages P, Die Wiederentdeckung schlafender Alternative in der Rechtslehre, Berliner Debatte Initial 18 (2007) pp 75–82.

[32] Zimmer D, Internationales Gesellschaftsrecht. Schriftenreihe Recht der Internationalen Wirtschaft. Band 50. Verlag Recht und Wirtschaft GmbH, Heidelberg (1996), Zweiter Teil A pp 131–136.

[33] BGHZ 64, 325, 329 = NJW 1975, 1412 (Bayer); BVerfGE 50, 290 = NJW 1979, 833. See nevertheless the discussion about the KonTraG.

[34] Section 4.1.1 of the German Corporate Governance Code: "The Management Board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value."

"the firm is autonomous in relation to its members, and the objective defined by its management must be to satisfy the general interest" (Aglietta and Rebérioux 2005).[35]

The approach that management should run the corporation in the public interest is also called "managerialism" (see above).[36] This term is slightly misleading, since the fact that managers customarily take into account various interests in the normal course of business does not necessarily mean that managers would run the corporation in the public interest.

The emergence of managerial theories of the firm after the Second World War happened roughly at the same time as the move from the classical growth theory of political economy (that stressed the importance of the accumulation of capital; Smith 1776) to the neo-classical growth model (that stressed the role of technological change; Solow 1957).

The neo-classical theory was later followed by the new growth theory or the endogenous growth theory (that stresses the importance of human capital; Romer 1986). The recognition of the importance of human capital has so far had a relatively minor impact on mainstream corporate governance theory,[37] but it played an important role in Unternehmensrecht even before the emergence of the new growth theory.

Variations of the stakeholder approach have contributed to management literature in recent years. They range from "putting employees first" to "customer-driven capitalism".[38] In economics, the stakeholder approach has influenced Tirole (2001) who defines corporate governance as "the design of institutions that induce or force management to internalize the welfare of stakeholders".[39] Generally,

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[35] See Aglietta M, Rebérioux A, Corporate Governance Adrift. A Critique of Shareholder Value. Edward Elgar, Cheltenham (UK) Northampton (Mass.) (2005) pp 41–43.

[36] Eisenberg MA, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) pp 24–25. In the Nordic area, examples of studies that have adopted a similar approach include Tolonen JP, Der allgemeine Erklärungshintergrund der wirtschaftlichen Ordnung und seine Anwendung auf das Aktiengesellschaftsrecht. Rechtsvergleichende Untersuchung. Suomalainen Tiedeakatemia, Helsinki (1974) and Sjåfjell B, Towards a Sustainable European Company Law. A Normative Analysis of the Objectives of EU Law, with the Takeover Directive as a Test Case. European Company Law Series 3. Wolters Kluwer, Alphen Aan Den Rijn (2009).

[37] The importance of human capital was pointed out in Rajan RG, Zingales L, The Governance of the New Enterprise. In: Vives X (ed), Corporate Governance, Theoretical & Empirical Perspectives. Cambridge U P, Cambridge (2000) pp 201–227: "... even if an agent sells her labor, she cannot sell it irrevocably for a long period. Thus the individual cannot pledge the residual control rights over her human capital to someone else for any significant length of time through contract. Control over valuable human capital would seem then to be a greater source of power than control over physical assets since almost all control rights over it are residual, i.e., not allocable through contract."

[38] See Shareholders v stakeholders. A new idolatry, The Economist, April 2010; Martin R, The Age of Customer Capitalism, HBR 1/2010.

[39] Tirole J, Corporate Governance, Econometrica 69 (2001) p 4.

representatives of the stakeholder approach regard it as "a genre of management theory" rather than a specific theory.[40]

6.3.2.5 The Shareholder Primacy Approach

Modern theories of corporate governance are customarily based on agency theory and the set-of-contracts theory of the firm.[41] Such theories are aligned with traditional English law - and therefore also with the fiction theory of von Savigny (see above) - rather than German law. The origins of the mainstream view could already be seen in Berle (1931, 1932) and Berle and Means (1932).

According to the mainstream view, the company and the firm are basically one and the same thing: a fiction which can neither be regarded as a party nor have its own interests. The mainstream view has, for various reasons, adopted the *shareholder primacy* model.[42] Managers should thus further the interests of *investors*, in particular the interests of *shareholders* as "residual claimants" and "the most important principal". The "director primacy" model (Bainbridge 2003) is an application of the shareholder primacy model. It is designed to reflect existing US laws. Director primacy "accepts shareholder wealth maximization as the proper corporate decisionmaking norm, but rejects the notion that shareholders are entitled to either direct or indirect decisionmaking control".[43]

The following is an example of an influential modern mainstream definition of corporate governance: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profit to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?"[44] Shortly put: "Corporate governance is, to a large extent, a set of

[40] Freeman RE, Harrison JS, Wicks AC, Parmar BL, de Colle S, Stakeholder Theory. Cambridge U P, Cambridge (2010) pp 63–64.

[41] 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 26 (1983) pp 301–325.

[42] Hansmann H, Kraakman R, The end of history for corporate law. In: Jeffrey N. Gordon, Mark J. Roe, Convergence and Persistence in Corporate Governance. Cambridge U P, Cambridge (2004) p 33: "There are, broadly speaking, three ways in which a model of corporate governance can come to be recognized as superior: by force of logic, by force of example, and by force of competition . . . There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."

[43] Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) p 563.

[44] Shleifer A, Vishny RW, A Survey of Corporate Governance, J Fin 52(2) (1997) p 737.

mechanisms through which outside investors protect themselves against expropriation by the insiders."[45]

However, the shareholder primary approach fails to give sufficient guidance as it does not solve the problem of conflicting intrests and relies on too many fictions (see below).

Transaction cost economics has not brought about any change. In transaction cost economics, potential principals include shareholders and other constituencies of the firm.[46]

6.3.3 The Problem of Conflicting Interests

Both the stakeholder approach and shareholder primacy give rise to two problems: How can one deal with conflicting interests? How can one combine the chosen approach with separate legal personality? We can start with the Formes.

Stakeholder approach. If the stakeholder approach means that the board and managers are asked to serve many masters with conflicting interests, it fails to provide sufficient guidance.

This seems to be the case in corporate governance research. There are different categories of stakeholders. Freeman (1984) distinguishes between the following strategies on the basis of the number of stakeholder categories: the specific stakeholder strategy; the stockholder strategy; the utilitarian strategy; the Rawlsian strategy; and the social harmony strategy.[47] The specific stakeholder strategy[48] and the stockholder strategy[49] are probably the most popular in business practice. However, the utilitarian strategy seems to predominate in corporate governance and corporate law research.[50] The utilitarian strategy does not give sufficient guidance, because it fails to identify the overriding objective of the firm, the relevant stakeholders, the stakeholders' relevant interests, and their relative weight.

One can illustrate this problem with the characteristics of the modern stakeholder approach mentioned by a British scholar:[51]

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[45] La Porta R, Lopez-de-Silanes F, Shleifer A, Vishny RW, Investor protection and corporate governance, J Fin Econ 58 (2000) p 4.

[46] See Williamson OE, The Economic Institutions of Capitalism. Free Press, New York (1985) pp 298–300.

[47] *Ibid*, p 102.

[48] *Ibid*, p 102: "Specific Stakeholder Strategy. Maximize benefits to one or a small set of stakeholders."

[49] *Ibid*, p 102: "Stockholder Strategy. Maximize benefits to stockholders. Maximize benefits to 'financial stakeholders'".

[50] *Ibid*, pp 102–105: "Utilitarian Strategy: Maximize benefits to all stakeholders (greatest good for greatest number). Maximize average welfare level of all stakeholders. Maximize benefits to society."

[51] Keay A, Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little? EBLR 2011 pp 6–7.

- It is fundamental to stakeholding that organisations are to be managed for the benefit of . . . all stakeholders
- All those who contribute critical resources to the firm should benefit
- The company works towards creation of value for all stakeholders
- The duty of managers is to create optimal value for all social actors who might be regarded as parties who can affect, or are affected by, a company's decisions
- It is necessary for the managers . . . when making decisions to have the aim of making the company a place where stakeholder interests can be maximised in due course
- The purpose of the company is that it is a vehicle to serve in such a way as to co-ordinate the interests of stakeholders
- It is necessary for the managers to balance the interests of all stakeholders in coming to any decision
- Organisations are to be managed . . . accountable to all stakeholders

The example shows that it remains unclear what interests are regarded as stakeholder interests. As a result, it is unclear what exactly should be coordinated, balanced, and maximised, to whom exactly organisations should be accountable, and how one should deal with conflicting interests. Moreover, managers cannot be expected to have enough information about external stakeholder interests for coordination and balancing purposes, and one may ask why a stakeholder would delegate the coordination and balancing of interests to managers rather than try to obtain the best possible bargain. In addition, maximisation is not a feasible goal for corporate decision-making,[52] and there is a measurement problem.[53]

Shareholder primacy. The stakeholder approach fails to provide sufficient guidance, but the same can be said of the shareholder primacy approach.

First, real shareholders can have different subjective interests. All real shareholders of the same company do not share the same subjective interests. Real shareholders of different companies can have different subjective interests.

Second, decisions on corporate strategy and decisions made in the course of operations management and financial management would not make any sense without taking into account the interests of stakeholders. They will thus require the balancing of many aspects.

Third, as the subjective interests of real shareholders can vary, there can be a conflict between the interests of different real shareholders, or between the interests of some shareholders and what is regarded as rational and reasonable in the context of corporate strategy, operations management, and financial management. For example, the phenomenon that financial investors prefer short-term profits while managers can take a long-term view was known already in the latter half of the 19$^{\text{th}}$ century when American railroad companies were financed by outside equity

[52] See already Alchian AA, Uncertainty, Evolution, and Economic Theory, J Pol Econ 58 (1950) p 213.

[53] Tirole J, Corporate Governance, Econometrica 69 (2001) pp 25–26.

investors.[54] Moreover, the aggressive use of the target's assets in the funding of corporate takeovers was common practice already in the 1980s.[55] It can increase the firm's debts and risk-level and reduce its long-term survival prospects.

Fourth, the interests of some shareholders can be illegal or contrary to fundamental societal values, or a shareholder may be looking for non-pecuniary private benefits that are unreasonable[56] rather than the reasonable pecuniary benefits of a shareholder in its capacity as shareholder.

6.3.4 The Problem of Separate Legal Personality

From a legal perspective, the chosen approach should be compatible with the separate legal personality of corporations. Separate legal personality means that the company is not identified with its shareholders or any third party. It is a fundamental rule of company law that the main duties of employees, sub-board managers, and board members are owed to the company as the legal person and enforceable by the company itself.[57] No other party is regarded as the appropriate direct beneficiary of their main duties; many other parties can nevertheless benefit indirectly.

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[54] Bratton WW, The New Economic Theory of the Firm: Critical Perspectives from History, Stanford L Rev 41 (1989) p 1486 (on American railroad companies that were financed by outside equity investors).

[55] *Ibid*, pp 1520–1521.

[56] An example of non-pecuniary private benefits that are *unreasonable* (and bad) is when a foreign country buys a block of shares in a company in order to force the company to further the country's foreign policy interests. An example of non-pecuniary private benefits that are *reasonable* (and good) is when a wealthy investor supports a loss-making book publisher or football club for the pleasure of it.

[57] See, for example, Section 1 of Chapter 29 of the Swedish Company Act; Section 8 of Chapter 1 and Section 1 of Chapter 22 of the Finnish Company Act; § 93(1) of the German Aktiengesetz; Salomon v A Salomon & Co Limited [1897] AC 22 (House of Lords) (separate corporate personality, a company is not identified with its shareholders); Re Smith & Fawcett Ltd [1942] Ch 304, [1942] 1 All ER 1032 (directors must exercise their powers "bona fide in the interests of the company" and "not for any collateral purpose"). The business judgment rule applied in the US and many other countries means that a court "will not substitute its own notions of what is or is not sound business judgment" [Aronson v. Lewis, 473 A.2d 805, 812 (Delaware Supreme Court 1984)] if "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" [Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Delaware Supreme Court 1971)].

6.3.5 Previous Attempts to Solve the Problems

There have been various attempts to solve these problems in the past. They include: using fictive rather than real circumstances; defining “the company” in new ways to suit the chosen approach; the Entity Maximisation and Sustainability Model; and diluting the stakeholder approach.

Fictions. The shareholder primacy model tries to deal with the problem of conflicting interests by fictions.

To begin with, all shareholders can be assumed to have just one goal in any company if the shareholders are *fictive* rather than real and the goal is a *fictive* one rather than real. In some cases, these fictive shareholders are assumed to be long-term investors that take a long-term view. In other cases (takeovers), they are assumed to be short-term investors with a short-term view. (In fact, the most vocal shareholders in the context of large takeovers are investment funds with very short-term interests.). The representatives of the shareholder primacy model do not regard this kind of variation as a problem although it makes one wonder whether the fictive shareholders have a long-term or short-term perspective.

What remains then is the need to align the shareholder primacy model with the separate legal personality of corporations. The customary way to achieve this result is to assume that the fictive interests of those fictive shareholders are really the interests of the company as well or that there are no collective corporate interests.[58]

These two shareholder primacy related approaches lead to obvious problems: they are based on several fictions; they do not reflect the interests of real shareholders and the different circumstances of real companies; they require the identification of the company with its shareholders contrary to the principle of separate legal personality; and the identification is proposed to work just one way (benefits) but not the other (responsibilities, liability).

Entity Maximisation and Sustainability Model. The Entity Maximisation and Sustainability Model (EMS) proposed by Keay (2008) is another attempt to address the problems. As the model’s name implies, it has two core elements: “First, there is a commitment to maximise the entity. This involves, inter alia, enhancing the company’s wealth . . . The second part is to sustain the company as a going concern, that is, to ensure its survival and more. An important aspect of the model is that there is focus on the company as an entity or enterprise, that is the company is an institution in its own right.”[59] Influenced by English law, this model does not distinguish between the legal entity and the firm.

It is hard to argue against sustainability (it is accepted as a fundamental goal below). However, there are three problems with EMS.

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[58] See also Bratton WW, *op cit*, p 1499: “Since no cognizable corporate collectivity appears amidst the nexus of contracts, no tension arises between collective and individual interests.”

[59] Keay A, Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model, MLR 71(5) (2008) p 679, citing Suojanen W, Accounting Theory and the Large Corporation, Acc Rev 29 (1954) pp 391, 393.

The first is the choice of the legal entity as the principal. The legal entity can change although the identity of the firm remains the same.[60] For example, a Finnish parent company listed in Helsinki (say, Nokia) can functionally be replaced by an American parent company listed in New York without the group losing its identity. (Nokia would still be a firm that makes and sells mobile phones.) Moreover, a model focusing on the maximisation and sustainability of a legal entity becomes unworkable in quite normal structural transactions such as mergers, re-incorporations, takeovers, or other transactions in which at least one legal entity ceases to exist or is reduced in size, and it does not explain the widespread popularity of corporate groups (subsidiaries) and business networks (outsourcing, the make or buy decision).

The second is its behavioural assumption: the maximising orientation.[61] How much is the maximum? Neither entity maximisation nor profit maximisation are feasible goals for corporate decision-making.[62] This is reflected in corporate laws which generally do not require profit maximisation.[63]

The third problem relates to the choice of two goals: maximisation and sustainability. Which goal should prevail? Keay (2008) suggests that EMS really has one overall goal and that maximisation and sustainability are complementary.[64] It should therefore be possible to identify a higher level goal (such a goal will be proposed below).

Dilution of the stakeholder approach. The stakeholder approach exists even in a diluted form. If the stakeholder approach means that the board and managers are asked to take into account the interests of stakeholders and any other circumstances to the extent that it is in the interests of the company to do so, there is no conflict between the stakeholder approach and company law. This is the position of company law as well.

There are similar approaches in management science. In strategic management, one of the solutions is to: regard the survival of the firm as the firm's most important objective; and choose a more specific enterprise strategy that focuses on the interests of a certain group of stakeholders as a way to improve the survival chances of the firm (Freeman 1984).[65] The concept of "shared value" (Porter and Kramer 2011) is an example of a similar diluted stakeholder approach.

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[60] See Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 86.

[61] Williamson OE, The Economic Institutions of Capitalism. 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."

[62] See already Alchian AA, Uncertainty, Evolution, and Economic Theory, J Pol Econ 58 (1950) p 213.

[63] See, for example, Bruner CM, The Enduring Ambivalence of Corporate Law, Alabama L Rev 59 (2008) pp 1400, 1402–1403, 1407, 1420, and 1425.

[64] See nevertheless Keay A, Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model, MLR 71(5) (2008) p 687.

[65] Freeman RE, Strategic Management. A Stakeholder Approach. Cambridge U P, Cambridge (originally published in 1984) p 107.

6.3.6 *The Interests of the Firm as a Way to Solve the Problems*

6.3.6.1 General Remarks

Focusing on the interests of the firm rather than the interests of shareholders or stakeholders would be an alternative way to deal with conflicting interests and separate legal personality. For various reasons, this is the most important way from a legal perspective. We can start with the bigger picture.

6.3.6.2 Why Laws Further the Interests of the Firm

The position of traditional company law has developed over a long period of time. Since company law is normative, company representatives must apply it or risk legal sanctions. It has, therefore, been tested in practice, and it has formed the business practices of firms in the West. Corporate strategy, operations management, financial management, and corporate risk management would not have developed as they have without being compatible with the legal regulation of companies.

Now, after the industrial revolution, capitalistic firms were recognised as the most important producers of goods and the most important market participants in the West. [66] In economics, this gave reason to define the firm and the factors that explain their existence (Chap. 2). For example, the firm could be defined by authority,[67] as an organisational construction or governance structure[68] whose members can be motivated in various ways,[69] or as a "team" whose members act from self-interest but realise that their destinies depend to some extent on the survival of the team in its competition with other teams.[70]

If firms exist and are capable of rational actions as firms, one can assume that they generally try to survive.[71] They "struggle for existence" by adapting to the

[66] Weber M, Wirtschaft und Gesellschaft. Grundriss der verstehenden Soziologie (1922), Erster Teil, Kapitel II, § 31: "Nur der Okzident kennt rationale kapitalistische Betriebe . . . Also: die kapitalistische Form der formal rein voluntaristischen Organisation der Arbeit als typische und herrschende Form der Bedarfsdeckung breiter Massen . . ." See Marx K, Das Kapital (1872).

[67] Coase RH, The Nature of the Firm, Economica, New Series 4(16) (1937) pp 388–389.

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

[69] Simon HA, Organizations and Markets, J Econ Persp 5(2) (1972) p 30. For an application in company law, see Eisenberg MA, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) pp 30–31.

[70] Alchian AA, Demsetz H, Production, Information Costs, and Economic Organization, Am Econ Rev 62 (1972) pp 777–795; Jensen MC, Meckling WH, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J Fin Econ 3 (1976) pp 305–360.

[71] Alchian AA, Uncertainty, Evolution, and Economic Theory, J Pol Econ 58 (1950) pp 211–221. The survival of organisations is also studied in organisational theory. See its classics Barnard CI, The Functions of the Executive. Harv U P, Cambridge, Mass. (1938) pp 60–61; Thompson JD, Organizations in Action: Social Science Bases of Administration. McGraw-Hill, New York (1967) p 13 (the central problem of complex organisations is one of coping with uncertainty).

competitive environment and other circumstances.[72] One can therefore say that strategic choices, operations management ("engineering"), financial management ("financial engineering"), and corporate risk management are ways to adapt to external and internal circumstances for the purpose of improving the firm's survival chances in a competitive environment.

States recognise the existence, importance, and diversity of firms and the market economy. For example, states have facilitated the survival and growth of firms by adopting rules on business forms. Firms can choose from a pool of legally recognised business forms. Some cannot be separated from the persons behind the business venture (sole traders, partnerships). Others have separate legal personality and are artificial persons not owned by anyone (foundations, co-operatives, corporations).

The existence of such artificial persons makes it necessary to adopt three kinds of rules: rules made necessary by separate legal personality, rules made necessary by the firm having an organisation (or because the firm is an organisational structure), and rules made necessary by the fact that the legal organisation and the real organisation can be different.[73]

Such issues must be addressed in some way or another. However, it is not sufficient to try to address them in a "mathematically rational" way. There are two preliminary questions which can only be answered according to what is regarded as reasonable. First, in whose interests should the questions be answered? There must be a "principal". Second, it must be defined what the interests of the principal are.

It is suggested here that traditional company law is based on the choice of the firm as the principal. The most fundamental interest of the firm is its own survival.[74]

This is reflected in the most fundamental rules of traditional company law such as separate legal personality, asset partitioning, separation of functions, and rules that set out to whom duties are owed. In the legal regulation of companies, it is customary to provide that the duties of employees, sub-board managers, and board members are owed to the legal person as the carrier of the firm.

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[72] For the struggle for existence, see Darwin C, The Origin of Species (1859).

[73] See Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010), Chapter 8.

[74] Compare Dooley MP, Two Models of Corporate Governance, Bus Law 47 (1991–1992) p 463 distinguishing between the "Authority Model" and the "Responsibility Model". At p 463, Dooley mentions the survival of the firm as an objective: "It should be readily apparent that neither Model exists in pristine form in the real world. Standing alone, neither Model could provide a sensible guide to the governance of firm-organized economic activity because each seeks to achieve a distinct and separate value that is essential to the survival of any firm. Accordingly, any feasible governance system must and does contain elements of both Models, and it is only one's assessment of which value seems to predominate in a given system that justifies categorizing the system as primarily concerned with Authority or Responsibility." At p 466, Dooley nevertheless argues that "decisions are to be made to the benefit the interests of the residual claimants".

6.3.6.3 German Law as an Example

German law provides the clearest example of this approach. The company is regarded as the carrier of the firm (Unternehmensträger). The duties of the board members of an AG are owed to *the company*.[75] All board members have a duty to act in the interests of *the firm* (Unternehmensinteresse). The most basic interests of the firm can be summarised as its own survival.[76] The main rule is that sanctions for the breach of such duties are enforced by the company.[77]

This view has been part of German law since 1965. When the Aktiengesetz of 1937 was replaced by the Aktiengesetz of 1965, the previous requirement to direct the company in accordance with the common benefit to the people and the empire was abolished.[78] The requirement to act in the interests of the firm remained,[79] complemented by a general duty under the German constitution to use property rights even in the public interest.[80]

In Germany, this manner of solving the problems is understandable not only in the light of the importance of firms but also in the light of the realist theory of von Gierke (according to which a company is treated as a person) and the doctrine of the firm in itself or Unternehmen an sich (which suggested that the firm exists and is not the same thing as any particular individual).[81] One can also find other reasons.[82]

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[75] § 76(1) AktG: "Der Vorstand hat unter eigener Verantwortung die Gesellschaft zu leiten." § 93 (2) AktG: "Vorstandsmitglieder, die ihre Pflichten verletzen, sind der Gesellschaft zum Ersatz des daraus entstehenden Schadens als Gesamtschuldner verpflichtet . . ."

[76] Kuhner C, Unternehmensinteresse vs. Shareholder Value als Leitmaxime kapitalmarktorienterter Aktiengesellschaften, ZGR 2/2004 pp 249–250, citing Raiser T, Unternehmensrecht als Gegenstand juristischer Grundlagenforschung, Festschrift Potthoff. Nomos, Baden-Baden (1989) pp 31–45.

[77] See § 147 AktG and § 112 AktG.

[78] See, for example, Flume W, Allgemeiner Teil des Bürgerlichen Rechts, Erster Band. Zweiter Teil, Springer, Berlin Heidelberg (1983) § 2 IV.

[79] § 93(1) AktG. See, for example, Teubner G, Corporate Fiduciary Duties and Their Beneficiaries. In: Hopt K, Teubner G, Corporate Governance and Directors' Liabilities. de Gruyter, Berlin (1994) pp 149–177; Kuhner C, Unternehmensinteresse vs. Shareholder Value als Leitmaxime kapitalmarktorienterter Aktiengesellschaften, ZGR 2/2004 pp 245–248; Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) p 340.

[80] Art 14(2) GG: "Eigentum verpflichtet. Sein Gebrauch soll zugleich dem Wohle der Allgemeinheit dienen."

[81] See Riechers A, *op cit*, pp 53–55.

[82] Kuhner C, Unternehmensinteresse vs. Shareholder Value als Leitmaxime kapitalmarktorienterter Aktiengesellschaften, ZGR 2/2004 p 247: Hegenialism or idealistic tendencies in German legal culture, the early introduction of worker co-determination in the Weimar republic, the secondary role of shareholders' capital as a source of funding, the national socialist ideology, and corporative tendencies.

6.3.6.4 Other Jurisdictions

Because of the importance and diversity of firms, laws are designed to further the interests of firms even in other countries.

Because of the *importance* of firms, the problem of potentially conflicting interests has traditionally been solved in similar ways. The main duties of a company's board members are owed to the company as the carrier of the firm, and they are enforceable by the company. For example, the position of English common law is that a company is not identified with its shareholders (separate corporate personality)[83] and that directors must exercise their powers "bona fide in the interests of the company" and "not for any collateral purpose".[84]

Because of the *diversity* of firms and the market economy, the main rule is that the board must be given plenty of discretion. Board members' general duty of care owed to the company as the carrier of the firm[85] is qualified by the "business judgment rule" or similar rules. In the US, the business judgment rule means that a court "will not substitute its own notions of what is or is not sound business judgment"[86] if "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company".[87] There is a similar rule in Germany.[88]

Company laws do not lay down a general duty to maximise welfare, entity size, profits, or anything else, because it would not be possible to enforce such a duty in

[83] Salomon v A Salomon & Co Limited [1897] AC 22 (House of Lords).

[84] Re Smith & Fawcett Ltd [1942] Ch 304, [1942] 1 All ER 1032. There are similar rules in Nordic company laws. See, for example, § 1 of Chapter 29 of the Swedish Company Act: "En stiftare, styrelseledamot eller verkställande direktör som när han eller hon fullgör sitt uppdrag uppsåtligen eller av oaktsamhet skadar bolaget skall ersätta skadan . . ." For Finnish law, see § 8 of Chapter 1 of the Finnish Company Act: "Bolagets ledning skall omsorgsfullt främja bolagets intressen." § 1 of Chapter 22: "En styrelseledamot, en förvaltningsrådsledamot och verkställande direktören skall ersätta skada som de i sitt uppdrag, i strid med den omsorgsplikt som föreskrivs i 1 kap. 8 §, uppsåtligen eller av oaktsamhet har orsakat bolaget . . ."

[85] See, for example, § 1 of Chapter 29 of the Swedish Company Act: "En stiftare, styrelseledamot eller verkställande direktör som när han eller hon fullgör sitt uppdrag uppsåtligen eller av oaktsamhet skadar bolaget skall ersätta skadan . . ." For Finnish law, see § 8 of Chapter 1 of the Finnish Company Act: "Bolagets ledning skall omsorgsfullt främja bolagets intressen." § 1 of Chapter 22: "En styrelseledamot, en förvaltningsrådsledamot och verkställande direktören skall ersätta skada som de i sitt uppdrag, i strid med den omsorgsplikt som föreskrivs i 1 kap. 8 §, uppsåtligen eller av oaktsamhet har orsakat bolaget . . ."

[86] Aronson v. Lewis, 473 A.2d 805, 812 (Delaware Supreme Court 1984).

[87] Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Delaware Supreme Court 1971).

[88] § 93(1) AktG: "Die Vorstandsmitglieder haben bei ihrer Geschäftsführung die Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiters anzuwenden. Eine Pflichtverletzung liegt nicht vor, wenn das Vorstandsmitglied bei einer unternehmerischen Entscheidung vernünftigerweise annehmen durfte, auf der Grundlage angemessener Information zum Wohle der Gesellschaft zu handeln . . ."

any meaningful way. However, they do recognise the central role of profitability for the survival of the firm.[89]

6.3.7 Summary

The shareholder primacy model fails to provide sufficient guidance in the event of conflicting interests. It tries to solve the problem by fictions. In addition, it is difficult to combine it with separate legal personality. The stakeholder approach fails to provide sufficient guidance unless it is diluted and means that it is permitted to take into account any interests to the extent that it is in the interests of the firm to do so. The Entity Maximisation and Sustainability model focuses too much on the legal entity (the form, a mere shell). In real life, the legal entity is always used for a purpose, and it has a function.

The newer approaches do not seem to beat traditional company law. In the legal regulation of companies, it is customary to provide that the duties of employees, sub-board managers, and board members are owed to the legal person which is the carrier of the firm. The duty to act in the interests of the company means a duty to act in the interests of the firm.

6.4 Shareholders

We can move on to the next big question, the question why there are shareholders. There is no doubt about the answer in mainstream corporate governance research. Shareholders are regarded as the most important principal and shareholder primacy as the "standard model".

But all business forms do not have shareholders with freely transferable shares. Business forms that do not have them range from partnerships and co-operatives to mutual insurance companies and foundations. Moreover, most firms are rather small family firms without freely transferable shares.

There must, therefore, be something that explains: the choice of a business form that does have shareholders; the degree of transferability of shares; and the share ownership structure. The answer can depend on the function of shareholders.

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[89] Spindler G, Unternehmensinteresse als Leitlinie des Vorstandshandelns – Berücksichtigung von Arbeitnehmerinteressen und Shareholder Value. Gutachten im Auftrag der Hans-Böckler-Stiftung. Hans-Böckler-Stiftung, Düsseldorf (2008): "Einigkeit besteht darüber, dass auf jeden Fall der Bestand des Unternehmens zu sichern und für eine dauerhafte Rentabilität zu sorgen ist, was zum Teil auch als 'angemessene' Gewinnerzielung konkretisiert wird." See also section 4.1.1 of the German Corporate Governance Code.

Mainstream research is unable to properly explain the function of shareholders and why they exist in the first place. Most corporate governance research takes the existence of shareholders for granted.[90]

This is caused by two things. First, mainstream corporate governance research is mostly limited to the very small minority of firms that are large listed companies. By definition, they have shareholders with freely transferable shares. Second, the function of shareholders is irrelevant when shareholders are chosen as the principal. It is not necessary to explain the existence and function of the principal. It is necessary to explain the function of the agent.

When mainstream research does try to explain the existence and function of shareholders, it tends to use weak arguments.

First, mainstream research assumes that shareholders are "owners" of the firm.[91] Fama nevertheless (1980) finds that ownership of the firm is an irrelevant concept when the firm is regarded as a nexus of contracts.[92] From a legal perspective, separate corporate personality ensures that shareholders of a company are not owners of the firm[93] any more than bondholders can be regarded as its owners. Neither bondholders nor shareholders own the company's assets or the company itself. All they own are securities that confer certain rights to their holders. Separate legal personality explains even limited liability. If shareholders or bondholders were regarded as owners of the firm rather than holders of securities issued by the company, it would be more difficult to explain their limited liability for the company's obligations. With ownership come not just rights but even obligations.

Second, mainstream research assumes that shareholders are providers of capital. However, this does not make them unique. From a financial perspective, retained earnings are the most important source of funding, and most of the capital raised from investors is in the form of debt. From a legal perspective, buyers of existing shares do not provide any funding.[94] Moreover, capital can flow in the opposite direction. Before the recent financial crisis, the amount of capital distributed by listed companies to shareholders in the form of dividends and share buybacks tended to exceed the amount of capital that they raised from shareholders.[95]

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[90] For example, Williamson is no exception. See Williamson OE, The Economic Institutions of Capitalism. Free Press, New York (1985) pp 274, 298 and 304–305. Neither is Bainbridge. Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) p 550: "... director primacy claims that shareholders are the appropriate beneficiaries of director fiduciary duties."

[91] See already Berle AA, Means GC, *op cit*, Book Four, Chapter I.

[92] Fama EF, Agency Problems and the Theory of the Firm, J Pol Econ 88(2) (1980) p 290.

[93] See, for example, Salomon v A Salomon & Co Ltd [1897] AC 22.

[94] This was pointed out already by Berle A, Property, Production and Revolution. A Preface to the Revised Edition. In: Berle AA, Means GC, *op cit*: "The purchaser of stock does not contribute savings to an enterprise, thus enabling it to increase its plant or operations."

[95] See, for example, Ireland P, Company Law and the Myth of Shareholder Ownership, MLR 62(1) (1999) pp 54–55.

The relative weight of shareholders as actual providers of funding can depend on the business cycle of the firm (start-ups may need equity capital, and some firms may need to issue new shares in order to raise capital). However, this does not change the fact that shareholders are not the only providers of capital and that many shareholders are not providers of capital.

Third, mainstream research assumes that shareholders are "risk bearers" as residual claimants. However, the employees, creditors and business partners of failed companies can tell you that shareholders are not the only risk bearers. Shareholders are not necessarily the biggest risk bearers. The higher the leverage, the more risk is allocated to creditors, and corporate failure can generally have a bigger impact on employees than on wealthy shareholders who have diversified their holdings. One can also add that acting as a residual claimant when a company is liquidated does not really explain the role of shareholders during the life of the company. During the life of the company, shareholders do not have an automatic claim to the residual. What they do have is a claim to distributions to the extent that the company has lawfully decided to distribute funds to shareholders. This decision is typically controlled by the board.

What is left are moral or social arguments.[96] However, it would be stretching the point too far to argue that company laws were adopted in all western countries just to create a rentier class whose wealth should be maximised by everybody else. Company laws are older than the shareholder primacy model. The mainstream view of the role of shareholders is just an ideological choice.

6.5 The Board

The last of the four big questions discussed here relates to the board. According to the mainstream models, large public corporations should have a board acting as a monitoring board, that is, a board that oversees managers instead of attempting to run the business directly. This has been a mandatory statutory requirement in Germany since the Commercial Code of 1897.[97] In the US, it was recommended by Eisenberg (1976) as well as by Fama and Jensen (1983).[98]

[96] Such as those used by Berle. Berle AA, Property, Production and Revolution. A Preface to the Revised Edition. In: Berle AA, Means GC, *op cit*: "Why have stockholders? . . . Wealth unquestionably does add to an individual's capacity and range in pursuit of happiness and self-development . . . Privilege to have income and a fragment of wealth without a corresponding duty to work for it cannot be justified except on the ground that the community is better off – and not unless most members of the community share it." Generally, see also Ireland P, *op cit*, pp 32–57.

[97] § 246 HGB 1897.

[98] Eisenberg M, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) p 170; Fama EF, Jensen MC, Separation of Ownership and Control, J Law Econ 26 (1983) pp 301–325.

If a large company has a unitary (one-tier) board, it is now customary to recommend or require the use of two-tier structures with committees and "independent" non-executive members acting as monitoring bodies. This can be a recommendation (many corporate governance codes recommend it) or a mandatory legal requirement (like the requirements based on the Sarbanes-Oxley Act).

However, most firms in the world are privately-owned family businesses rather than large listed firms. Not all limited-liability companies have a board (for example, the board is not mandatory for the German GmbH and the European SPE[99]), and if they do, their structures and functions may vary (there are one-tier models, two-tier models, and other board models).

A theory of corporate governance should be able to explain for what purpose it is necessary for the board to monitor management and have other functions. There are different views about what that purpose is. Moreover, a theory of corporate governance should explain why there are boards in the first place.

Shareholder primacy. The most popular starting point is the shareholder primacy model. It dominates the theoretical literature. For example, Williamson (1985) argues that "the board of directors should be regarded primarily as a governance structure safeguard between the firm and owners of equity capital and secondarily as a way by which to safeguard the contractual relation between the firm and its management".[100] Primarily, the board can be "a governance structure that holders of equity recognize as a safeguard against expropriation and egregious mismanagement".[101]

The stakeholder approach. The stakeholder approach customarily does not attempt to explain the existence of the board. One can say that the starting point of the stakeholder approach is the shareholder primacy model. The stakeholder approach (such as Ireland 1999) tries to modify it.[102] According to the "communitarian" or "progressive" school of corporate scholars, corporate law ought thus to require directors to serve not only the shareholders' interests, but also those of employees, consumers, creditors, and other corporate stakeholders.

Team production. The team production theory of Blair and Stout (1999) is a variation of the stakeholder approach theme.[103] What explains the existence of the board is that it acts as a "mediating hierarchy". According to Blair and Stout, stakeholders are "team members" who give up important rights to the legal entity. Corporate assets belong to the corporation itself. Within the corporation, control over the assets is exercised by "an internal hierarchy whose job is to coordinate the activities of the team members, allocate the resulting production, and mediate

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[99] §§ 6 and 52 GmbHG; Article 28 of the draft SPE Regulation.

[100] Williamson OE, The Economic Institutions of Capitalism. Free Press, New York (1985) p 298.

[101] *Ibid*, p 305. For an application of this theory, see Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) p 550.

[102] Ireland P, Company Law and the Myth of Shareholder Ownership, MLR 62(1) (1999) p 53.

[103] Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virginia L Rev 85 (1999) pp 247–328.

disputes among team members over that allocation. At the peak of this hierarchy sits a board of directors whose authority over the use of corporate assets is virtually absolute and whose independence from individual team members . . . is protected by law." Blair and Stout further argue that directors should not be under direct control of either shareholders or other stakeholders.

Board-centric corporate governance. Team production is an example of board-centric corporate governance. Many mainstream corporate governance scholars have advanced theories that emphasise the board's superior decision-making capacities.[104]

On the other hand, their analysis tends to be limited to large US companies with a dispersed share ownership structure (and exclude companies that have an entrepreneur-manager-shareholder or another kind of controlling shareholder) and the board has superior information about relatively few issues in such companies (people responsible for the day-to-day management of the firm tend to have more information than a body that convenes a few times a year).

According to one extreme approach, the board should, therefore, act as a monitoring board that appoints and removes the chief executive but should not do much else.[105] The opposite approach could be to regard the board as the nexus of all contracts, "a sui generis body that hires all of the factors of production necessary for the corporation to conduct its business and affairs".[106]

Individual directors. It is also customary to study board composition and the function of different categories of board members. For example, non-executive board members fulfil both control and service functions according to current theory (Shleifer and Vishny 1997; Becht et al. 2003; Tirole 2006; Adams et al. 2010). The function of different categories of board members should nevertheless reflect the function of the board as a whole.

6.6 Summary

The customary research approaches fail to answer the most fundamental corporate governance questions or answer them only partly. Of the shareholder primacy approach and the stakeholder approach, the former is particularly problematic from a legal perspective, because it fails to recognise separate corporate personality. The shareholder primacy approach fails to give sufficient guidance in real

[104] For an overview, see Bruner CM, The Enduring Ambivalence of Corporate Law, Alabama L Rev 59 (2008) pp 1396–1405.

[105] For example, Eisenberg argues that the main function of the board of a publicly-held corporation is the selection and removal of the chief executive. Eisenberg MA, The Structure of the Corporation. Beard Books, Washington, D.C. (1976) pp 162–170.

[106] Bainbridge S, The New Corporate Governance in Theory and Practice. OUP, Oxford (2008) p 24.

corporate practice, because it is both too rigid and based on too many fictions. The problem with the Entity Maximisation and Sustainability Model is that it focuses on the legal entity and the form rather than the firm and the function. Tested in business practice over a long period of time, traditional company law gives firms enough flexibility to adapt to changes in the market and other circumstances. Whereas traditional company law is not a theory of corporate governance itself, a theory of corporate governance could help to explain its contents. This is what we will try to study in the following two chapters.