Petri Mäntysaari

Organising the Firm

Theories of Commercial Law, Corporate Governance and Corporate Law

Chapter 7
Theory of Corporate Governance: Proposed Legal Theory

7.1 Introduction

Because of the failings of the mainstream approaches, there is room for a new legal corporate governance theory. The proposed theory is an application of Management-based Commercial Law (MBCL) and defines the law of corporate governance as a functional area of law and a branch of MBCL.[1] Unlike most corporate governance theories, the proposed theory is not limited to listed limited-liability companies.[2] It can be applied to all forms of commercial cooperation that are sufficiently ring-fenced and self-contained.

Context. One can identify certain issues that must be addressed in the context of corporate governance.

Some issues can be identified in a "mathematically-rational" way (Zweckrationalität), that is, by the force of logic alone. In the context of corporate governance, it is necessary to address issues caused by three things. The first is the existence of a *legal entity*, that is, a legal institution facilitating a ring-fenced and self-contained organisation. The firm will need a business form in order to operate. Typically, the business form is a legal entity and an artificial person. The second is the existence of an *organisation*. These two aspects are reflected already in early legal theories of corporations (Sect. 5.2). In addition, there may be a difference

[1] See Fleischer H, Gesellschafts- und Kapitalmarktrecht als wissenschaftliche Disziplin – Das Proprium der Rechtswissenschaft'. In: Engel C, Schön W (eds), *op cit*, p 50 (where corporate governance is identified as a functional branch of law); Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) pp 16 and 30 (where it is discussed from a functional perspective in the context of comparative law); Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 1 and 165 (where it is defined functionally).

[2] For example, Bainbridge's director primacy model is limited to large US corporations with a dispersed share ownership structure. Bainbridge S, The New Corporate Governance in Theory and Practice. OUP, Oxford (2008) pp 12–13.

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between the firm's legal form and its *real organisation*. These issues raise various questions which will have to be answered in some way or another.[3]

However, one cannot provide answers to such questions without deciding in whose interests they should be answered and what the interests are. One must therefore *choose the principal* and *determine the interests* of the principal. These choices cannot be made in a "mathematically-rational" way. They require the use of another form of rationality, that is, rationality as reasonableness (Wertrationalität). This means that they are more political.

Definition. One can, therefore, define the law of corporate governance as a functional area of law that focuses on the study of the use of legal tools and practices for the management of issues caused by the existence of legal entities and organisations. One can distinguish between three levels of questions: What must be addressed? In whose interests should it be done? What are the interests?[4]

7.2 First Level Questions

There are certain questions that must be addressed in the context of corporate governance. First, there are questions caused by two fundamental matters. The firm will need a business form in order to operate. Typically, the business form is a *legal entity* and an artificial person. The firm will also need an *organisation*. These two fundamental matters raise various questions which will have to be answered in some way or another[5] (for example, according to the principles of self-enforcing governance models discussed in Chap. 8, according to the principles of governance models that foster innovation discussed in Chap. 9, and/or the principles of organisational design discussed in Sect. 8.1).

Legal entity. There are particular questions that must be answered somehow in all artificial persons: small privately-owned limited-liability companies, NGOs, co-operatives, and other artificial persons.

[3] Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) pp 16 and 30; Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 165–174.

[4] For previous models, see Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) pp 549–550: "Essentially, all of [the previous] models are ways of thinking about the means and ends of corporate governance. They strive to answer two basic sets of questions: (1) as to the means of corporate governance, who holds ultimate decisionmaking power? and (2) as to the ends of corporate governance, whose interests should prevail? When the ultimate decisionmaker is presented with a zero-sum game, in which it must prefer the interests of one constituency class over those of all others, which constituency wins?"

[5] See Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) pp 16, 30; Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 165–174.

- To whom do assets linked to the entity belong? Some form of "asset partitioning" is necessary. It is necessary to designate a separate pool of assets that are associated with the entity, and that are distinct from the personal assets of the entity's shareholders, if any, and managers. The second component of asset partitioning is the assignment of rights in this distinct pool of assets (Hansmann and Kraakman 2000; Fleischer 2004).[6]
- Who is to be regarded as acting as or on behalf of the entity? An artificial person cannot act on its own in the physical sense.
- How should the persons acting as or on behalf of the entity act? It may be necessary to make these persons act in a certain way.
- How should the various stakeholders act? It may also be necessary to make stakeholders act in a certain way. Even their behaviour must be modified. There must be rules telling stakeholders what to do.
- How are these persons and stakeholders motivated? The self-interest of all these parties may not always lead them to act in the desired way. The entity stakeholders and people acting as or on behalf of the entity must be given incentives.

Organisation. Various corporate governance tools and practices are necessary because an artificial person has an organisation:[7]

- How is power allocated?[8]
- How is risk allocated?
- How is information produced, distributed, and disclosed?

Legal organisation v real organisation. The legal organisation of the firm is not necessarily the same as its real or relational organisation.[9] This raises additional questions:

- How are the questions addressed in corporate groups and networks? For example, a large firm customarily uses a fleet of legal entities rather than just one legal

[6] See Hansmann H, Kraakman R, The Essential Role of Organizational Law, Yale L J 110 (2000) pp 392–393; Fleischer H, Gesetz und Vertrag als alternative Problemlösungsmodelle im Gesellschaftsrecht, ZHR 168 (2004) p 679.

[7] Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) p 30; Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 167.

[8] Bainbrige distinguishes between "shareholder primacy" (here a first level question) and "shareholder value maximization" (here a second and third level question). Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) p 574: "Although often used interchangeably, the terms 'shareholder primacy' and 'shareholder wealth maximization' express distinct concepts. As we have seen, shareholder primacy encompasses a decisionmaking model vesting ultimate control in the shareholders. In contrast, the narrower concept of shareholder wealth maximization charges directors with managing the corporation so as to maximize shareholder wealth, but without prescribing any particular model of corporate decisionmaking."

[9] See, for example Aoki M, Toward a Comparative Institutional Analysis. The MIT Press, Cambridge, Mass. (2001) pp 116–117 and 222.

entity. A large firm can use a combination of different types of legal entities and contracts. A private equity firm can choose one of many available business forms (for example, a partnership, a limited partnership, a privately-held limited-liability company, or a listed limited-liability company) for its own management, pool its own and investors' assets in funds that are limited partnerships, use special purpose vehicles owned by the fund when making business acquisitions, and limit its own liability by using particular limited-liability companies as vehicles for its own investments in the fund as well as for the management services it provides to the fund and the companies acquired by the fund.
- How are the legal organisation and the real organisation different?

7.3 The Second Level Question

The first level questions can be identified rationally (Zweckrationalität). However, they cannot be answered without choices that are regarded as reasonable (Wertrationalität). It is necessary to determine *whose interests* one should further when answering the first level questions (Mäntysaari 2010a).[10] This means that it is necessary to choose the *principal*. There are different views about who should reasonably be chosen as the principal.

According to the shareholder primacy model and the mainstream view, shareholders are the most important principal. According to the stakeholder approach (communitarian models, die Lehre vom Unternehmen an sich, team production), shareholders are not the only principal; even other stakeholders can be principals.

Both models are nevertheless problematic. There are artificial persons that do not have shareholders in any meaningful sense. If the artificial person is a limited-liability company that does have shareholders, its real shareholders may have different and conflicting interests. Some real shareholders may have interests that are not only in conflict with the interests of other shareholders but also with the interests of the firm. One could circumvent this problem by choosing fictive shareholders as the principal. For example, one could assume that all shareholders of the company are long-term investors whose interests are perfectly aligned. However, fictive shareholders do not exist; in real life, it is necessary to deal with the real interests of real shareholders. Choosing other stakeholders as additional principals would make it impossible to determine whose interests should prevail and why.

It seems reasonable to choose the firm itself as principal. This view can be aligned with traditional company law (Sect. 6.3) and leaves just one main master. Accordingly, there should be a duty to act in the interests of the company as the

[10] Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 169.

carrier of the firm that is, a duty to act in the interests of the firm owed to the company. This would mean a duty to protect the firm against all stakeholders.[11]

If the firm is the principal, all stakeholders – managers, board members, creditors, shareholders, contract parties, the state – can be regarded as its agents.

7.4 The Third Level Question

The third level question is *how to define the interests* of the principal. Of course, the interests depend on who is chosen as the principal.

According to the mainstream view, the interests of the principal (shareholders) can be defined as wealth maximisation. The stakeholder approach makes it more difficult to define the interests, as there are various kinds of principals.[12]

If the hypothetical firm can be assumed to have interests, its most basic interest is its own *long-term survival* in a competitive environment (Sects. 4.2 and 4.4).

The interests of the firm are sometimes recognised implicitly even by representatives of competing models. This can be illustrated with two examples.

Hansmann and Kraakman are representatives of the *shareholder primacy* model.[13] On one hand, they suggest that “there is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value”. They call this model the standard model. On the other, they also argue that firms compete on increasingly international product and financial markets and that “[f]irms organized and operated according to the standard model can be expected to have important competitive advantages over firms adhering more closely to other models” – depending on their needs and the circumstances.[14] This leads to the question, why do firms seek those competitive advantages? Do firms exist, and do they have objectives of their own? Do all firms regardless of the governance model have one or more similar objectives? Obviously, the long-term competitive advantages that firms may gain do not matter unless it is assumed that firms exist and have objectives, and the choice between, say, shareholder orientation and stakeholder orientation by firms cannot be explained unless firms try to achieve a higher level objective.

Bainbridge is a representative of shareholder wealth maximisation and *director primacy*.[15] According to Bainbridge, a higher cost of capital increases the

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[11] The need for such a duty was identified already in the Weimar republic by Rathenau and Bernhard. See Riechers A, *op cit*, p 10.

[12] See, for example, Tirole J, Corporate Governance, Econometrica 69 (2001) pp 4 and 25–26.

[13] Hansmann H, Kraakman R, The end of history for corporate law. In: Gordon JN, Roe MJ, Convergence and Persistence in Corporate Governance. Cambridge U P, Cambridge (2004) p 33.

[14] *Ibid*, p 47.

[15] Bainbridge S, The New Corporate Governance in Theory and Practice. OUP, Oxford (2008) pp 65–67.

probability of firm failure or takeover. Due to the negative effects of firm failure, directors will seek to minimise the cost of capital. Shareholders will demand a higher rate of return, if directors expose shareholders to greater risk. Greater risk translates directly into a higher corporate cost of capital. For this reason, shareholder wealth maximisation should apply according to Bainbridge. On the other hand, this makes one wonder whether this is the highest objective. Is the highest objective not reducing the probability of firm failure (and increasing the firm's long-term survival chances)? Moreover, do shareholders matter when they are not a source of funding or not the most important source of funding? Most of the external funding is provided by banks and bondholders, and shareholder wealth maximisation can increase the firm's overall funding costs (Sect. 7.9).

7.5 The Fourth Level

One can also add a fourth level. One should provide answers to the first level questions in the interests of the principal, that is, in the light of what is regarded as reasonable answers to the second and third level questions. For example, rational decisions on the allocation of power between shareholders and corporate bodies will depend on the choice of the principal, because the choice of the interests to be served should influence the allocation of power in the company.[16]

7.6 The Entity

We can now discuss the four fundamental questions that a general theory of corporate governance should be able to answer: (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*?

According to the theory of MBCL, the firm is not the same thing as the legal entity. Legal entities are tools used by firms for the purpose of managing: cash flow and the exchange of goods and services; risk, principal-agency relationships; and information. Depending on the circumstances, the firm may benefit from different business forms and different corporate structures. The firm adapts to circumstances by changing its business form and corporate structure.

One can illustrate this with railroad companies and private equity. The building of railroads is capital intensive. The railroad firms of the nineteenth century raised

[16] This was identified already by Tolonen JP, *op cit*, pp 93–96 and 101.

locked-in funding by *incorporating* as limited-liability companies and issuing *shares* to the public. This lead to a dispersed share ownership structure.

A private equity firm manages other people's money in the context of leveraged buyouts. Like the building of railroads, leveraged buyouts are capital intensive. However, a private equity firm needs neither to be incorporated as a limited-liability company nor to issue shares to investors in order to raise locked-in funding. Instead, investors are asked to invest directly in the *core transactions* (leveraged buyouts) and to share profits with the private equity firm. The assets are locked in *contractually* for many years. Investors pay a fixed fee and a slice of profits to the private equity firm for its services. Much of the risk is allocated to banks that provide most of the required capital, and target companies that will end up repaying the takeover debts. This means that a private equity firm can invest in very large transactions without diluting its own share ownership structure and with very low risk exposure. – In practice, investors' investments are pooled in a limited partnership (private equity fund). The fund is managed by the private equity firm, or rather, a limited-liability company that the private equity firm uses as a tool in order to limit its own risk exposure. A limited-liability company is used as a takeover vehicle in order to manage risk and facilitate refinancings.

7.7 The Interests

The choice of interests is a fundamental question according to the proposed legal theory of corporate governance. It is necessary to choose the principal and define the principal's interests. According to the proposed theory, this is a question of what is regarded as reasonable, and a political question. For reasons discussed above, the proposed theory chooses the interests of the firm as an organisational structure (governance construction). The most fundamental interests of the firm consist of its own long-term survival.

7.8 The Board

Neither separate legal personality nor the fact that the firm has an organisation can explain the use of boards. There can be limited-liability companies without a "board" in any meaningful sense.[17] The board is therefore not a necessary

[17] The German GmbH, § 6(1) GmbHG: "Die Gesellschaft muß einen oder mehrere Geschäftsführer haben. "The English company, section 154(1) of the Companies Act 2006: "A private company must have at least one director." Section 154 (2): "A public company must have at least two directors." The SPE, Recital 13 of the Proposal for a Council Regulation on the Statute for a European private company: "Since small businesses need legal structures that can be adapted to their needs and size and are able to evolve as activity develops, shareholders of the SPE should be

ingredient of the corporation. Moreover, the existence of a board is not a central characteristic of the governance model of private equity.

What is necessary is that there is at least one person that acts as or on behalf of the legal entity (a first level question)[18] and that there is at least one person that protects the interests of the principal (a second level question). Because of separate legal personality, the state that facilitates the use of the corporate form must ensure that somebody is responsible for compliance with laws (a third level question). The firm also needs somebody to decide on fundamental issues in the interests of the firm (a first, second, and third level question). These issues may relate to strategy, major investments, and the allocation of value and risk between the firm and stakeholders and between stakeholders inter se.

Such functions could be in the same hands or in different hands, and they could be in the hands of many people or just one person.

In order to save direct administrative costs, all such functions could be in the hands of the same person. The interesting question is then why there are boards that consist of more than one person, have many functions, and have more than minimum functions.

The fact that boards exist and have more than minimum functions can be explained by the existence of costs, risk, agency relationships (as well as agency costs), and information-related issues. (a) Generally, there are benefits brought by *specialisation* (Fama and Jensen 1983[19]; an alternative explanation is provided by Blair and Stout 1999 who argue that there must be a "mediating hierarchy"[20]).

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free to determine in their articles of association the internal organisation which is best suited to their needs. An SPE may opt for one or more individual managing directors, a unitary or a dual board structure."

[18] See, for example, Article 2(1) of Directive 68/151/EEC (First Company Law Directive): "Member States shall take the measures required to ensure compulsory disclosure by companies of at least the following documents and particulars: . . . (d) The appointment, termination of office and particulars of the persons who either as a body constituted pursuant to law or as members of any such body: (i) are authorised to represent the company in dealings with third parties and in legal proceedings; (ii) take part in the administration, supervision or control of the company."

[19] Fama EF, Jensen MC, Separation of Ownership and Control, J Law Econ 26 (1983) pp 301–325: ". . . separation of the management and control of decisions contributes to the survival of any organization where the important decision managers do not bear a substantial share of the wealth effects of their decisions – that is, any organization where there are serious agency problems in the decision process."

[20] Blair MM, Stout LA, A Team Production Theory of Corporate Law, Virginia L Rev 85 (1999) pp 247–328: ". . . an internal hierarchy whose job is to coordinate the activities of the team members, allocate the resulting production, and mediate disputes among team members over that allocation". "In other words, boards exist not to protect shareholders per se, but to protect the enterprise-specific investments of all the members of the corporate 'team,' including shareholders, managers, rank and file employees, and possibly other groups, such as creditors." See also Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) pp 551–552 for the difference between "team production" and "director primacy".

Specialisation can reduce costs, improve the quality of corporate decision-making, and reduce risk. (b) The *separation* of decision-making powers (decision management and decision control) belongs to the generic tools used in the management of agency relationships.[21] The use of boards can be an efficient way to manage agency relationships and reduce agency costs and agency-related risks. (c) In particular, there should be a suitable *top decision-maker* for various categories of corporate decisions. The use of boards is a way to manage agency relationships between (1) the firm as the principal and (2) executives at lower levels of hierarchy or shareholders as agents. Because of agency problems, company laws generally do not provide for "shareholder primacy" in corporate decision-making.[22] There are decisions that should not be left to the discretion of agents whose interests are not aligned with those of the principal. (d) The same can be said of *monitoring* and transparency. There should be a top monitor acting in the interests of the firm.

The fact that boards have more than one member can be explained by three things. First, it can be explained by risk management.[23] If the board consists of just one member, many risks are increased. If the board consists of more members, risks can be reduced. Second, it is also an example of the management of agency relationships with the firm as the principal and board members as agents. The existence of many members can facilitate mutual monitoring that reduces the need to rely on external monitors. Mutual monitoring can also be part of a governance structure that helps to answer the "who monitors the monitors" problem (for self-enforcing corporate governance models, see Chap. 8). The third reason relates to information. Boards that have more than one member have a better knowledge base and can take better decisions.

Firms use boards in different ways. Many differences can be explained by legal requirements, as different types of legal entities must comply with different sets of laws. There are also differences between firms that have chosen the same business form.[24] For example, the company's share ownership and management can be in the same hands or separated; the company can have one controlling shareholder or a dispersed share ownership structure; control and management can be in the same hands or separated; and societal and corporate culture combined with path dependency can favour a certain board model.

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[21] Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010), Chapter 6.

[22] For the limited powers of shareholders, see, for example, Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005). See also Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) p 559: "the board is the nexus".

[23] Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 130.

[24] *Ibid*, section 9.4.3.

7.9 Shareholders

The choice of the firm as the principal makes it possible to define the function of shareholders as the firm's agents, the reason for their existence, the services they are paid for, and the firm's share ownership structure.

Generally, investors can be providers of funding and ancillary services. Whereas investors in private equity funds are predominately providers of funding, the private equity management firm is mainly a provider of services. Banks provide both funding and ancillary services, and their ancillary services are particularly important in relational banking. Shareholders are not always providers of funding, but they are always providers of at least some ancillary services.

Shareholders are providers of funding in their capacity as shareholders when they subscribe for new shares issued by the company or buy existing shares from the company. However, most shareholders of large listed companies have not subscribed for new shares, and the distributions that large listed companies make to shareholders often exceed the funding raised from shareholders.

Shareholders can provide various kinds of ancillary services:

- Shareholders can be providers of *equity* capital (in addition to other forms of funding). The availability of equity capital can increase the long-term survival prospects of the firm.
- The existence of equity capital can increase the availability of debt capital and reduce its cost.
- Shareholders are a mechanism to monitor the profitability of the company. As residual claimants, self-interested shareholders can be expected to demand better profitability.
- Shareholders are a pricing mechanism for shares. Shares issued by the company have a value for investors, because shareholders are residual claimants and shares are transferable. A high share price makes it easier for the company to use its shares as a means of payment and reduce its funding costs.
- The existence of shareholders can help to separate control and management and to avoid dead-lock situations.
- Depending on the case, shareholders or a certain shareholder can provide even other ancillary services such as signalling services, management services, takeover defences, access to markets, access to technology, or rescue in corporate crisis. Their services can be actual or contingent.[25]

The function of shareholders explains why shareholders exist, what shareholders are paid for, why shareholders have company law rights, why there may be

[25] For "contingent governance", see Aoki M, Toward a Comparative Institutional Analysis. The MIT Press, Cambridge, Mass. (2001) p 300.

company law provisions according to which the purpose of the company is to make a profit, and why the share ownership structure matters.[26]

Shareholders are paid for the provision of funding and the provision of ancillary services. The *relative weight* of shareholders and each task nevertheless depends on the company. For example, in order to prevent hostile takeover bids, a medium-sized listed company with a dispersed share ownership structure must ensure that both its share price and its leverage are high. This can require large distributions to shareholders and mean that the overall cost of shareholders' services is high. A privately-owned company with a controlling shareholder may end up paying less for its shareholders' services, provided that the controlling shareholder's interests are long-term and aligned with those of the firm. On the other hand, a firm that is dependent on the inputs of the company's controlling shareholder may have reason to pay that shareholder more compared with other shareholders, and a firm completely dependent on the personal input of a charismatic manager may need to make the manager a large shareholder.[27]

Shareholders' company law rights are primarily designed to facilitate the provision of shareholders' *ancillary services*, because shareholders are always providers of ancillary services but not necessarily providers of funding.[28] For example, company law rights can be designed to increase the valuation of shares by reducing shareholders' perceived risk; the rights can act as constraints on management or make transactions subject to shareholders' consent. Another example is that voting rights can be vested in shareholders where there is no other reasonable way to separate control and management or to avoid dead-lock situations.

Company law rules that set out that the purpose of the company is to make a profit (or to make a profit for shareholders in particular) can thus be explained in three ways. First, legal entities are legal tools used by firms (Sect. 4.6). Second, such statutory constraints on the management of the firm are designed to improve the firm's survival chances directly, as long-term survival requires profitability. Third, they are designed to improve long-term survival chances even indirectly, as such statutory constraints can: change the behaviour of the board and managers; reduce the perceived risk of shareholders; increase the availability of equity capital; and reduce its cost.

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[26] Compare Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) p 563: "In contrast, 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." The director primacy model cannot explain the existence and function of shareholders.

[27] Rajan and Zingales discuss how Saatchi and Saatchi, a British advertising agency, failed due to the fact that the value of its charismatic chairman was not recognised. See Rajan RG, Zingales L, The Governance of the New Enterprise (2000).

[28] The standard law and economics explanation is different. See, for example, Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harvard U P, Cambridge, Mass. (1991) pp 66–72.

It should be irrelevant whether such rules state that the purpose of the company is to "make a profit" or to "make a profit for shareholders", because shareholders benefit in both cases as residual claimants, and such rules cannot set out how much profit a company should make, how it should make a profit, when it should make a profit, or how much profit it should distribute to shareholders. The essential thing is that the company's board and management have a legal duty to try to make a profit for the company, not that the various kinds of equity investors (providers of debt-based equity or share-based equity)[29] or residual claimants will be better off in the event that the company does make a profit. The reference to shareholders in connection with making a profit has nevertheless been used as an argument for shareholder primacy and/or shareholder wealth maximisation in legal dogmatics.[30]

Share ownership structure is likely to influence the availability and cost of equity capital, and the provision of shareholders' ancillary services. The quality of shareholders as providers of ancillary services varies greatly, for which reason share ownership structure matters even where shareholders are not required as providers of fresh capital. For example, in a large listed company with dispersed ownership, all shareholders may be short-term investors. The board should then try to protect the firm against shareholders and reduce their relative weight – it would be absurd to give such shareholders more power or align the interests managers with their interests[31]; however, the entry of a friendly long-term block-holder might help.

Limited liability can be explained by separate legal personality (in addition to historical reasons). The main rule is that a person is not responsible for the obligations of another person, and neither lenders nor shareholders are responsible for the obligations of a corporation. Separate legal personality is designed to help both the firm and all its stakeholders to manage risk in an efficient way. Another main rule is that unlimited liability exists in the context of entities that are not regarded as separate legal persons. This can be the case with partnerships and unlimited partnerships depending on the jurisdiction.[32] There are also intermediate

[29] Mäntysaari P, The Law of Corporate Finance. Volume III. Springer, Berlin Heidelberg (2010), section 5.2 (on share-based equity and equity that is not share-based) and Chapter 6 (on mezzanine funding).

[30] See Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919); Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) pp 574–576; Bainbridge S, The New Corporate Governance in Theory and Practice. OUP, Oxford (2008) p 59.

[31] This is certainly *not* the mainstream view in the financial markets. See, for example, Shareholders v stakeholders. A new idolatry. The Economist, April 2010: ". . . the problem is not the emphasis on shareholder value, but the use of short-term increases in a firm's share price as a proxy for it. Ironically, shareholders themselves have helped spread this confusion. Along with activist hedge funds, many institutional investors have idolised short-term profits and share-price increases rather than engaging recalcitrant managers in discussions about corporate governance or executive pay. Giving shareholders more power to influence management (especially in America) and encouraging them to use it should prompt them and the managers they employ to take a longer view."

[32] See Mäntysaari P, The Law of Corporate Finance. Volume III. Springer, Berlin Heidelberg (2010), sections 5.6.3 and 5.6.4.

business forms. Unlimited liability can thus be applied in the context of separate legal entities that nevertheless resemble partnerships.

Because of separate legal personality, a corporation is not owned by its shareholders. There is no difference between shareholders and creditors in this respect. Both own legal instruments issued by the legal entity with particular limited rights and duties attached to the respective instruments. One could say that the separate legal personality of corporations works in the same way as the legal personality of men. Neither free men nor separate legal persons are owned by anyone.

7.10 Summary

This chapter was based on the theory of MBCL. MBCL assumes that firms exist and try to survive in the long term. In order to improve their long-term survival chances in a competitive environment, firms try to reach their generic legal objectives by generic legal tools and practices at the strategic level, operational level, and transaction level. MBCL is a functional area of law. One can define particular branches of MBCL by identifying the particular functional issues that must be addressed by the firm in a certain commercial context. This is also a way to define a functional theory of corporate governance.

In the context of corporate governance, the most general issues that must be addressed are caused by the existence of legal entities (separate legal persons or other ring-fenced and self-contained legal institutions for the management of organisations) and the fact that the firm has an organisation (or is an organisational structure). One can define the particular questions caused by these two issues. This is a rational excercise. However, the answers will not be reasonable without answering two preliminary questions. One should choose the principal and define the interests of the principal.

In this chapter, it was suggested that the choice of the firm as the principal and its own long-term survival in a competitive environment as its objective can explain existing laws and the real behaviour of firms better compared with the mainstream models. For example, the shareholder primacy model is unable to explain the existence and function of shareholders.

However, this chapter primarily focused on *what* should be addressed. It did not explain *how* exactly these issues should be addressed. The choice of a particular organisational model as a way to achieve the generic objectives of the firm can depend on several other aspects such as *self-enforcement* and the need to ensure the firm's ability to *innovate*. We will discuss these issues in Chaps. 8 and 9.