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  para.291 et seq 57n
  para.312 58n
Corporations are a product and a part of society. Thus understanding corporations involves insights into the way in which the corporation is viewed as a social phenomenon. This may be discovered by investigating historical and theoretical foundations and forming a conception of the functioning of the corporation as a dynamic entity. The models of companies that have been adopted in various jurisdictions are shaped by the theories concerning the place of companies within society. Different theories concerning the origin and purpose of corporations influence the model of company adopted and thus shape the relationship that companies have with all the participants in their economic activity and with their regulators. Formulating a regulatory structure without such an enquiry invites incoherence. Thus Bottomley:

The broad and basic purpose of examining corporate theory is to develop a framework within which we can assess the values and assumptions that either unite or divide the plethora of cases, reform proposals, legislative amendments, and practices that constitute modern corporation law. This law has not sprung up overnight. We need some way of disentangling the different philosophical and political perspectives from which it has been constructed.¹

Or, more pithily, ‘one cannot intelligently discuss whether a corporation is acting responsibly when it shuts down a factory without taking a position on the role of corporations in society’.²

It should be noted that some theories seek to provide explanations of corporations by studying their origins. Others look at the way in which corporations operate. Some theories have both aspects. Thus, corporations may be seen as the product of a contract between founding members (legal contractualism). This is a foundational theory. But when this is used to justify the pre-eminence of shareholders as ‘owners’ of the company it becomes an operational theory. Some of the difficult-

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ies encountered by contractualism in seeking to explain the operation of companies have arisen because foundational theories have been applied to the operation of companies without an understanding of the difference between a foundation contract and the dynamics involved in the operation of a company. The key point in the difference is the way in which the company’s constitution operates, not merely as a contract but as an arbiter of the rights and duties of those concerned with the ongoing nature of the concern. One purely operational theory is the organic conception of companies as used in the criminal law to justify conviction of a company as the ‘alter ego’ of its controlling mind and will. Although this arose primarily to explain how a company could form a will if it was the fictional product of a state concession of power, it could apply to any functioning company whatever its theoretical foundations are seen to be.

A key element in determining what model of company particular societies have adopted and therefore the relationship with participants and regulators is the way in which the ‘corporate veil’ is viewed. The strength and purpose of the corporate veil is directly derived from the theories that shape the model adopted in any jurisdiction. The status of the corporate veil contains the essence of the model of company adopted and also contains important lessons for those seeking to regulate companies. Corporate personality and the corporate veil may be seen as a shorthand expression to encompass the theoretical and sociological underpinings of the existence of a company.

It is therefore vital to understand the derivation of companies if progress is to be made in steering them in a desired direction. Such an understanding is also essential for the proper characterisation of contentious issues which will arise. For example: is a dispute between two shareholders about an alteration of the constitution of the company to be classified as a contractual dispute or as a constitutional one that requires the imposition of public law principles? The proper classification may well depend on whether the company is seen as a creature of the state or as a contractual arrangement between a group of people.

This chapter seeks to examine the way in which disparate theories give rise to different models of companies. The analysis has the eventual purpose of determining the optimum basis for regulating companies and continuing the analysis into situations involving groups of related companies.

The existence of companies: theories

Theories of company existence are all important in the understanding of the appropriate corporate governance model. Critically, they affect the degree of state interference that is deemed appropriate in the conduct of company affairs, as well as the range of interests that compose the 'interests of the company'. Although theories overlap and interweave, it is suggested that a convenient structure can be imposed by taking as a starting point three theories that have been influential in shaping models of companies. These are the contractual, the communitaire, and the concessionary theories. The contractual and communitaire theories represent two extremes since they reflect notions of the company as a product of laissez-faire individualism and as an instrument of the state, respectively. The concession theory may provide a less extreme 'middle way'.

Contractual theories

Legal contractualism

According to legal contractual theory, four or more parties come together to make a pact to carry on commercial activity and it is from this pact that the company is born. Bottomley labels this the 'aggregate' theory, explaining various versions thus:

Contract supplies the explanatory framework for both the judicial and the political status of the corporation. Internally the corporation is regarded as an association or aggregation of individuals; it comprises contractual relations between members inter se, and between members and management.

The logical outcome of the theoretical contractual base is to limit the social responsibility of the company and create an entity remote from regulatory interference because any denial of the right to use the free enterprise tool which is available tends to interfere with this concept of

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4 This differs from the economic nexus of contracts theory. See J. Parkinson, Corporate Power and Responsibility (Clarendon, Oxford, 1995), 75–76. See also discussion of economic theories below.

5 It is unclear exactly how this theory adapts to one-person companies.

6 Bottomley, 'Taking Corporations Seriously'.

7 Ibid., 208. He attributes the label to J. C. Coates, 'State Takeover Statutes and Corporate Theory: the Revival of an Old Debate' (1989) 64 New York University Law Review 806.

Theoretical underpinnings

the company. The theory has the effect of putting the corporation into the sphere of private law, of viewing the legitimisation of the power it wields as coming from the entrepreneurial activities of the members and lessening the state’s justification for regulatory interference.

In the UK this doctrine is reflected in section 14 of the Companies Act 1985, which reads:

Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and articles.

Although this expresses the contractual view well, the difficulties that the courts have had in its interpretation also flag the limits of the doctrine. For example, the ‘contract’ is unenforceable if the plaintiff is suing in a capacity other than shareholder, and the courts have categorised those given a ‘special’ right by the articles as ‘outsiders’ in order to exclude them from the right to enforce the section 14 contract.

Eley v Positive Government Life Assurance is a case that illustrates the court’s dilemma well. In that case, Article 118 of the company’s articles provided for Eley’s indefinite employment by the company. The article provided that he could be removed only for misconduct. Eley had drafted the articles. Despite the fact that Eley was a shareholder the court refused to allow him to enforce the article.

Although the court often uses contractual language, a better explanation of these cases may be that the vision of the articles as a contract is

9 D. Sugarman and G. Rubin (eds.), Law, Economy and Society, 1750–1914 (Professional Books, Abingdon, 1984) note (at 12–13): ‘The ideology of freedom of contract was an important element in the liberalisation of English company law in the 19th century... However, as in other areas of private law, the power of freedom of contract, the rise of legal formalism and perhaps, on occasions, a sympathy for these agencies of economic growth, encouraged the courts frequently to adopt the mantle of legal abstentionism rather than the watchdog.’
10 Ibid., 209.
12 See also Automatic Self-Cleansing Filter Syndicate Co v Cunninghame [1906] 2 Ch 34.
13 Bottomley, ‘Contractualism’.
14 Eley v Positive Government Security Life Assurance Co Ltd (1876) 1 ExD 88 (Court of Appeal).
15 See also Hickman v Kent or Romney Marsh Sheepbreeders Association [1915] 1 Ch 881; Beatte v Beatte Ltd [1938] Ch 708. But management rights appear to have been enforced in Quin & Axtens v Salmon [1909] AC 442; Pulbrook v Richmond Consolidated Mining Co (1878) 9 ChD 610, and Imperial Hydropathic Hotel Co, Blackpool v Hampton (1882) 23 ChD 1.
16 (1876) 1 ExD 88.
false and they are in fact a constitutional document which requires some public law principles to be applied for its proper interpretation. These might well include preventing a solicitor from entrenching his employment position by using his privileged position as drafter of the constitution. However, as explained below, this vision would require the adoption of a concession notion of the company.

Because legal contractual notions are ‘strained’ in explaining the effects of this ‘contract’, Bottomley suggests two explanations. First, he sees the historical development of unincorporated joint stock companies as emerging from an amalgam of partnership and trust concepts, and secondly ‘it allows us to define the boundaries of the company by circumscribing the rights of membership’. The first explanation he dismisses as conservative, requiring us to accept that time has stood still since the mid nineteenth century. Although this is a valid criticism, there is more. It can be seen that the climate for companies changed radically between the time when the state conceded both trading and political powers to trading organisations and the later situation where several persons could come together and, provided that the formalities were in order, could form their own company.

It is therefore unsurprising that the emphasis changed from notions such as ultra vires to ideas of bargains and contracts between individuals. But the picture is not complete until we accept that the state still plays a significant role in the new companies, the essence of which is their limited liability. Trading with limited liability removes our modern companies a momentous distance from unincorporated joint stock companies. There are therefore two strands to the difference: the advent of incorporation by registration in 1844, and the grant of limited liability in 1855. Despite the possibility that some form of limited liability could have been achieved by private law devices, ‘it is clear

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19 Ibid., 283.
20 See below under discussion of concession theory.
22 Joint Stock Companies Act 1844.
23 Limited Liability Act 1855.
that without the legislative intervention, limited liability could never
have been achieved in a satisfactory and clear cut fashion, and it was this
intervention which finally established companies as the major instru-
ment in economic development. Of this the immediate and startling
increase in promotions is sufficient proof.'

The second criticism rests on the way in which the courts have sought
to use the contract to designate insiders and outsiders in order to
determine whether or not a right under the articles can be enforced.
As we have seen above, the court’s treatment of this issue gives powerful
force to the argument that the company has a constitution rather than a
contract at the heart of its organisational structure. However, a further
consequence is that the focus on the contract between members and
the company has the inevitable effect of excluding other participants in the
economic enterprise, thereby giving us a limited model serving the
shareholders alone. Thus, this foundational theory has a significant
tendency to limit the ‘interests of the company’ to the interests of those
contractors. It also emphasises the free enterprise rights of the con-
tractors. Stokes argues that the contractual model legitimises the
power of the board of directors because they are the appointees of the
owners: ‘Thus, by invoking the idea of the freedom of a property owner
to make any contract with respect to his property the power accorded to
corporate managers appears legitimate, being the outcome of ordinary
principles of freedom of contract.’

26 *Quin & Astens Ltd v Salmon* [1909] 1 Ch 311, [1909] AC 442; *Eley v Positive Government Security Life Assurance Co Ltd* (1876) 1 ExD 88 (Court of Appeal).
27 Bottomley ‘Contractualism’, at 287: ‘Economic’ contractualism promises a framework that either eschews or plays down consideration of the company as an analytical construct, focusing instead on the roles of managers and shareholders.’
28 And the ownership of the founders. It is criticised by M. Wolff, ‘On the Nature of Legal Persons’ (1938) *Law Quarterly Review* 494 at 497, citing the transference of the property of five promoters to a company. ‘If we are to assume . . . that the five members still remain owners of the estate, we are obliged to add the proviso: “But they are treated in every respect as if they were no longer owners and as if a new, a sixth, person had become the owner.”’ He accepts that it has some justification where ‘economic’ ownership is the issue rather than ‘juristic’ ownership but feels that even here it is ‘not completely sound; not all the members of a corporation are (from the economic standpoint) masters of the undertaking and owners of the corporation’s property. If one member has 95 per cent of all the shares, he alone determines the fate of the enterprise.’
orientated\textsuperscript{30} behaviour whereby: 'Provided that corporate actions and decisions comply with the terms of the contract they can be judged primarily in terms of whether they achieve some desired goal, rather than by reference to their impact on the rights or interests of the persons involved.'\textsuperscript{31}

As explained above, a key reason for the strain experienced in applying the notion of legal contractualism to the operation of companies is the different considerations that apply to the balancing of rights and duties of the participants when the company is up and running. The foundational theory becomes less convincing at this point.

A reflection of the contractual theory can also be seen in rules such as the UK rule in \textit{Foss v Harbottle}, which accepts that in most cases the majority decision of the contractors, taken according to the constitutional (contractual) rights of the shareholders, represents the will of the corporation. Thus, according to Friedman,\textsuperscript{32} a corporation is owned by its shareholders, who should be able to rely on their agents (the directors) to make as much money for them as possible. Taking account of other social concerns would amount to imposing a tax on shareholders to which they had not consented.

This approach has roots in realist\textsuperscript{33} theory 'according to which groups have natural moral and legal personality'.\textsuperscript{34} The theory sees companies as made up of natural persons, the majority of members representing the will of the corporation. The corporation is thus entitled to autonomy from the state as being the natural expression of the desires of the corporators.

Consequently, corporations obtained their political and thus legal status independently from the state.\textsuperscript{35} As Greenfield persuasively argues, the debate about the purpose of corporations becomes bogged down in 'rights' based notions relying on the legal metaphors of ownership and contract.\textsuperscript{36}

\begin{itemize}
\item[31] Ibid.
\item[33] See in particular P. Ewick, ‘In the Belly of the Beast: Rethinking Rights, Persons and Organisations’ (1988) 13 \textit{Law and Social Inquiry} 175 at 179; ‘Individuals can no more be separated or detached from their organisational affiliations than the organisation can be abstracted from its membership.’ See also Bottomley, ‘Contractualism’, 288. For a study of the way in which association means sacrificing selfish ‘ends’, see S. Leader, \textit{Freedom of Association} (Yale University Press, New Haven, CT, 1992), especially ch. 7; and see below on methods of regulation for a fuller treatment of these issues.
\item[34] Leader, \textit{Freedom of Association}, 41.
\end{itemize}
Legal contractualism differs substantially from economic contractualism because it has a greater flexibility, allowing notions of reasonableness and equity to be considered as integral in a contract. However, both are arguing from a similar foundation in that the essence of the company is seen as residing in the contractual relationships between the actors.

**Economic contractualism**

The economic analysis starts from the perspective that ‘the company has traditionally been thought of more as a voluntary association between shareholders than as a creation of the state’. Cheffins argues that ‘companies legislation has had in and of itself only a modest impact on the bargaining dynamics which account for the nature and form of business enterprises. Thus, analytically an incorporated company is, like other types of firms, fundamentally, a nexus of contracts.’ For the purposes of economic analysis individuals rather than the state are the legitimation for the operation of the commercial venture. Denial of a separate personality to the entity formed by the human group of actors is a necessary foundation for the application of market theories, since the underlying assumption is the creation of maximum efficiency by individual market players bargaining with full information. Taking the view that free markets are the most effective wealth creation system, neo-classical economists including Coase have analysed companies as a method of reducing the costs of a complex market consisting of a series of bargains among parties. Transaction costs are reduced by the organisational design of the company. ‘Corporate law establishes a set of off-the-rack legal rules that mimic what investors and their agents would typically contract to do. Most shareholders, it is assumed, would

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39 But Bottomley, ‘Taking Corporations Seriously’, at 211, sees it as a way to ‘submerge the tension that exists in making choices between individual and group values’.
42 And firms that are not always companies.
contract with the business managers to ensure that the managers seek to maximise profit.45

The theories rest on notions of rationality, efficiency and information. The economists posit that a person acting rationally will enter into a bargain which will be to his or her benefit. In a sale transaction, both parties acting rationally will benefit both themselves and therefore society.46 However, notions of the measurement of efficiency vary. Pareto efficiency requires that someone gains and no one loses. In contrast, the Kaldor–Hicks test accepts as efficient ‘a policy which results in sufficient benefits for those who gain such that potentially they can compensate fully all the losers and still remain better off’.47

The explanation of what is ‘rational’ also varies widely, from simple wealth maximisation to complex motives including altruism, leading to the somewhat exasperated criticism that ‘[f]rom the point of view of understanding motivation in terms of rational self-interest . . . if we expand backward with self-interest as an explanation until it absorbs everything, including altruism, then it signifies nothing – it lacks explanatory specificity or power.’48

The third pillar for the economic analysis is information flows. The rational actor is seen as making rational choices with full and perfect information at his or her command.

Rational actors utilising perfect information will produce maximum allocative efficiency by making choices that exploit competition in the market. However, allocative efficiency will not occur unless all the costs incurred in the transaction are internalised. Thus, if a company pollutes a river, causing damage to other river users but incurring no penalty, the goods produced by that company will be underpriced. That this type of behaviour causes real problems for those who would impose minimal regulation and rely instead on market behaviour and private law instruments is evident.

Applying market economics to company law involves seeing the company not as a free standing institution but as a network of bargains

46 Ogus gives the following example: ‘Bill agrees to sell a car to Ben for £5,000. In normal circumstances it is appropriate to infer that Bill values the car at less than £5,000 (say £4,500) and Ben values it at more than £5,000 (say £5,500). If the contract is performed, both parties will gain £500 and therefore there is a gain to society – the car has moved to a more valuable use in the hands of Ben . . . this is said to be an allocatively “efficient” consequence.’ A. Ogus, Regulation: Legal Form and Economic Theory (Clarendon Press, Oxford, 1994).
47 Explanation given by Ogus, Regulation, 24, who immediately points out that there is no requirement for the gainers to compensate the losers. See below in criticism section.
between all involved, all acting rationally with perfect information. The utility of company law is to prevent the high costs of reaching individual bargains with every involved person. Company law thus reduces transaction costs.

This approach has a number of consequences. State interventions, such as the decisions of the courts on constitutional issues, are seen as imposing implied terms in the contract between shareholders, and the duties of directors are imposed because their interests and that of the shareholders are imperfectly aligned. Posner explains that because the interests of management and shareholders are not perfectly aligned the potential of management to divert resources to their own use would lead shareholders in a free bargaining position to insist on 'protective features' in the corporate charter. In this respect the corporate governance aspects of company law reduce transaction costs by 'implying in every corporation charter the normal rights that shareholders could be expected to insist upon, of which the most important right is the right to cast votes. This is a variation of the implied terms approach but it comes close to recognising the constitutional nature of the venture.'

As noted above, company law itself is seen as an off-the-shelf set of implied terms that can be adopted to reduce the expense of inventing individual bargains. Regulation is required only as a means of redressing imperfections in the market. Starting from the premise that free, perfect, markets produce optimum wealth implies that only where there is 'market failure' should the state intervene to attempt to redress the failure and permit the market to function again.

One interesting facet of many of the neo-classical economic models is the lowly place occupied by the doctrine of limited liability. It is seen as an incentive to investment but the role of the state in providing this

50 F. Easterbrook and D. Fischel, The Economic Structure of Corporate Law (Harvard University Press, Cambridge, MA, 1991) have provided a recent restatement of the contractual theory in the context of public companies raising money from the public. Governance structures are seen as necessary to ensure that promises made on the raising of capital are kept and to prevent the exploitation by managers and others.
51 Posner, Economic Analysis, 411.
potentially ‘market rigging’ mechanism is generally played down, and the argument is made that, if limited liability were not provided by the state as an available attribute of a company, participants would incorporate it into individual bargaining arrangements. However, this belittles a mechanism that fundamentally altered the structure of the market by representing it merely as a mechanism for removing transaction costs and re-creating a more perfect market.

The reluctance to accept a significant state role is thus a product of the contract/group realist theories which reject state power as a source of legitimation for organisations. Linked with the conception that the state’s role is solely an ‘enabling’ one rather than as a controlling power, it is anathema to suggest that the corporation should be used in any way as a form of social engineering. The enabling viewpoint was well put by Professor Ballantine, who drafted new legislation for California in the 1930s. He wrote:

The primary purpose of corporation law is not regulatory. They are enabling Acts, to authorise businessmen to organise and operate their business, large or small, with the advantage of the corporate mechanism. They are drawn with a view to facilitate efficient management of business and adjustment to the needs of change.

It is, however, naive to view any system as wholly enabling. Any structure inevitably limits as well as empowers, so that pure enablement is always a fiction. This is well put by Greenfield who argues:

One would not suggest . . . that Eastern European nations recently freed from communism would succeed as economic powers simply by having the government completely disentangle itself from the economic decisions of its citizens. On the contrary, one would start with putting in place a set of basic rules of economic interaction, supplemented with a system of contract and property entitlements that individuals could negotiate around. One would also seek to guarantee that disputes could be resolved fairly.

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54 See F. Easterbrook and D. Fischel, ‘Limited Liability and the Corporation’ (1985) 52 University of Chicago Law Review 89, sidestepping the argument by A. Manne in ‘Our Two Corporation Systems: Law and Economics’ (1967) 53 Vanderbilt Law Review 259 that the modern public corporation with many small investors could not exist without limited liability by arguing that limited liability shifts responsibility to creditors. This may be true but does not explain away the need to raise capital from shareholders.

55 See Cheffins, Company Law, 41 and 502, but contra 250 pointing out the importance of the nineteenth century enabling legislation. See also Gower, Company Law, chs. 2 and 3.

56 For a contrary argument see Maitland, Selected Essays, 392, arguing that limited liability would have come about by contract if not introduced by law; and J. Farrah, Company Law (4th edn, Butterworth, London, 1998), 21, citing Posner and Williamson.


The concept of regulation being of use only as a corrective for ‘market failure’ is a troubling one capable of encompassing almost any situation that is seen as an imbalance in the perfect market, where actors ‘act rationally, are numerous, have full information about the products on offer, can contract at little cost, have sufficient financial resources to transact, can enter and leave the markets with little difficulty, and will carry out the obligations which they agree to perform’. The justifications for and shaping of regulations in the context of this approach are addressed below.

Criticism of contractual theories

Economic contractualism tends to be the more extreme of the contractualist theories. Many of the criticisms examined below are aimed at the proponents of those theories, although some also relate to legal contractualism.

The economic contractualist attracts criticism both at the level of the conception of companies and company law and on the basis of the perceived political results of the analysis. The former criticisms go to the utility and accuracy of the analysis itself. The latter include the rejection of state regulation and the consequences of the resulting ‘free market’, which have been particularly recognised and documented in the context of transnational and global corporations and will be considered in more detail in later chapters.

On the first level we have seen that the conception of rationality is variously perceived and that the further the theorists move away from pure wealth maximisation as motivation the less valuable economic contractualism is as an analytical tool. Further, rationality is bound up with the amount of information possessed by the rational actor. Accepting that ‘perfect information’ is a myth, most economists accept the notion of ‘bounded rationality’ or ‘satisficing’. Bounded rationality accepts that the capacity of individuals to ‘receive, store and process information is limited’. Satisficing is ‘searching until the most satisfactory solution is found from among the limited perceived alternatives’. Thus, the ‘pure’ concept of rationality suffers from the twin problems of simplistic motivation and a defect in the theory of perfect information.

References:

60 See ch. 4.
63 And this is true of both legal and economic contractualism.
64 Ogus, *Regulation*, 41.
65 Ibid.
The above criticisms are aimed at the conceptual structure of the theories. It must be noted that any identified defect in the underlying assumptions tends to have a cumulative effect, each building block contributing to a picture that emphasises the necessity for a market free of regulatory interference. The basis of the theories on a pseudo-scientific notion of efficiency and the claim that creating wealth is beneficial for society as a whole means that the end result is a picture where interference with the freedom of markets needs to be justified by anyone who argues for any regulation of corporate behaviour.

Take first the Kaldor–Hicks notion of efficiency. The concept that net gains and losses need to be calculated and any net gain to any party is equivalent to efficiency is open to ‘several powerful objections, at least as a conclusive criterion of social welfare’. Ogus points to the coercive imposition of losses on individuals, the assumption that one unit of money is of equal value whoever owns it and its hostility to the notion of distributive justice. Ogus gives the following example:

Suppose that the policymaker had to choose between (A) a policy that increased society’s wealth by $1 million and benefited the poor more than the rich, and (B) a policy that increased its wealth by $2 million, the bulk of which devolved on the rich? Many would argue for (A) on the grounds of fairness but (B) would be considered to be superior in Kaldor–Hicks terms.

Secondly, the concept of fiduciary duties and implied terms as methods of controlling corporate decision-making has appeal, but economic contractualism rejects the concept of such controls as being the imposition of public interest goals such as equity and fairness. Coupled with the Kaldor–Hicks notion of efficiency, the concept of implied term is a weaker control on the exploitation of minorities by majorities than the public interest concepts that the courts do seem ready to apply. A wonderful example of the convergence of economic theory and the concept of imposition of public interest norms can be seen in Lindley MR’s statement in Allen v Gold Reefs of West Africa Ltd:

Wide, however, as the language of s50 is, the power conferred by it must, like all other powers, be subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities . . . These conditions are always implied, and are seldom, if ever, expressed.

The contractualist implied term analysis gains support from the latter

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66 Ibid., 25.
67 Ibid., 25.
69 This argument has powerful resonance when the operation of transnational and global corporations is under scrutiny; see ch. 5.
70 [1900] 1 Ch 656.
phrase, but the passage could equally be read as the imposition of public interest general principles. The emphasis laid by the economists on the freedom of the *parties* to contract diverts attention from the fact that general principles of justice are being imposed by the courts. If the implied term analysis is to hold water it must be expanded to include the legitimate expectations of parties living in a state that imposes principles other than market forces to govern relationships even in the marketplace, and this brings back into play public interest justifications for regulation, which run counter to the view that regulation can be justified only as a correction for market imperfections.

A further legitimate criticism of the economic view of companies in action is that it may foster a short-term view of the company’s best course of action. It relies on the rationality of the actors involved in the company at any one time. The logical result of this is to exclude considerations of ‘future generations’. This point is well made by Ogus in an environmental context,\(^\text{71}\) but the same point may be made in relation to all aspects of corporate governance. In effect, this is one facet of the acknowledged problem of ‘negative externalities’. This is the term used to indicate transaction costs that may be unfairly allocated by a private bargaining system. This may be because small losses incurred by individual right holders will not be corrected because to incur the expense of court proceedings for a small amount will not be worth while. Ogus describes this as ‘market failure’ accompanied by ‘private law failure’\(^\text{72}\) and as a justification for public interest regulation.

Thus it can be seen that the economist’s insights are valuable but limited and must be treated with caution, in particular in spheres where overemphasising the role of the individual actors could lead to ignoring public interest goals and lending undue weight to wealth maximisation, particularly for the few, as the ultimate good for society.

Bottomley criticises both economic and legal contractualism on three grounds: first, ‘the organisational life of a company is more than the sum of the actions of individual corporate insiders’,\(^\text{73}\) secondly, contractualism favours an ‘economic’ approach over a ‘political’ approach; and, thirdly the legitimation of managerial power is predicated on the voluntary consent given by the ‘owners’. All these mean that the private law nature of the company is seen as regulation unfriendly.\(^\text{74}\)

In both legal and economic contractualism we have seen that there is a struggle to move from the foundational theory into the operational

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\(^{71}\) Ogus, *Regulation*, 37.  
\(^{72}\) Ibid., 28.  
\(^{73}\) Bottomley, ‘Contractualism’, 288.  
\(^{74}\) While not doubting that these ideas have a role in corporate governance, Bottomley believes them to be overstated and thus dangerous.
sphere. One key difficulty with both approaches is the explanation of the rights and duties that arise when the constitution of the company is up and running. We have seen that legal contractualism struggles to explain the failure to enforce the contract in the articles and the regulation of the power of majorities over minorities. Economic contractualism has an exactly similar problem. It relies on an explanation of incomplete contracts. ‘Only in a world where some contracts contingent on future observable variables are costly (or impossible) to write ex-ante, is there room for governance ex-post.’75 Neither accepts the legitimacy of state regulation of power: ‘The political approach to corporate governance accords with . . . values about how major institutions in our society should be governed.’76

In fact the implied term or incomplete contracts theory could benefit from the insights of Cooter, who argues that all involved in the company internalise not only the organisational norms of the company but also society’s norms. Any person involved in the company has therefore an expectation (call it an implied contractual term if you will) that society’s norms of fair dealing and freedom from expropriation will be applied to them. Cooter puts his argument in terms of absorption of institutional norms.77 Cooter78 posits the idea of thin and thick self-interest in that he believes that the internalisation of moral norms will affect decision-making by the development of a different form of self-interest he calls ‘thick self-interest’. This accords with Teubner’s belief that ‘Franz Wieacker [came close by stating] “the socio-empirical reality of the social group [including corporations] . . . lies in the group consciousness of the members and their partners and in the specific nature of the group’s behaviour.”’79 Thus ‘the social substratum of the legal person . . . is conceived properly as a “collectivity”’.80

77 Teubner diverges from these analyses. Founding the legitimation of the autonomy of the corporation in its ‘overall social function and performance’, he nevertheless pays great attention to the group dynamics that occur within the company, seeing the decision-making founded not in separate individual contracts or in the will of policy makers but in a “pulsating” sequence of meaningfully interrelated communicative events, that constantly reproduce themselves. While denying that the group forms the legitimation base for corporate power, Teubner nevertheless makes a contribution to the understanding of the dynamics that underlie the ‘actions of the corporation’, and his views may be seen as a development of the organic theories. Teubner, ‘Enterprise Corporatism’, 130.
78 Cooter, ‘Law and Unified Social Theory’; discussed in ch. 4.
80 Ibid.
So, within the conception that the company owes its existence to individuals, we have a clear distinction between those who accept that the formation of people into a group activity changes the nature of their relationships and those who do not.81

In relating the theories to wider concerns, Bottomley emphasises the relationship between individualism and ‘liberal’ thought,82 and Campbell sees the link between laissez-faire economics and the economic theories of the firm. Thus, at the political level, economic theory is anti-regulatory, relying on the mechanisms of the marketplace and allowing regulation only to ‘correct market failures’.83 Where economic analysis is used as an ideology rather than as a tool for analysis the danger is that,

by maintaining that the only obligation of the individual is to honor contracts and the property rights of others, the ‘moral’ philosophy of market liberalism effectively releases those who have property from an obligation to those who do not. It ignores the reality that contracts between the weak and the powerful are seldom equal, and that the institution of the contract, like the institution of property, tends to reinforce and even increase inequality in unequal societies. It legitimates and strengthens systems that institutionalise poverty, even while maintaining that poverty is a consequence of indolence and inherent character defects of the poor.84

Further, the rejection of regulation by the cry of ‘free’ markets permits this effect to take place in the absence of wealth redistribution programmes imposed by regulation.

The corporation as a nexus of contracts is ‘incapable of having social or moral obligations much in the same way that inanimate objects are capable of having these obligations’,85 a view convincingly shown by O’Neill to contain a conceptual error86 in that ‘Jensen and Meckling have evidently confused the idea of having social responsibilities with having a social conscience’.87 It is true that individuals have consciences (that is the capacity to feel such emotions as guilt and remorse) whereas

81 See Bottomley, ‘Taking Corporations Seriously’, 211, adopting the suggestion of J. Coates, ‘State Takeover Statutes and Corporate Theory: The Revival of an Old Debate’ (1989) 64 New York University Law Review 806, that the organic theory, in particular, was prompted by the concern that if the company were merely a nexus of contracts it was difficult to justify the incidence of limited liability etc. which did not attach to other contracts.
83 See discussion of models of regulation, ch. 4.
84 Korten, When Corporations Rule the World, 83; and see Dworkin, ‘Is Wealth a Value?’.
87 Italics in original.
organisations can incur responsibilities, and they can incur social responsibilities or contractual responsibilities.

Economic contractualism, by excluding the social responsibility of corporations, rejecting regulation and weakening control mechanisms within the corporation, has created global monsters.88

The communitaire theories

The second group of theories to consider are the communitaire theories, which see the grant of company status not only as a concession by the state but as creating an instrument for the state to utilise. These theories start from a position diametrically opposed to the individualist contractual theories. Companies modelled on these theories were familiar in the former communist countries and in fascist Italy.89 “The standard of a corporation’s usefulness is not whether it creates individual wealth but whether it helps society gain a greater sense of the meaning of community by honouring individual dignity and promoting overall welfare.”90 It has two consequences. The company has no strong commercial identity because it has become a political tool with diffused goals. Although diffused goals will give it considerable social responsibility a further consequence is to remove its commercial focus. The state merely uses the corporate tool to further its ends. The emphasis is on identification of the aims of the company with those of society. This contrasts with the concession approach (see below), which emphasises the right of the state to ensure that a corporation is properly run according to its standards of fairness and democracy.

Those who argue that a company should have a social conscience are thus running the risk warned against by Friedman that, once profit maximisation by stockholders has ceased to be the narrow focus of the company, businesspeople would not know what interests to serve.93 The issue was discussed at length by Berle and Dodd following the insights

88 See Korten, When Corporations Rule the World; P. Harrison, Inside the Third World (Penguin, Harmondsworth, 1990); J. Karliner, The Corporate Planet (Sierra, San Francisco, 1997).
93 Friedman, ‘The Social Responsibility of Business Is to Increase Its Profits’.
Theoretical underpinnings

of Berle and Means that the structure of the modern corporation means that ownership and control have been irreversibly separated.\(^{94}\) Essentially the fear expressed by Berle was that any departure from the view that the board should use its powers solely for the maximisation of profits was to abdicate responsibility over the board.\(^{95}\) The interests of the company must therefore be seen as coextensive with the interests of the shareholders, or measurement of the directors’ performance becomes impossible.\(^{96}\)

Of course, as Wedderburn notes, a limited ‘social’ expenditure may be justified by profit maximisation.\(^{97}\) “The “social” expenditure so explained becomes no more than “seed corn”, sown in the surrounding ground with a long-term view of profit, scattered because: “The best place to do business is in a happy, healthy community.”\(^{98}\) Wedderburn dismisses this view as giving support only to a very narrow range of corporate social activity. So narrow a view, he believes, cannot explain the full picture but a way to conceptualise the ambit of social responsibility is not readily forthcoming.

In seeking to rediscover the ‘social dimension of the legal person’ Teubner seeks its legitimation ‘primarily not in the consent of those involved, but in its overall social function and performance’.\(^{99}\) This means that the interests of the ‘corporate actor’ must be strengthened as against its internal interest groups. ‘This turns the current logic of legitimation entirely on its head. It is not pluralism within the firm that justifies the actions of the corporate actor, but the contrary: internal pluralism is legitimate only in so far as it is orientated towards the corporate actor’s goals, which in turn must be legitimised by the firm’s function and performance in society.’ Teubner adheres to a fiction theory in that the legal person is a ‘self-supporting construction’. Thus: Collectivisation means a shift in the attribution of an action from one social construct to another, from a ‘natural’ to a ‘legal’ person. A self-description of the system as a whole is produced and to this construct actions are attributed as

\(^{96}\) And see below, the discussion in the concluding section of this chapter.
\(^{98}\) And see Greenfield, ‘From Rights to Regulation’, 3–4: ‘It is tempting to explain away the apparent tension between shareholders and other stakeholders by focusing on the long run . . . corporations maximise the return to shareholders by being good citizens. Concern for employees, for example, engenders loyalty, which will induce employees to accept lower wages and care more about product quality and company profitability.’
actions of the system. This is a self-supporting construction: collective actions are the product of the corporate actor, and the corporate actor is nothing but the product of these actions.\textsuperscript{100}

Teubner’s adherence to a communitaire viewpoint is qualified because he sees corporations as having a degree of autonomy. He believes that the development of the collectivity means that the corporation becomes separate both from internal actors and from the external market environment. Although admitting that this gives the corporation some autonomy, he believes that the change of emphasis from the human actors to the legal person also transfers the obligation to be socially responsible to the organisation itself, so that ‘it opens up far-reaching perspectives of economic and political control’. The unexplained issue here is the source of the obligation to be socially responsible. The profit maximisers would dispute its presence either in the individual or in collectivities. Perhaps it lies in the Cooter notion of absorption of moral norms.\textsuperscript{101} At any event, Teubner sees its transference to the legal person as a possible justification for whatever regulation the state sees fit. His views would thus fit comfortably with the communitaire theorists.\textsuperscript{102}

However, Teubner sees the political consequence of his view of corporations to be a legal policy of ‘enterprise corporatism’ which accepts that the autonomy of the corporation is ultimately beneficial provided that a corporation is seen as a network of decision makers at a lower level than the organic theorists would admit:

flexibility can be brought about not only through contractual arrangements but also through decentralization of organisation, and that a policy based on organisation can additionally use the productivity advantages of a ‘producers’ coalition’ (capital, management, labor, state), which in the conditions of the new industrial divide are becoming increasingly necessary.\textsuperscript{103}

Thus, although Teubner’s theory would justify state intervention, its communitaire base lies more in the identification of the state and the corporation working together to attain socially acceptable goals. It therefore at once resembles the profit maximisation viewpoint in its emphasis on a producer’s coalition and diverges from it by the adherence to the concept of the social conscience of the corporation.\textsuperscript{104}

Another version of this theory, known as ‘liberal corporatism’, may

\begin{flushright}
\textsuperscript{100} Ibid., 139.  \\
\textsuperscript{101} See ch. 4 below.  \\
\textsuperscript{102} From different standpoints, Cooter, Teubner and the organic theorists are attempting to explain group decision-making and their insights will be valuable in attempting to construct a model corporation.  \\
\textsuperscript{103} ‘Teubner, ‘Enterprise Corporatism’, 154.  \\
\textsuperscript{104} Although even Teubner seems to doubt the efficacy of this conscience: ‘[producers’ coalitions] may arrive at their agreements at the expense of third parties and even of the public interest.’
\end{flushright}
also have value in understanding governance structures. The basis of this theory is still a blurring of the line between public and private domains, but emphasis is placed on the role of groups within society to represent various interests (for example, labour represented by trade unions). Although the emphasis on the blurring of lines between public and private concerns may have unfortunate consequences (see below), some theorists lay emphasis on collective goals. Thus Stokes views the company through corporatist lenses as "an organic body which unifies the interests of the participants into a harmonious and common purpose under the direction of its leaders". The theory seems to point in two directions simultaneously, both putting forward a public role for companies and emphasising the importance of good balancing between interest groups as the secret of internal regulation. The apparent conflict may only be one of emphasis. Once it has been accepted that any role is played by the state in creating or permitting the company to operate with concessions such as limited liability, the right to regulate on social grounds is conceded and the degree of regulation is then the concern. The attachment of this theory to authoritarian economies makes one wary about accepting the 'public' emphasis too readily.

The efficacy of the company as a commercial tool may well depend on legal recognition of it as an entity separate both from its members and from state interests. A diffusion of goals is widely regarded as inefficient. The issue has gained much prominence in the context of the 'stakeholder' debate, but Deakin and Hughes argue that:

A major difficulty with stakeholder theory, at least as it has been applied in Britain, is that the term 'stakeholding' has been used to refer to a very wide range of interests which are loosely related at best . . . If the category of stakeholding interests is widened to include those of all potential consumers of the company's products, for example, or to refer to the general interest of society in the sustainability of the environment, there is a danger that the idea of stakeholding will cease to be relevant.

Thus the move to communitaire theory risks losing sight of the commercial goal of the company. On the other hand, the contrasting contractualism viewpoint would narrowly focus the goals of the corporation,