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## Foundations of the Firm I: Business Entities and Legal Persons

Whether and how to recognize business enterprises as organizational “entities” and legal “persons” that bear enforceable rights, privileges, and responsibilities has been one of the most vexing issues in the history of legal thought. These issues, though often raised with respect specifically to corporations, are relevant to business firms in general.<sup>1</sup> Debates about whether business firms are simply “legal fictions” created by the state or “real entities” that exist independently as institutions trace at least to classical Roman times.<sup>2</sup> These debates mirror an historical tension between “top-down” and “bottom-up” perspectives on business enterprises. An appreciation of these two perspectives helps to explain and resolve the differences among the main competing legal theories of the firm.

### An institutional theory of the firm

“Top-down” legal theories see business firms as creatures of the state. The Roman jurist Gaius expressed this view as follows:

Partnerships, *collegia*, and bodies of this sort may not be formed by everybody at will; for this right is restricted by statutes, *senatus consulta* [rules], and imperial *constitutiones* [edicts]. In a few cases only are bodies of this sort permitted. For example, partners in tax farming, gold mines, silver mines, and salt works are allowed to form corporations. Likewise, there are certain *collegia* at Rome whose corporate status has been established by [law], for example, those of the bakers and certain others and of the shipowners. . . . Those permitted to form a corporate body consisting of a *collegium* or partnership . . . have the right on the pattern of

<sup>1</sup> The literature on this topic is both broad and deep. For an overview, see Alfred F. Conard, *Corporations in Perspective* (Foundation Press 1976), pp. 417–45. Contemporary treatments derive from original discussions in Europe, especially in Germany and France. *Id.*, pp. 417–19 (citing especially the work of Friedrich von Savigny and Otto von Gierke in Germany and René Clemens in France). See also Ron Harris, “The Transplantation of the Legal Discourse on Corporate Personality Theories: From German Codification to British Political Pluralism and American Big Business,” 63 *Washington and Lee Law Review* 1421 (2006).

<sup>2</sup> See Reuven S. Avi-Yonah, “The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility,” 30 *Delaware Journal of Corporate Law* 767 (2005). For an historical treatment of this jurisprudence in the United States, see Gregory A. Mark, Comment, “The Personification of the Business Corporation in American Law,” 54 *University of Chicago Law Review* 1441 (1987).

the state to have common property, a common treasury, and an attorney... through whom... what should be transacted and done in common is transacted and done.<sup>3</sup>

On this ancient view, business firms exist only at the behest and at the pleasure of government.

More recently, the U.S. Supreme Court expressed this top-down conception of the firm in a famous, often repeated declaration by Chief Justice John Marshall in the *Dartmouth College* case: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."<sup>4</sup> The top-down view sees the business corporation—and, by extension, any business enterprise—as the subordinate subject of law and, derivatively, of the governments that charter or otherwise recognize them.<sup>5</sup>

The "bottom-up" point of view of the participants in business firms yields a different, almost opposite legal theory. Although the law may provide the basic social structure and "rules of the road" for the creation and operation of business firms, participants who invest their own wealth, time, labor, and knowledge in a business enterprise tend to favor the recognition of legal rights and obligations that inhere in the enterprise itself. Participants' see firms as representing, derivatively, their own interests and expectations, rather than those of a sponsoring government. Although the Roman emperors were intolerant of this participants' point of view, the long-term history of the business enterprise suggests that the emergence of a bottom-up view has gained traction in various geographical locations over the *longue durée*.<sup>6</sup> Traces of the bottom-up view appear even in the ancient Roman debates, though they are less easy to make out than the top-down declarations of control by emperors.<sup>7</sup> At least some early Roman firms had the right to pass the equivalent of bylaws to govern their own affairs.<sup>8</sup>

A bottom-up view comports also with the long-term historical trajectory described by Friedrich Hayek of a "spontaneous order" of firms that grow in different shapes and sizes once a basic legal infrastructure has been put into place.<sup>9</sup> Hayek

<sup>3</sup> Dig. 3.4.1 pr.-1 (Gaius, Provincial Edict 3) (Alan Watson trans. 1985), quoted in Avi-Yonah, op. cit., p. 773. *Collegia* included private clubs, religious groups, and informal economic organizations.

<sup>4</sup> *Dartmouth College v. Woodward*, 17 U.S. 518, 636 (1819). Modern cases that cite this language favorably include *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 89 (1987) and *Citizens United v. Federal Election Commission*, 130 S. Ct. 876, 950 (2010) (Stevens, J., dissenting).

<sup>5</sup> In fact, *Dartmouth College* held against the government, finding that a royal charter creating a private institution could not be constitutionally altered by New Hampshire under the Contracts Clause. 17 U.S. at 624–53. The case is discussed further below in Chapter 3 with respect to the public/private distinction.

<sup>6</sup> Fernand Braudel, *The Perspective of the World: Civilization and Capitalism, 15th-18th Century*, vol. III (trans. Siân Reynolds) (University of California Press 1992), pp. 619–23.

<sup>7</sup> See Avi-Yonah, op. cit., pp. 775–6 (citing passages from Ulpian). Different legal theories of business organization have been "cyclical" in terms of their adoption and influence. Id., pp. 767, 770–813.

<sup>8</sup> See Samuel Williston, "History of the Law of Business Corporations Before 1800," 2 *Harvard Law Review* 105, 121 (1888).

<sup>9</sup> See Friedrich A. Hayek, *Law, Legislation, and Liberty: Volume 1, Rules and Order* (University of Chicago Press 1973), pp. 35–54; Friedrich A. Hayek, *The Road to Serfdom: Text and Documents*

accounts for the top-down versus bottom-up dichotomy as the difference between an imposed or “made” social order (*taxis*) and a “grown” or spontaneous social order (*kosmos*).<sup>10</sup> For Hayek, economic markets constitute a “catallaxy,” that is, “the special kind of spontaneous order produced by the market through people acting within the rules of the law.”<sup>11</sup> Although business firms must comply with relevant law, on this view, they also create and define themselves—and then make a legitimate claim to an independent right to existence and legal recognition on the basis of this self-creation.

In the United States, the Supreme Court has at least implicitly endorsed this bottom-up point of view as well, such as in *Santa Clara County v. Southern Pacific Railroad*. This case extended the constitutional principle of “equal protection under the law” to business corporations as well as individual human beings as “legal persons.”<sup>12</sup> (Some scholars, emphasizing that this case declared corporations to be “persons,” have urged a nefarious conspiracy theory claiming that corporate lawyers hijacked the Fourteenth Amendment designed to protect former slaves to serve corporate masters instead. But this historical interpretation has been debunked.<sup>13</sup>)

The *Santa Clara* case held that the aggregation of private property in a business corporation deserves constitutional respect (in the specific context of the assessment of an unequal corporate tax) because the property belonged, derivatively, to the individual investors in the enterprise.<sup>14</sup> In this manner, the Court adopted a bottom-up view of the individual interests represented by the corporation. The Supreme Court has more recently extended this legal notion of the constitutional protection of corporate “persons” in other contexts, such as in the controversial *Citizens United* case, which asserted First Amendment free-speech rights for business corporations in political elections.<sup>15</sup> Despite the top-down language of *Dartmouth*

(University of Chicago Press 2007) (1945), pp. 71–3. See also John Gray, *Hayek on Liberty* (Routledge, 3rd ed., 1998), pp. 25–55, 118–25.

<sup>10</sup> Hayek, *Law, Legislation, and Liberty: Volume 1, Rules and Order*, op. cit., pp. 35–54.

<sup>11</sup> Friedrich A. Hayek, *Law, Legislation, and Liberty: Volume 2, The Mirage of Social Justice* (University of Chicago Press 1976), pp. 108–9. See also Gray, *Hayek on Liberty*, op. cit., pp. 34–40. As Gray explains, Hayek’s idea of “spontaneous order” includes three distinct elements: (1) *an invisible-hand thesis* that “social institutions arise as a result of human action but not by human design”; (2) *a tacit or practical knowledge thesis* that “our knowledge of the world, and especially of the social world, is embodied first of all in practices and skills, and only secondarily in theories”; and (3) *a thesis of the natural selection of competitive institutions* that cultural traditions as “whole complexes of practices and rules of action and perception” undergo “continuous evolutionary filtering.” *Id.*, pp. 33–4. I do not address all of these elements here. Suffice it to say that I agree with Hayek that the bottom-up view of a “spontaneous order” describes one side of the theoretical problem of the nature of firms. But I emphasize the other side too: the top-down *taxis* of law as well as the bottom-up *kosmos* of self-organizing markets.

<sup>12</sup> 118 U.S. 394 (1886). See also Avi-Yonah, op. cit., pp. 793–4.

<sup>13</sup> See Mark, op. cit., pp. 1463 and n. 62. See also James Willard Hurst, *The Legitimacy of the Business Corporation in the United States, 1780 to 1970* (University Press of Virginia 1970), pp. 66–8 (finding insufficient evidence for this “conspiracy theory” of constitutional law).

<sup>14</sup> See Mark, op. cit., pp. 1463–4. For a more recent case limiting the principle of equal protection as applied to business corporations, see *Western and Southern Life Insurance Co. v. State Board of Equalization of California*, 451 U.S. 648 (1981). But cf. *Granholm v. Heald*, 544 U.S. 460 (2005) (voiding under the Commerce Clause legislation discriminating against out-of-state firms selling wine).

<sup>15</sup> *Citizens United*, op. cit. See Chapter 7 below for further discussion of this case.

*College*, then, some constitutional cases involving business enterprises adopt a bottom-up view, rather than simply allowing the government to adopt and enforce any new rules or impositions at all with respect to its “creatures.” The Supreme Court recognizes and protects constitutional rights for corporations and other business entities as “persons” in some cases but not others.<sup>16</sup>

The jurisprudence of recognizing business enterprises to have “personality” and treating them as “entities” is complex. Legal scholars who have ventured into this literature, however, have consistently identified three major legal theories of the business enterprise.<sup>17</sup> Two of these theories represent the top-down and bottom-up perspectives. I will label them the *concession theory* (top-down) and the *participant theory* (bottom-up). A third—which I will call the *institutional theory*—captures an intermediate perspective that views firms as existing at a social level between political states and individual people. The institutional theory helps to explain and clarify the meaning and usefulness of both top-down and bottom-up theories. These two legal theories remain important and often applicable, as long as either one or the other is not adopted as the only theoretical truth. In my view, the institutional theory allows for a coherent explanation of the main legal theories of the firm. For a schematic overview of some key features of these theories, see Table 1.1.<sup>18</sup>

The *concession theory* of business enterprise represents the top-down perspective of the political state. It holds that business enterprises, including corporations, are simply the creations of government. For example, the English East India Company existed because the King granted a charter to create it.<sup>19</sup> On this theory, it follows also that the act of creation authorizes the King to determine the nature and scope of the activities of his institutional “creature.”<sup>20</sup> From this perspective, business

<sup>16</sup> For treatments of this topic from different perspectives, see, e.g., Phillip I. Blumberg, *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (Oxford University Press 1993), pp. 24–5, 30–45; Jess M. Krannich, “The Corporate ‘Person’: A New Analytical Approach to a Flawed Method of Constitutional Interpretation,” 37 *Loyola University Chicago Law Journal* 61 (2005); Carl J. Mayer, “Personalizing the Impersonal: Corporations and the Bill of Rights,” 41 *Hastings Law Journal* 577 (1990); Larry E. Ribstein, “The Constitutional Conception of the Corporation,” 4 *Supreme Court Economic Review* 95 (1995); Note, “Constitutional Rights of the Corporate Person,” 91 *Yale Law Journal* 1641 (1982).

<sup>17</sup> The extent to which scholars agree on a tripartite division of the leading theories is remarkable. See Avi-Yonah, *op. cit.*, pp. 771 (noting that “the same three theories of the corporation” have recurred over the course of “two millennia”); H.L.A. Hart, “Definition and Theory in Jurisprudence,” in *Essays in Jurisprudence and Philosophy* (Oxford University Press 1983), pp. 24–5 (describing “three great theories of corporate personality”). See also John C. Coates IV, Note, “State Takeover Statutes and Corporate Theory: The Revival of an Old Debate,” 64 *New York University Law Review* 806, 808–24 (1989); Mark M. Hager, “Bodies Politic: The Progressive History of Organizational ‘Real Entity’ Theory,” 50 *University of Pittsburgh Law Review* 575, 579–80 (1989); Ron Harris, *op. cit.*, pp. 1423–4; Michael J. Phillips, “Reappraising the Real Entity Theory of the Corporation,” 21 *Florida State University Law Review* 1061, 1063–73 (1994); Sanford A. Schane, “The Corporation Is a Person: The Language of a Legal Fiction,” 61 *Tulane Law Review* 563, 564–9 (1987).

<sup>18</sup> This approach may represent an example of dialectical reasoning. On the usefulness as well as the dangers of triadic dialectical reasoning, see Karl R. Popper, “What Is Dialectic?” 49 *Mind* 403 (1940).

<sup>19</sup> This theory has also been called the “grant theory.” See, e.g., Mark, *op. cit.*, p. 1452.

<sup>20</sup> One theorist goes so far as to call this the “creature theory.” See, e.g., Schane, *op. cit.*, pp. 565–9. The metaphor has led some opponents of corporations to imagine them as artificial monsters. See, e.g., I. Maurice Wormser, *Frankenstein, Incorporated* (McGraw-Hill 1931).

Table 1.1 The main legal theories of the firm

	Social perspective	Primary focus
<i>Concession theory</i>	Top-down view that political states “grant” firms rights to exist	Government as law-giver
<i>Participant theory</i>	Bottom-up view that firms are created by the individual people who compose them	Individual participants
<i>Institutional theory</i>	Intermediate view that firms are understood as institutions both formed according to legal rules and organized and run by individual people	Firm itself as an “entity” (or group of entities)

firms exist only because governments say so. They exist, in other words, only “by concession” of government. This theory is compatible with strong versions of state capitalism. Firms are viewed as subordinate (and perhaps even subservient), and they are subject to strict government oversight and direction.<sup>21</sup>

The *participant theory* of business enterprise takes a bottom-up perspective of individual people who aggregate together within a firm. On this view, states may allow for the existence of firms, and governments may grant some of the original charters for companies and corporations. Once these authorizations are given, however, and once the individual participants invest their wealth, time, labor, and knowledge in advancing the purposes of the enterprise, there is a shift in legal emphasis over time. The individual participants begin to possess cognizable rights and interests within the firm that the state should not, according to this theory, extinguish by fiat.

The advent of legal templates for the creation of business organizations—such as the general incorporation statutes adopted in the United States and Great Britain in the nineteenth century and then spreading throughout the world—reinforced this bottom-up, participant theory of firms. General or “free” incorporation statutes were adopted first in the United States (at the level of different states, beginning with New York in 1811) followed closely by Great Britain (at the national level in 1844). They responded to political pressures against the “special privileges” of companies or corporations chartered by special acts of legislation or by monarchs.<sup>22</sup> Once governments removed themselves from the

<sup>21</sup> Friedrich von Savigny advanced an early version of this view in Germany. See, e.g., Katsuhito Iwai, “Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance,” 47 *American Journal of Comparative Law* 583, 601–2 (1999); Arthur W. Machen, Jr., “Corporate Personality,” 24 *Harvard Law Review* 253, 255 (1911).

<sup>22</sup> See Hurst, *op. cit.*, pp. 25–33, 135; Henry Hansmann, Reinier Kraakman, and Richard Squire, “Law and the Rise of the Firm,” 119 *Harvard Law Review* 1333, 1386–7, 1394–6 (2006); Mark, *op. cit.*, pp. 1450, 1453–4. The adoption of general incorporation statutes for businesses in the United States followed an earlier type of general incorporation statute for religious or charitable institutions which included for-profit businesses that could demonstrate a “public service,” such as insurance companies and banks. Ronald E. Seavoy, “The Public Service Origins of the American Business Corporation,” 52 *Business History Review* 30 (1978).

direct “chartering” of business firms (with continuing exceptions, such as government corporations or business licensing requirements), they tended to follow a version of the participant theory.

The approach of market capitalism followed by most countries today emphasizes free markets of self-organizing firms. This approach supports the participant theory of the firm, though competing varieties of market capitalism may have different views about who counts as a legitimate business “participant,” particularly with respect to regular or rank-and-file employees.<sup>23</sup> Some legal systems (and some firms) tend to recognize employees as true participants, and others tend to categorize employees as mere “inputs” to a firm’s production processes. These different views of firms, their relationship to government, and the role of employees (among other variables) reflect theoretical controversies in different disciplines, including law, economics, and political theory, as well as geographical and cultural differences.

In any event, the participant theory, broadly construed, maintains that the business enterprise is created as an aggregate entity by and for its participants. The firm “belongs” to its participants and not the government. This “belonging” of members to an organization depends on the recognition of this relationship by the legal order, as Hans Kelsen emphasized, which is much different than saying that the relationship depends directly on a top-down governmental authorization or “concession.”<sup>24</sup> The legal recognition of a firm follows from recognition of the aggregated rights and interests of the people who constitute it.

A third view develops an intermediate position. The *institutional theory* sees firms as socially established entities that are *both* authorized and recognized by governments *and* organized and managed by individual participants. The institutional recognition of the business enterprise as a legal “entity” or “person” interposes a conceptual separation between the political state and the firm’s individual participants. Once a regular legal process for the governmental recognition and individual creation of firms has become established, business firms become social institutions. In legal terms, they become “entities” and “persons” with specified legal rights and obligations. The most important of these rights and obligations (which are assumed without much reflection in legal practice today) include: (1) the holding of a legal name; (2) the designation of a place of residence or citizenship; (3) the ability to sue and be sued in court; (4) the power to own tangible and intangible property, including real estate and other capital; (5) the capacity to make contracts, incur debt, and enter into other financial arrangements in the name of the firm; and (6) the right to self-govern by adopting founding documents, bylaws, and other “private statutes.”<sup>25</sup>

<sup>23</sup> On “market capitalism” versus “state capitalism,” see Introduction, page 4 and accompanying note. Themes regarding this distinction are also further discussed in Chapters 3 and 5 below.

<sup>24</sup> Hans Kelsen, *General Theory of Law and State* (Anders Weberg trans.) (Harvard University Press 1945), pp. 98–9.

<sup>25</sup> See Williston, *op. cit.*, pp. 116–17 (quoting Coke and Blackstone on these points with respect to corporations). Most of these general rights and obligations apply to other basic legal forms of business

Law plays a dual role here, integrating top-down and bottom-up theories. First, the government adopts statutes, supplemented by judicial decisions, which set forth the “rules of the game” for the establishment and governance of firms. These rules are then adjusted over time and within constitutional limits to address various policy issues that arise. Constitutional limits in the United States, for example, include a prohibition of the expropriation or “taking” of the property of a business enterprise without “just compensation,” such as in the “nationalization” of a private business firm converting it to government ownership.

Second, individual participants rely on and use this established legal framework to create firms by entering into organizational contracts, as well as formally registering these firms with the government, when and if required. Individual participants arrange for the self-governance of their firms by doing the following: (1) adopting “constitutional” documents (such as the charter and by-laws of a corporation); (2) issuing governing resolutions via designated representatives (such as the board of directors in a corporation); and (3) following policies that authorize managers to run the firm through an ordering and structuring of the activities of subordinates.<sup>26</sup> (As discussed in Chapter 5 below, variations in the governance methods of firms depend in part on the legal type of firm selected, e.g. corporation, partnership, or limited liability company.)

The institutional theory of the firm is broad enough to encompass the main features of both the concession and participant theories. As such, it describes most of the world with respect to the legal structure of business enterprises today. This approach is also consistent with the philosophical and sociological approach to the firm that is advanced by “institutional” theorists in various disciplines. The institutional theory shows how the legal system squares the circle of social and individual perspectives on the firm, and it also allows for legal analysis and historical change over time from both “macro” and “micro” points of view.

Note that the institutional theory advanced here emphasizes the recognition of firms as “entities” and “persons,” but it does not require subscribing to what has been called the “real entity” theory associated most prominently and notoriously with the German legal theorist Otto von Gierke. The strongest version of this “real entity” theory holds that intermediary institutions such as business enterprises should be considered to have a metaphysically “real” existence and an “organic” institutional permanence separate from their individual participants.<sup>27</sup> Gierke even

enterprise, such as partnerships, but corporations tend to have the broadest array of powers as “entities” or “persons.” See Robert C. Clark, *Corporate Law* (Aspen 1986), pp. 15–21.

<sup>26</sup> Cf. Melvin Aron Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Little Brown 1976), p. 1 (“Corporate law is constitutional law; that is, its dominant function is to regulate the manner in which the corporate institution is constituted, to define the relative rights and duties of those participating in the institution, and to delimit the powers of the institution vis-à-vis the external world”).

<sup>27</sup> For an account of this theory and its influence in the English-speaking world through the translations of Frederic Maitland and Ernst Freund (among others), see Mark, *op. cit.*, pp. 1464–78. See also William W. Bratton, Jr., “The New Economic Theory of the Firm: Critical Perspectives from History,” 41 *Stanford Law Review* 1471, 1490–1 (1989).

went so far as to posit a “physico-spiritual unity” of a “real corporate personality.”<sup>28</sup> No such metaphysical assertions are made here. Instead, my argument is that business enterprises are social institutions created by human beings—and thus both “artificial” and “fictional” (rather than metaphysically “real”). Nevertheless, firms have a social ontological existence because they are artificial fictions that are legally reinforced in the real world. They are therefore “fictions” that become “real” and “actual” in an everyday, pragmatic sense.

An institutional theory of the business enterprise that recognizes both the top-down authority of government and the bottom-up authority of participants in intermediate institutions is consistent with the jurisprudence of Robert Cover. In Cover’s view, law is best conceived as having a bottom-up feature—a norm-generating “jurisgenesis”—as well as a top-down “imperial” aspect.<sup>29</sup> Various non-state institutions, including religions and other organizations, develop a plurality of normative systems or worlds (*nomos*). Governments then act through statutes and other legally enforceable rules to establish an “imperial” order in particular areas of social life and conduct. Courts and judges hold an intermediate position. They are “jurispathic” in that they suppress associational norms when they conflict with “imperial” law. On one hand, then, judges are “people of violence” because they impose a single law within their jurisdiction backed by the force of the state. On the other hand, judges are “people of peace” because they often play the role of finding compromises and resolving disputes between normative worlds without resorting to violence.<sup>30</sup>

Cover writes that “modern corporation law continues to bear the formal character of a grant of norm-generating authority” in the United States and, to extend his argument, elsewhere in the world. Cover refers to “company town[s]” and the original Massachusetts Bay colony in the United States as historical examples of strongly independent norm-generating associations.<sup>31</sup> The delegation of internal law-making authority to promoters, organizers, and managers of firms remains a strong feature of contemporary enterprise law. Business participants make their own rules—and create their own “nomos”—subject to the “imperial” constraints of governing law.

Although political states have often suppressed business enterprises (and other independent groups) or bent them to serve only political purposes in the manner of Roman emperors, the *longue durée* of history suggests that the idea of “associational autonomy” has become relatively strongly established in many places in the world.<sup>32</sup> To this extent, non-state institutions—including but not limited to business enterprises—become a source of bottom-up normative arguments for

<sup>28</sup> Iwai, *op. cit.*, p. 616 (citing Maitland).

<sup>29</sup> Robert M. Cover, “The Supreme Court, 1982 Term—Foreword: Nomos and Narrative,” 97 *Harvard Law Review* 4, 4–18 (1983).

<sup>30</sup> *Id.*, pp. 40–6, 53.

<sup>31</sup> *Id.*, pp. 30–1.

<sup>32</sup> *Id.*, pp. 31–2. See also Eric W. Orts, “A Short History of the Business Enterprise” (unpublished manuscript, available from the author on request). For interdisciplinary treatments of “associational autonomy,” see *Freedom of Association* (Amy Gutmann ed.) (Princeton University Press 1998).



the authority to make their own legal rules and interpretations. For Cover, the norm-generating features of freedom of association should translate into the legal recognition of the rights of certain groups. In his words: "Freedom of association implies a degree of norm-generating autonomy on the part of the association. It is not a liberty to *be* but a liberty and capacity to create and interpret law—minimally, to interpret the terms of the association's own being."<sup>33</sup> At the same time, the exercise of this associational freedom is subject to legal limits.

Influential theorists have argued forcefully against a need to select among the several different legal theories of the business enterprise described above. H.L.A. Hart, for example, argues that "though these theories spring from the effort to define notions actually involved in the practice of a legal system they rarely throw light on the precise work they do there."<sup>34</sup> He recommends a practical institutional approach. Hart brushes aside unhelpful debates, such as whether a firm is "a mere abstraction, a fiction, a metaphysical entity," and he calls for closer attention to "the legal rules of the game" about how terms such as the "corporation" are actually used and what legal consequences follow.<sup>35</sup>

Similarly, John Dewey surveys the debates surrounding the idea of corporate personality and recommends caution. The idea of a legal "person," he says, is empty: it "signifies what law makes it signify." If one agrees that the legal reference to a "person" is simply to designate "a right-and-duty-bearing unit," then the most important questions shift from "regarding the nature of things" to thinking "in terms of consequences."<sup>36</sup>

In my view, both Hart and Dewey support a pragmatic institutional approach to legal theories of the business enterprise.<sup>37</sup> Dewey warns against relying too heavily on either the "concession theory" or the "fiction theory" because they have been used historically to support conflicting ends that are politically or otherwise determined.<sup>38</sup> He concludes that attention should focus on "concrete facts and

<sup>33</sup> Cover, *op. cit.*, p. 32 (original emphasis). For a controversial case in which the U.S. Supreme Court recognized a "right of expressive association" for groups, see *Boy Scouts of America v. Dale*, 530 U.S. 640 (2000) (striking down a state law prohibiting discrimination on the basis of sexual orientation as a violation of associational rights). But see *Roberts v. United States Jaycees*, 468 U.S. 609 (1984) (holding that a private business group did not have the right to exclude women); *Rumsfeld v. Forum for Academic and Institutional Rights, Inc.*, 547 U.S. 47 (2006) (upholding military recruiting access requirement to universities against a group-rights challenge).

<sup>34</sup> Hart, "Definition and Theory in Jurisprudence," *op. cit.*, p. 25.

<sup>35</sup> *Id.*, pp. 43–7.

<sup>36</sup> John Dewey, "The Historic Background of Corporate Legal Personality," 35 *Yale Law Journal* 655, 655–6, 660 (1926).

<sup>37</sup> Some may object that my interpretation of support by Hart and Dewey for an institutional theory is misplaced. Dewey in particular has been given credit (or blame) for contributing to "the decline of corporation theory" in the United States. Mark, *op. cit.*, pp. 1478–83. See also Bratton, *op. cit.*, pp. 1508–10 (discussing Dewey's influence on legal scholars). A close reading of Dewey, however, suggests that he did not take the extreme position that the idea of legal personality should be abandoned. Dewey argued only that the idea itself should not drive legal and policy-related conclusions about the rights and obligations of legal persons. Hard policy questions remain concerning the definition and boundaries of organizational legal persons, but this does not mean that the "persons" themselves somehow disappear from the analysis.

<sup>38</sup> Dewey, *op. cit.*, pp. 655–7, 663–9.

relations” rather than theories of legal personality.<sup>39</sup> Attention to the “concrete facts and relations” of the firm leads to a consideration of how the law creates these institutions, what the rules of the game are for them, and what social consequences obtain. The “concrete facts and relations” of the business enterprise refer, at least in part, to the legal infrastructure that permits their construction, recognizes them, and channels their activities. In addition, Dewey observes that legal results related to corporate personality have been driven by many different “non-legal considerations,” including “considerations popular, historical, political, moral, philosophical, metaphysical and, in connection with the latter, theological.”<sup>40</sup> These policy considerations should be made explicit.

Hart expresses a similar view when he argues that “the essential elements of the legal corporation” become visible through how legal rules apply in particular contexts and circumstances to express a “unity” or “identity” in the actions of groups of people.<sup>41</sup> The complexity of law, however, requires analytical care: one should not extrapolate a finding of legal “identity” under one set of circumstances to apply without reflection to another set of circumstances. (This concern relates also to the issue of the shifting boundaries of firms discussed further below, especially in Chapters 4, 5, and 6.)

A legal theory that sees the business firm as institutionally created can embrace in a pragmatic and therefore substantively open fashion the elements of the two other main theories, which focus on the prerogatives of both government and participants, respectively. One may read Dewey to say that adopting an intermediate institutional theory of this kind commits one to taking a substantive political and economic position.<sup>42</sup> And this is true to a degree. At a minimum, the institutional theory assumes that both government and business participants have legitimate, substantive claims that deserve recognition. To this extent, the institutional theory does not adopt an entirely “positive” legal theory. It recognizes substantive institutional limits that extend minimal necessary roles to both governments and business participants, thus combining elements of both concession and participant theories.<sup>43</sup>

The institutional theory of the firm is minimalist with respect to substantive political content because it leaves open for elaboration both (1) what substantive legal rules and restrictions government may impose; and (2) how far the aims and interests of business participants should be legally protected.<sup>44</sup> In other words, the

<sup>39</sup> *Id.*, p. 673.

<sup>40</sup> *Id.*, p. 655.

<sup>41</sup> Hart, “Definition and Theory in Jurisprudence,” *op. cit.*, p. 30.

<sup>42</sup> Dewey, *op. cit.*, pp. 670–3. Specifically, Dewey makes this point against the early organic or “real entity” theorists such as Gierke, as well as more recent interpreters such as Harold Laski. *Id.* See also Harold J. Laski, “The Personality of Associations,” 29 *Harvard Law Review* 404 (1916).

<sup>43</sup> Cf. H.L.A. Hart, *The Concept of Law* (Oxford University Press, 2nd ed., 1997), pp. 193–200 (describing a “minimum content of natural law” included in a theory of positive law). I will not elaborate extensively on the jurisprudential implications, except to say that the institutional legal theory of the firm advanced here is compatible with several different jurisprudential orientations, including most if not all contemporary versions of legal positivism, legal realism, and natural law theory.

<sup>44</sup> One may take a stronger *political* position with respect to the usefulness or normative desirability of societies that recognize, respect, and encourage the formation of intermediate non-state institutions, including business enterprises. These justifications might include an argument in favor of a vibrant

scope and breadth of substantive claims made by government (for regulation) and business participants (for limits on regulation and protection of their rights and interests) remain open for determination—both theoretically (through scholarly study and policy debate) and institutionally (through legal and political processes). Following the advice of Hart and Dewey, it makes better sense to decide specific policy questions with respect to the law applicable to business firms in particular contexts and situations rather than in general.

In addition, an institutional approach allows for the possibility that multiple values and purposes may apply to decide particular regulatory questions. Relatively open procedural methods, such as democratic government and deliberative judicial decisions, enable choices among different values and purposes to apply in different situations, depending on the social context and the legal questions raised. Different values may also apply more strongly in some circumstances than others. For example, the economic consequences of a particular legal rule are not always easily known or estimated, and in these cases ethical arguments may have stronger persuasive force.

An institutional theory of the firm describes a broad middle ground between the extremes that result from strict adherence to either a concession theory or a participant theory. Again, this institutional theory provides a moderate perspective by (1) recognizing that governmental regulation of firms makes sense on a policy level, but leaving open the substantive content and scope of this regulation for elaboration through political and legal processes; and (2) recognizing that some of the prerogatives and rights of individual participants represented in business firms deserve legal protection against government intrusion.

On one hand, with respect to the prerogatives of government, multiple alternative policy objectives are available for selection. Some economists and law-and-economists advocate the objective of promoting economic efficiency and overall wealth creation. This value is sometimes promoted as the only permissible objective to pursue in business regulation.<sup>45</sup> Neo-mercantilist or “industrial policy” proponents aim to advance national economic development, which has been one justification used to support state capitalism and the promotion of nationalistic economic competition among different varieties of market capitalism.<sup>46</sup> In contrast with economics, philosophers often advocate justice and fairness as policy alternatives that focus, for example, on the inequality of wealth distribution.<sup>47</sup> They may appeal

“civil society” (as well as governmental protection of individual rights) and an argument that the existence of independent organizations of sufficient size and strength provide an institutional check on tendencies toward absolute government. But these questions of political theory lie outside the scope of this book.

<sup>45</sup> See, e.g., Louis Kaplow and Steven Shavell, “Fairness Versus Welfare,” 114 *Harvard Law Review* 961 (2001) (arguing that values of social welfare should trump other considerations).

<sup>46</sup> For an example of a debate along these lines with respect to national U.S. and Japanese policies in the 1980s, compare Robert B. Reich, “Making Industrial Policy,” 60 *Foreign Affairs* 852 (1982), with Charles L. Schultze, “Industrial Policy: A Dissent,” 2 *Brookings Review* 3 (1983).

<sup>47</sup> See, e.g., Liam Murphy and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford University Press 2002) (arguing in favor of “negative” and “progressive” taxes from considerations of justice and fairness); Jared D. Harris, “What’s Wrong with Executive Compensation?” 85 *Journal of*

also to other basic moral values such as honesty (e.g. the prohibition of fraud) or respect for property (e.g. the prohibition of theft). These moral values derive from either deontological (duty-based) or utilitarian (consequentialist) moral principles.<sup>48</sup> Laws against insider trading, for example, may express primarily moral rather than economic principles.<sup>49</sup> Governments may adopt any of these multiple values or objectives and promote them through the enactment and interpretation of laws applicable to business enterprise.

On the other hand, a concern for the legal protection of the rights and interests of business participants recommends limits on governmental regulation, including (1) a prohibition of “takings” of private property (including business capital and financial investments) without compensation; and (2) guarantees of basic freedoms of self-organization and association.<sup>50</sup> These kinds of constitutional and other legal limitations recognize that business firms are “self-created” rather than “state-created.”<sup>51</sup> Takings jurisprudence, which draws difficult conceptual lines between private property and its permissible regulation, fits also within a more general idea in constitutional law of protecting settled expectations, especially with respect to property interests, while recognizing that the legal definition of property itself changes over time.<sup>52</sup> Future-oriented, forward-planning business people tend to value stability, certainty, and the preservation of “settled expectations” in the law, which may also support other social and economic objectives.<sup>53</sup> The growth of sustainable long-term economic development and cultural cohesion may depend in part on a relatively stable legal order.

*Business Ethics* 147 (2009) (examining executive compensation levels on ethical grounds). For a critique of U.S. corporate law for ignoring concerns about wealth distribution, see Ronald Chen and Jon Hanson, “The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law,” 103 *Michigan Law Review* 1, 121–5 (2004).

<sup>48</sup> A line between deontological theories (positing fundamental moral duties) and utilitarian theories (deriving moral principles from expected or proven social consequences, most often in terms of measures of human welfare) divides modern ethical philosophy. See, e.g., Dale Jamieson, “Method and Moral Theory,” in *A Companion to Ethics* (Blackwell Publishers 1993), p. 477. Other theoretical views are possible which prioritize a process of “moral theorizing” in practical circumstances rather than looking to apply a priori principles. See, e.g., id., pp. 478–86. For an attempt to unify competing ethical theories, see Derek Parfit, *On What Matters*, vol. 1 (Oxford University Press 2011).

<sup>49</sup> See, e.g., Alan Strudler and Eric W. Orts, “Moral Principle in the Law of Insider Trading,” 78 *Texas Law Review* 375 (1999).

<sup>50</sup> On constitutional “takings,” see, e.g., Richard A. Epstein, *Takings: Private Property and the Power of Eminent Domain* (Harvard University Press 1985); William A. Fischel, *Regulatory Takings: Law, Economics, and Politics* (Harvard University Press 1995). On freedom of association, see pages 16–17 and accompanying notes 32–3.

<sup>51</sup> Laski, op. cit., p. 413.

<sup>52</sup> See Laurence H. Tribe, *American Constitutional Law* (Foundation Press, 2nd ed., 1988), pp. 587–613.

<sup>53</sup> See Frederic R. Coudert, *Certainty and Justice: Studies of the Conflict Between Precedent and Progress in the Development of the Law* (D. Appleton 1914). For a theory emphasizing the preservation of expectations, see Niklas Luhmann, *Law as a Social System* (Klaus A. Ziegart trans.) (Fastima Kastner et al., eds.) (Oxford University Press 2004); Niklas Luhmann, *A Sociological Theory of Law* (Elizabeth King and Martin Albrow trans.) (Routledge and Kegan Paul 1985). See also Thomas D. Barton, “Expectations, Institutions, and Meanings,” 74 *California Law Review* 1805 (1986) (book review).

## Two extremes: concession theory and participant theory

By embracing the perspectives of both government and business participants, the institutional theory of the firm described here is consistent with most existing legal systems in the world today. The substantive virtues of this institutional theory are illustrated by considering the extreme outcomes that would follow from adhering *only* to the concession theory or *only* to the participant theory.

The concession theory, taken alone, is too authoritarian with respect to the business enterprise. It may have appealed to ancient Roman emperors and old English monarchs, but in part exactly for this reason it conflicts with a contemporary viewpoint that accords basic respect to individual human rights, including positive freedoms of association and negative freedoms against arbitrary dispossession.<sup>54</sup> To subject business enterprises entirely to the whims of government (even one that is democratically elected) would run roughshod over the most basic rights that most countries today recognize for individual citizens—who are also individual participants in business firms—such as human rights to property and freedom of association. The Universal Declaration of Human Rights, for example, enshrines the following provisions.

- “Everyone has the right to own property alone as well as in association with others.”<sup>55</sup>
- “No one shall be arbitrarily deprived of his [or her] property.”<sup>56</sup>
- “Everyone has the right to freedom of peaceful assembly and association.”<sup>57</sup>
- “Everyone has the right to work, to free choice of employment, to just and favorable conditions of work and to protection against unemployment.”<sup>58</sup>

Most nation-states provide for similar or analogous legal protections of these rights in their constitutions or basic laws.<sup>59</sup>

Some modern versions of state capitalism adopt a strong concession view, which influential policy makers seem to hold today in China, Russia, and elsewhere, which can often violate basic rights. This view, at least when taken to its extreme, is incompatible with the varieties of capitalism (and their accompanying legal regimes) that recognize and respect basic political and economic rights. And it

<sup>54</sup> For the distinction between positive and negative freedom, see Isaiah Berlin, “Two Concepts of Liberty,” in Isaiah Berlin, *The Proper Study of Mankind: An Anthology of Essays* (Farrar, Straus and Giroux 1998) (Henry Hardy and Roger Hausheer eds.), pp. 191–242. The value of freedom to engage in economic activity, including participation in private business enterprise, is also central in Hayekian theory. See, e.g., Hayek, *Law, Legislation, and Liberty: Volume 1, Rules and Order*, op. cit.; Hayek, *Law, Legislation, and Liberty: Volume 2, The Mirage of Social Justice*, op. cit.

<sup>55</sup> Universal Declaration of Human Rights (1948), sect. 17(1).

<sup>56</sup> Id., sect. 17(2).

<sup>57</sup> Id., sect. 20(1).

<sup>58</sup> Id., sect. 23(1).

<sup>59</sup> See, e.g., Jeremy Waldron, *The Right to Private Property* (Oxford University Press 1988), p. 18 (noting protection of property rights “around the world”).

almost goes without saying that these rights of associational freedom, property ownership, and labor must be respected in actual practice as well as simply written into formal constitutions or statutes.

Extreme versions of the participant theory of the firm also go too far. Standing alone, this theory amounts to nothing much more than a theory of anarchy (or at least a very strong libertarianism). On its own terms and taken to its logical conclusion, this theory of the firm asserts that *only* the interests of individual participants matter. Even though the legal framework that makes firms possible is provided by government—in addition to any specific organizational privileges that might be extended (such as limited liability, discussed further below and in Chapter 4)—the extreme version of this theory posits that government should refrain from setting *any* limits to what participants may do through the organization and use of firms. Some of the so-called *Lochner*-era cases of the U.S. Supreme Court in the 1930s, which struck down broad-based business regulations such as minimum-wage laws as unconstitutional infringements of basic rights to “liberty,” approached this extreme.<sup>60</sup> To forbid any government regulation of business enterprises that would abridge private contracts or private property would swing the institutional pendulum too far in the direction of protecting entrenched business participants and disregarding legitimate public interests expressed through government.

Admitting that business firms play a central role in modern social life and therefore share an institutional responsibility for negative as well as positive consequences for their actions should prove sufficient to demonstrate that adopting an extreme version of the participant theory goes too far. Given the foundational role of government in providing the legal infrastructure for firms, it seems relatively uncontroversial that some level of further regulation may be needed (with the extent and scope of the regulation left open for further elaboration). This regulation may include both the prohibition of harmful activities and the encouragement of positive actions by firms. In economic terms, regulation may counter “negative externalities” (such as environmental pollution) and encourage “positive externalities” (such as reducing crime by encouraging the expansion of employment).<sup>61</sup> In fact, the very idea of an economic “externality” assumes a corresponding organizational “internality.” It is within firms that the *internal* economic calculations and decisions are made—which do not include the *external* social costs or benefits that these decisions may impose outside of the firm. Economic accounts of “externalities” regarding business decision-making therefore recognize (at least implicitly) the institutional existence of firms as real legal “persons” or “entities” that follow internal self-governing processes.

<sup>60</sup> For a review of cases, see Laurence H. Tribe, *American Constitutional Law*, vol. 1 (Foundation Press, 3rd ed., 1999), pp. 1332–81. Even at the high-water mark of this era, however, more regulatory measures were constitutionally upheld than struck down. *Id.*, p. 1344 and n. 4.

<sup>61</sup> See, e.g., Harold Demsetz, “Toward a Theory of Property Rights,” *57 American Economic Review* 347, 348–9 (1967).

President Woodrow Wilson may have expressed the point too strongly when he said:

A corporation [or other business firm] exists, not of natural right, but only by license of law, and the law, if we look at the matter in good conscience, is responsible for what it creates. . . . If law is at liberty to adjust the general conditions of society itself, it is at liberty to *control* these great instrumentalities which nowadays, in so large part, determine the character of society.<sup>62</sup>

Wilson's use of the word "control" suggests that he may fall somewhat closely to the extreme of the concession theory rather than an institutional perspective.<sup>63</sup> A more moderate interpretation of Wilson's observation, however, seems difficult to deny: namely, that the government should play an important role in setting the ground rules and basic operational parameters for the creation, organization, and management of business enterprises. From the perspective of legal theory, the substantive provisions of the regulation of business firms (as well as constitutional or other structural limitations on such regulation) are best left open for elaboration through political and deliberative processes.

If contemporary China and Russia are places where concern about an overly rigorous application of the concession theory of business enterprise is justified, the United States may illustrate the perils of adopting an extreme version of the participant theory. At present, the business-related jurisprudence in the mainstream of academic law in the United States (and, to a lesser extent, in other English-speaking countries) borrows its substantive legal theories of the firm mostly from the discipline of economics, following the success (in terms of institutional influence in leading law and business schools) of the law-and-economics movement.<sup>64</sup> This approach tips the balance too far toward participants and against government interests.

Law-and-economics is well-described as "a leading example of a highly successful legal ideology" with particularly strong influence in business-related fields, including the law of enterprise organization.<sup>65</sup> (Note that to say that a philosophical or jurisprudential movement is "ideological" is not to say that other approaches are "non-ideological." The question is rather whether the theoretical assumptions and views expressed are right, true, or useful.) Law-and-economics as a jurisprudential

<sup>62</sup> Woodrow Wilson, Governor's Inaugural Address, Minutes of Assembly of New Jersey, January 17, 1911, pp. 65, 69, reprinted in *The Public Papers of Woodrow Wilson* (Ray Stannard Baker and William E. Dodd, eds.) (Harper 1925–7), vol. II, pp. 273–5, and quoted in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 559 n. 37 (1933) (Brandeis, J., dissenting in part) (emphasis added).

<sup>63</sup> Prior to becoming President, Woodrow Wilson played a significant historical role in the development of corporate law in the United States as Governor of New Jersey. The state of New Jersey had become a haven for incorporations, and then Governor Wilson led a charge for reform. As a result, many leading corporations moved to incorporate themselves in Delaware (which had copied New Jersey's permissive statute)—following a famous "race to the bottom" (or, according to scholars favoring regulatory competition, a "race to the top") in U.S. corporate law. For an overview, including Wilson's role, see Christopher Grandy, "New Jersey Corporate Chartermongering, 1875–1929," 49 *Journal of Economic History* 677 (1989). See also Chen and Hanson, *op. cit.*, p. 143.

<sup>64</sup> For the classic and most influential example of this approach, see Richard A. Posner, *Economic Analysis of Law* (Aspen, 7th ed., 2007).

<sup>65</sup> Spencer Weber Waller, "The Law and Economics Virus," 31 *Cardozo Law Review* 367, 367–8, 379–90 (2009).

movement has had deep influence, especially in U.S. law schools. One recent historical analysis concludes: "Simply measured in terms of the penetration of its adherents in the legal academy, law and economics is the most successful intellectual movement in the law in the last thirty years, having rapidly moved from insurgency to hegemony."<sup>66</sup>

The influence of economic theories with respect to the business enterprise has been especially acute.<sup>67</sup> The currently dominant economic theories of the firm focus almost exclusively on individual participants—a consequence of methodological individualism. Law-and-economics jurisprudence with respect to business firms tends therefore to favor the principles of freedom of contract, freedom of association, and the protection of private property of the *participants* in business rather than to adopt the perspective of *government*. In other words, a deregulatory and even anti-regulatory bias (except perhaps for regulatory or constitutional protection of individual participants' rights) is built into a legal theory that takes contemporary neoclassical economic models as its guide. There are exceptions, and law-and-economics scholarship has grown to become highly diverse normatively as well as methodologically. It is also quite possible for economic analysis to take a broader view. For example, one well-known founder of law-and-economics has focused his fire on both *the failure of government* to regulate in a manner that would have prevented or at least significantly reduced the risks of the financial meltdown of 2008, as well as on *the failure of economists* to predict the problems.<sup>68</sup> Nevertheless, the overall bias or critical "tilt" of law-and-economics scholarship is well-known and derives from the underlying theoretical positions taken by the leading neoclassical economists.<sup>69</sup> Recent historical accounts reveal also that at least some of the influence of law-and-economics derives from anti-regulatory political as well as intellectual sources, especially through the funding of private think tanks and law-and-economics centers in law schools.<sup>70</sup>

<sup>66</sup> Steven M. Teles, *The Rise of the Conservative Legal Movement: The Battle for Control of the Law* (Princeton University Press 2008), p. 216. For an assessment of the influence of law and economics from an insider to the movement, see William M. Landes, "The Empirical Side of Law & Economics," 70 *University of Chicago Law Review* 167 (2003). See also Robert C. Ellickson, "Trends in Legal Scholarship: A Statistical Study," 29 *Journal of Legal Studies* 517 (2000) (finding an increase in law-and-economics work published in law journals from 1982 to 1996); William M. Landes and Richard A. Posner, "The Influence of Economics on Law: A Quantitative Study," 36 *Journal of Law and Economics* 385 (1993) (finding significant increases in terms of citation counts of law-and-economics work).

<sup>67</sup> For a heavily influential example in U.S. corporate law, see Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1996). See also Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford University Press 2007) (applying economic analysis in British law); Reinier R. Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 2nd ed., 2009) (applying economic analysis in comparative perspective). For another leading source that employs economics as its lodestar, see William A. Klein, John C. Coffee, Jr., and Frank Partnoy, *Business Organization and Finance: Legal and Economic Principles* (Foundation Press, 11th ed., 2010).

<sup>68</sup> Richard A. Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Harvard University Press 2009); Richard A. Posner, *The Crisis of Capitalist Democracy* (Harvard University Press 2010).

<sup>69</sup> For a critique along these lines, see Chen and Hanson, op. cit., pp. 7–66.

<sup>70</sup> See Kim Phillips-Fein, *Invisible Hands: The Businessmen's Crusade Against the New Deal* (W.W. Norton 2009), pp. 162–3, 167; Teles, op. cit., pp. 90–134, 181–219.



In any event, most law-and-economics views of the firm, including so-called “contractarian” theories of the firm discussed in Chapter 2, adopt a relatively extreme version of the participant theory of the firm. Dissenting legal academics warned that followers of law-and-economics who adopted an exclusively “aggregate” rather than an “entity” theory of the business firm would lead to unpleasant consequences, but their voices were not heeded.<sup>71</sup> The global financial meltdown beginning in 2008—which most observers believe to have been caused mainly by a combination of factors including general deregulation, an overly laissez-faire approach to investment banking, and the under-regulation of new financial products (such as credit default swaps, subprime mortgages, and various kinds of securitizations)—may have taken the shine off the deregulatory presumptions of traditional law-and-economics.<sup>72</sup> As of this writing, however, the larger global trends with respect to regulation and the influence of traditional law-and-economics in the United States and elsewhere are unclear.

In addition, the business participants considered most relevant for law-and-economics theories, which closely follow neoclassical economic models, are capital investors or “owners.” One can roughly divide capital investors in business enterprises into the categories of “creditors” (who make various kinds of loans) and “equity owners” (including both shareholders in corporations and investing members of other firms such as partners who claim a share of residual profits of a business). Some legal theorists continue to insist on a distinction between debt and equity as essential, but actual practice has become more complex, including the use of hybrid debt–equity instruments.<sup>73</sup> Blurring the distinction between debt and equity is not new. As one commentator worried as early as 1928:

Stockholders and creditors are . . . two distinct classes of people, whose interests in the corporation are of such different natures as to be often diametrically opposed. . . . Should resort to devices under which rights are conferred to be either the one or the other, as expediency may later dictate, continue to grow in popularity, the effect must be the ultimate breaking down of the barrier between stockholders and creditors, a result which will necessitate the re-writing of an important part of the law of corporations.<sup>74</sup>

In contemporary practice, a “financial revolution” in investment products and options has indeed expanded the focus of financial views of the firm beyond simple assumptions of “shareholders as owners” and challenged the mantra of “shareholder value maximization” as the univocal objective of corporate firms.<sup>75</sup>

<sup>71</sup> See Bratton, *op. cit.*; David Millon, “Theories of the Corporation,” 1990 *Duke Law Journal* 201, 201–4, 220–31 (1990). For an early critique, see also Arthur Allen Leff, “Economic Analysis of Law: Some Realism about Nominalism,” 60 *Virginia Law Review* 451 (1974).

<sup>72</sup> See Preface, page xv and accompanying note 25.

<sup>73</sup> For further explanation, see Eric W. Orts, “Shirking and Sharking: A Legal Theory of the Firm,” 16 *Yale Law and Policy Review* 265, 306–9 (1998).

<sup>74</sup> E. Ennalls Berl, “The Vanishing Distinction Between Creditors and Stockholders,” 76 *University of Pennsylvania Law Review* 814, 822–3 (1928).

<sup>75</sup> See Henry T.C. Hu, “New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare,” 69 *Texas Law Review* 1273 (1991); Peter H. Huang and Michael S. Knoll, “Corporate Finance, Corporate Law, and Finance Theory,” 74 *Southern California Law*

Much more narrowly but nevertheless predominantly, many economists and law-and-economists hold the view that the business participants who matter most are the equity investors: for example, shareholders in corporations rather than creditors or lenders. When taken into legal theory unadulterated, this economic view of the firm threatens to reduce the scope of policy analysis by focusing only on a select group of business participants (and arbitrarily excluding others) and at the same time ignoring the larger institutional and legal realities of firms. Even for theories that focus only on the financial ownership of firms, it is now recognized that a focus on the “entity” of the firm (and various entities often constructed within firms) is required in order to make sense of competing financial claims, at least when conflicts arise among equity owners, creditors, and the many “hybrid” financial interests in modern firms.<sup>76</sup>

In addition, other business participants are considered important in different societies—sometimes equally so—including non-owner managers and employees as well as other capital providers and financial owners. The varieties of capitalism in different parts of the world today are distinguished in part by the different levels of legal protection provided to various groups of participants within firms. (A complete specification of the “varieties of capitalism” in the world today is beyond the scope of this book.<sup>77</sup> For the purposes here, I simply assume that several varieties of capitalism exist and elaborate how law contributes to the creation and maintenance of some aspects of this variety.) Politics as well as economics determine the relative legal status accorded to different participant groups in different countries. Variations are also negotiated in the form of specific organizational contracts and property structures (such as different voting and profit-participation rights for different equity and debt interests). One useful global analysis of interests within firms and the relative legal protections accorded to them in different countries refers to a tripartite divide within large firms among the following main groups: (1) investors (notably shareholders as well as creditors); (2) managers; and (3) other

*Review* 175 (2000); Frank Partnoy, “Financial Innovation in Corporate Law,” 31 *Journal of Corporate Law* 799 (2006); Raghuram G. Rajan and Luigi Zingales, “The Influence of the Financial Revolution on the Nature of Firms,” 91 *American Economic Review* 206 (2001).

<sup>76</sup> See, e.g., Hu, *op. cit.*, pp. 1306–9. On the misuse of business entities in several high-profile scandals, see also William W. Bratton and Adam J. Levitin, “A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs,” 86 *Southern California Law Review* (forthcoming 2013).

<sup>77</sup> On different systems, see, e.g., *Big Business and the Wealth of Nations* (Alfred D. Chandler, Jr. et al. eds.) (Cambridge University Press 1997); *Creating Modern Capitalism: How Entrepreneurs, Companies, and Countries Triumphed in Three Industrial Revolutions* (Thomas K. McCraw ed.) (Harvard University Press 1997); *A History of Corporate Governance Around the World* (Randall K. Morck ed.) (University of Chicago Press 2005); *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Peter A. Hall and David Soskice eds.) (Oxford University Press 2001). See also William J. Baumol, Robert E. Litan, and Carl J. Schramm, *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity* (Yale University Press 2007); Charles Hampden-Turner and Alfons Trompenaars, *The Seven Cultures of Capitalism: Value Systems for Creating Wealth in the United States, Britain, Japan, Germany, France, Sweden, and the Netherlands* (Doubleday 1993); Ronald Dore, William Lazonick, and Mary O’Sullivan, “Varieties of Capitalism in the Twentieth Century,” 15 *Oxford Review of Economic Policy* 102 (1999).

employees.<sup>78</sup> A purely economic analysis of the firm focused only on financial owners elides the competing and often conflicting interests of these different groups.

### The existence of firms as persons

Following an exclusive focus on business participants rather than the firm as an institution, one standard economic view has been to consider firms as merely “fictions”—thus recapitulating the misuse of a single theory of legal personality warned against by the likes of Hart and Dewey.<sup>79</sup> Some economists, when pushed on the subject, conclude that there is really no topic for a theory of the firm to address at all. Eugene Fama, for example, is fairly explicit with respect to the implications of his financial theory of the firm. Rejecting “classical models” of the firm that emphasize ownership and management of assets, Fama sees the firm as “a set of contracts among factors of production, with each factor motivated by its self-interest.”<sup>80</sup> On this view, the “ownership of the firm” is “an irrelevant concept.”<sup>81</sup> The logical conclusion: There are no firms, but only an immense aggregate of individuals contracting and trading with each other. Firms, to the extent that they exist, are merely one form among many “sets of contracts” that may be chosen. This conclusion is not surprising, given that a method focusing only on individuals—namely, the set of human beings who enter into contracts and own property—is assumed at the beginning of the analysis. In other words, “firms” as entities or persons with an ontological reality separate from the human beings that constitute them are not believed to exist because of a priori methodological assumptions. Human beings exist, but firms don’t.

The institutional reality of business enterprises belies this assertion of the non-existence of firms. Asserting the non-existence of firms from an economic perspective denies or at least misunderstands the role of law in the institutional creation, construction, and maintenance of firms. It also flies in the face of a blizzard of contrary perspectives from other disciplines, including law, which reveal and explain the social reality of firms.

Note that even the starting assumption of a natural human being as the relevant “person” or unit assumed for economic analysis is problematic and requires law for definition and recognition. As the legal scholar Joseph Vining observes: “There is no such thing as a natural person [in law]. . . . A human being shifts among any

<sup>78</sup> Peter A. Gourevitch and James Shinn, *Political Power and Corporate Control: The New Global Politics of Corporate Governance* (Princeton University Press 2005), pp. 10–13, 57–83, 95–278.

<sup>79</sup> See, e.g., Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” 3 *Journal of Financial Economics* 305, 310–11 (1976).

<sup>80</sup> Eugene F. Fama, “Agency Problems and the Theory of the Firm,” 88 *Journal of Political Economy* 288, 289 (1980).

<sup>81</sup> *Id.*, p. 290.

number of identities during the day, during the year, and during his or her life: sports player, parent, drug taker, dancer, corporate director, juror, investor, automobile salesman, artist, and so forth.”<sup>82</sup> Like firms, natural human beings are given fictional names at birth, and limits are placed on whether human beings have access to courts with respect to age and mental acuity (such as in the concept of “capacity” in contract law), as well as national citizenship and other qualifications (as reflected in various provisions of immigration laws).

In addition, human beings, as well as firms, seek “standing” before courts in different kinds of roles. Again as Vining explains, “when a ‘real’ person comes before a court he [or she] does not come as a whole— . . . but in one of his [or her] roles, as a tenant farmer, perhaps, or a drug user, or a religious believer, or an investor.”<sup>83</sup> Similarly, a firm can seek legal “standing” or recognition in different roles: as an employer, as a party to a contract with a supplier of goods, or as a bearer of certain constitutional rights.

The legal recognition of firms as “entities” or “persons” in these respects cannot be avoided or short-circuited through appeals to economics, because economic analysis itself depends on the legal recognition and definition of the relevant “units,” including human beings as well as firms. With respect to theories of the firm, law is therefore a necessary starting point for any coherent economic analysis. Major errors in economics and law-and-economics have occurred when scholars invoke vaguely defined legal concepts (such as “implicit contracts” or “agency costs”) without a sufficient appreciation of the richness of the legal meaning and context of these concepts.

From a legal point of view, then, the idea that “there are no firms” (and only individual human beings) is a non-starter. Firms as well as markets are created by law.<sup>84</sup> Firms exist as legal “entities” and “persons” because statutes and courts have recognized them as such for centuries and continue to do so today in almost all modern societies. The legal infrastructure supporting the business enterprise as an institution relies on these concepts. For example, the very idea of a “shareholder” depends on the legal recognition of an organizational entity (namely, the corporation) in which one may hold or own a “share.” The role of a “manager” or a “director” presumes the existence of an organizational “entity” to be managed or directed. At least one recent economic theory of the firm is generally consistent with the emphasis placed here on legal definition and recognition. A firm, on this view, is “a nexus of specific investments: a combination of mutually specialized assets and people . . . [within] a complex structure that cannot be instantaneously replicated.”<sup>85</sup>

<sup>82</sup> Joseph Vining, *Legal Identity: The Coming of Age of Public Law* (Yale University Press 1978), p. 59.

<sup>83</sup> *Id.*

<sup>84</sup> In discussing the difference between markets and firms, two influential legal commentators suggest that degrees of “firmishness” might replace attempts to distinguish firms and markets. Klein, Coffee, and Partnoy, *op. cit.*, pp. 19–20. However, this idea presupposes that one can have a solid conception of a “firm” in mind from which varying degrees of “firmishness” could then be deduced or approximated.

<sup>85</sup> Luigi Zingales, “Corporate Governance,” reprinted in *The Economic Nature of the Firm: A Reader* (Randall S. Kroszner and Louis Putterman eds.) (Cambridge University Press, 3rd ed.,

Even if one concedes that firms are “artificial legal fictions,” they are legal fictions with social consequences that are real, practical, and large. The nation-state is another example of an “artificial fiction.” Like business firms, the nation-state has a legal and institutional reality (in the social rather than the metaphysical sense), and few would deny that the “imagined communities” of nation-states exist and matter greatly in practical affairs.<sup>86</sup> The legal scholar Arthur Machen made the point as follows: “The state, like other corporations, is actually an impersonal entity; by a legal fiction or metaphor, that impersonal entity is regarded as a person. Uncle Sam is a fictitious person; but the government of the United States is a reality.”<sup>87</sup> Nation-states matter because constitutional and international law recognize these entities—and people who live within the geographical and conceptual boundaries of nation-states empirically believe in them. Alexis de Tocqueville said: “The government of the Union rests almost entirely on legal fictions. The Union is an ideal nation which exists, so to say, only in men’s minds and whose extent and limits can only be discerned by the understanding.”<sup>88</sup> The belief in a nation-state reinforced by the legal recognition of this belief makes it practically real.

Money is another example of an “artificial” and “fictional” institutional invention which is, objectively, merely some bits of more or less colorful paper or shiny pieces of metal (or symbolic representations on computer screens).<sup>89</sup> Few, if any, would deny that money exists or amounts to “merely a legal fiction.” The institutions of law, politics, and markets make the representation of “money” socially real, meaningful, and consequential. The same is true of the business firm, which the law creates, recognizes, and defines as a type of institutional “person” and “entity.”

Much ink has been spilled over concepts such as “legal fictions,” “legal entities,” and “legal persons.” Unfortunately, as the likes of Hart and Dewey point out, these concepts have too often been used categorically to support one or another substantive legal theory of the firm—or sometimes rejected entirely as unhelpful. Taking an institutional perspective allows one to explain and demystify these ideas, finding them both useful and descriptive, without either becoming a slave to the ideas or feeling a need to jettison them.

2009), p. 71. The author qualifies this economic definition of the firm with the caveat that it “does not necessarily coincide with a legal definition.” Id. But it is actually closer to a foundational legal understanding than most other economic definitions, allowing for legal variations in different circumstances with respect to participants included and legal structures adopted. See also Raghuram G. Rajan and Luigi Zingales, “Power in a Theory of the Firm,” 113 *Quarterly Journal of Economics* 387 (1998); Raghuram G. Rajan and Luigi Zingales, “The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms,” 116 *Quarterly Journal of Economics* 805 (2001).

<sup>86</sup> See Benedict Anderson, *Imagined Communities: Reflections on the Origins and Spread of Nationalism* (Verso, 2nd ed., 2006).

<sup>87</sup> Arthur W. Machen, Jr., “Corporate Personality,” 24 *Harvard Law Review* 346, 347 (1911).

<sup>88</sup> Aviam Soifer, “Reviewing Legal Fictions,” 20 *Georgia Law Review* 871, 872 (1986) (quoting Tocqueville).

<sup>89</sup> For a discussion of the “social construction” of money as an “institutional fact,” see John Searle, *The Construction of Social Reality* (Free Press 1995), pp. 32–3, 41–3, 52–3, 63, 76, 79–81, 119.

## Legal fictions

To an average citizen, the idea of “legal fictions” may seem daunting or, worse, evidence of pettifoggery: the use of arcane legal concepts to achieve hidden, politically determined results by lawyers and those who hire them. A general theme in the history of jurisprudence has been to perceive legal fictions as problematic and unhelpful, obscuring the application of clear, scientific principles. Jeremy Bentham, for example, compared the use of fictions in law to swindling in trade.<sup>90</sup> And legal fictions can sometimes be used in this fashion.

At the same time, the use of legal fictions provides a means by which legal change can occur—pouring new wine of changing content into old legal bottles of established concepts.<sup>91</sup> Lawyers use fictions all the time. In fact, it is often difficult to say when an idea transforms from a “legal fiction” into an established “legal truth.” Even some of the most central legal ideas, such as a “contract,” are fictional in the sense that the recognition of an enforceable promise (with consequences involving either judicial enforcement or the payment of money in damages) depends on the interpretation of legal sources of authority and the institutional invocation of this authority. One may say that natural “agreements” and “promises” occur through the use of language and human interaction.<sup>92</sup> But it is law that determines whether a particular promise or agreement amounts to an enforceable “contract.” A contract is therefore a legally determined social fact and an “artificial fiction.” Over time, as the practice of making promises and enforcing contracts based on them becomes institutionally imbedded and relied upon in a particular culture, the fictional origins of the idea are forgotten as the concept becomes socially “real” through experience and settled cultural expectations.

Another example of a legal fiction is the business corporation. One can describe corporations as “legal fictions” in the sense that they are invented (in general) and created (in specific instances) by human beings who use established legal methods and processes to do so. However, once a framework of corporate statutes has been established, and once specific business firms are up and running, the corporation as an institution is no longer a “mere fiction.” It becomes socially real through its construction and maintenance in accordance with a specific set of internal and external legal rules, principles, and understandings. As one legal philosopher puts it, “very old fictions are no longer considered as such.”<sup>93</sup> Particularly useful legal fictions become converted over time into “juristic truth.”<sup>94</sup>

<sup>90</sup> Lon L. Fuller, *Legal Fictions* (Stanford University Press 1967), p. 2 (citing Bentham).

<sup>91</sup> See *id.*, pp. 1–3 (discussing Bentham, Blackstone, Jhering, and others).

<sup>92</sup> See, e.g., T.M. Scanlon, “Promises and Contracts,” in *The Theory of Contract Law: New Essays* (Peter Benson ed.) (Cambridge University Press 2001), pp. 86–117 (arguing that breaking promises and “lying promises” are morally wrong without regard to background legal institutions or likely enforcement).

<sup>93</sup> Pierre du Tourtoulon, *Philosophy in the Development of Law* (Macmillan 1922), quoted in Fuller, *op. cit.*, p. 15 n. 36.

<sup>94</sup> Fuller, *op. cit.*, p. 23.

Policy debates may then arise concerning the principled foundations that support particular legal fictions such as a “contract” or a “corporation.” In contract law, for example, the assertion of moral principle (keeping promises as a moral duty owed to people living in society together) may diverge from the assertion of economic principle (designing legal rules to achieve the greatest efficiency) as justifications for enforcing promises.<sup>95</sup> “Mixed theories” of ethics and efficiency can resolve or at least describe these kinds of normative conflicts.<sup>96</sup>

At the same time, one should remember that legal fictions—even useful ones—remain legal fictions. Therefore they remain open to the possibility of change. “A fiction becomes wholly safe,” warns the legal scholar Lon Fuller, “only when it is used with a complete consciousness of its falsity.”<sup>97</sup> Because ideas such as the “corporation” and other business forms are fictions, they are also malleable. Again in Fuller’s words: “Some fictions should be rejected; some should be redefined. Redefinition is proper where it results in the creation of a useful concept . . .”<sup>98</sup> Law defines business firms, and it can therefore re-define them.

Legal fictions differ from literary fictions. The key difference is that legislatures and courts back legal fictions with institutional authority and, as a last resort, organized force.<sup>99</sup> Yet there is nothing necessarily permanent about the adoption of a legal fiction. Legislatures and courts may dismantle, disregard, or reform legal fictions if and when they are no longer useful or no longer found to advance the social policies for which they were originally established. Again to follow Hart and Dewey, the legal fictions that designate the “entities” and “persons” of the business enterprise are not written in stone. Legal institutions invent and reinforce these fictions over time because they are found socially beneficial, and their continued use should then depend on whether they are working well or not. When a legal fiction is not working for the purposes intended, it should be either adapted or discarded.<sup>100</sup>

Law is not alone among the disciplines in using “fictions.” Economics employs the fiction of the “rational actor.” Political theorists and philosophers refer to imaginative “social contracts.” And scientists employ theoretical constructs that are at least partly fictional or created imaginatively.<sup>101</sup> Lon Fuller, following the German philosopher Hans Vaihinger, asserts that conceptual fictions are even “an indispensable instrument of human thinking.”<sup>102</sup>

<sup>95</sup> See Stephen A. Smith, *Contract Theory* (Oxford University Press 2004), pp. 41–2, 106–19, 140–58.

<sup>96</sup> *Id.*, pp. 158–61.

<sup>97</sup> Fuller, *op. cit.*, p. 10.

<sup>98</sup> *Id.*, p. 22.

<sup>99</sup> See Soifer, *op. cit.*, pp. 882–3 (noting the difference and observing that “the nexus between even the most powerful literary fiction and actual force is quite attenuated”).

<sup>100</sup> For further discussion of the use and misuse of legal fictions, see Fuller, *op. cit.* See also Nancy J. Knauer, “Legal Fictions and Juristic Truth,” 23 *St. Thomas Law Review* 1 (2010).

<sup>101</sup> See Fuller, *op. cit.*, pp. 98–110, 107.

<sup>102</sup> *Id.*, pp. 93–123. But cf. Louise Harmon, “Falling Off the Vine: Legal Fictions and the Doctrine of Substituted Judgment,” 100 *Yale Law Journal* 1 (1990) (renewing concern about the misuse of legal fictions).

From this perspective, rhetorical references to business corporations as “Frankenstein’s monsters” may capture the truth of their artificial creation, but business firms in various legal forms are no more dangerous or unusual than other legal fictions, such as “contract” or “property.”<sup>103</sup> Legal fictions can become socially embedded as institutions, and the resulting historical inertia and “path dependence” can make change very difficult along many social dimensions.<sup>104</sup> The legal infrastructure of business enterprise engenders reliance and even economic dependence of many participants on the “rules of the game.” Appreciating the fictional features of business firms, however, allows one also to gain the critical perspective needed to reform them over time as social circumstances and needs change. Because the legal forms of business are fictions, they can be *re*-formed.

On the topic of whether business firms of various kinds should be considered “fictional” or “real,” one is tempted to follow the position taken by the legal theorist John Chipman Gray who noted an “old saying” that “everybody is born either a nominalist or a realist.” He concluded that it is unhelpful to argue for either point of view.<sup>105</sup> My view offers a different compromise, arguing that the legal entities and persons known as business firms are best considered *both* “fictional” *and* “real.” Institutional fictions become real over time through the social and legal practices that recognize them. This theoretical approach combines nominalism and realism. Understanding the firm as a “legal fiction” highlights the prerogatives of government (including legislatures and courts) to change the legal forms of business enterprise, as well as the rules applicable to them when social conditions or relevant knowledge changes. Understanding the firm as “socially real” recognizes that people participating in business build up interests and expectations over time and presume (with justifications that the law often recognizes, respects, and enforces) that the forms and rules relied upon will remain relatively stable, thus supplying solid institutional foundations for productive work and commerce.

### Legal entities

From an institutional perspective, describing firms as “entities” is not problematic once one appreciates the flexibility of using legal fictions. “Entities” are artificial creations of the legal imagination. There is nothing strange or unusual in the use of

<sup>103</sup> For references to business corporations as Frankenstein’s monsters, see Wormser, *op. cit.* See also *Liggett v. Lee*, *op. cit.*, 288 U.S. at 567 (Brandeis, J., dissenting in part).

<sup>104</sup> See Lucian Arye Bebchuk and Mark J. Roe, “A Theory of Path Dependence in Corporate Ownership and Governance,” 52 *Stanford Law Review* 127 (1999) (describing both “structure-driven” and “rule-driven” path dependence in institutional evolution). See also W. Brian Arthur, *Increasing Returns and Path Dependence in the Economy* (University of Michigan Press 1994); S.J. Liebowitz and Stephen E. Margolis, “Path Dependence, Lock-in, and History,” 11 *Journal of Law, Economics, & Organization* 205 (1995); Paul Pierson, “Increasing Returns, Path Dependence, and the Study of Politics,” 94 *American Political Science Review* 251 (2000); Stephen Redding, “Path Dependence, Endogenous Innovation, and Growth,” 43 *International Economic Review* 1215 (2002).

<sup>105</sup> John Chipman Gray, *The Nature and Sources of the Law* (Macmillan, 2nd ed., 1927), pp. 52–3.



entities to understand firms and how they work legally. One entity is the institutional “unity” of an enterprise such as a “corporation” (or an instantiated “body”). Considering the enterprise as an entity looks to the organizational coherence of the management, decision processes, and operations of a business as a framework for legal thinking.<sup>106</sup> One might even go as far as Joseph Vining who argues:

Entities, units of reference, building blocks may be essential to thought itself. . . . A large part of thinking *seems* to consist of the rearranging or modifying of already given units of reference. But the establishment of a unit of reference is often the critical point in reasoning or discussion, legal or nonlegal, and when one is unpersuaded by an argument but does not quite know why, analysis often shows that one has tacitly rejected the unit of reference being used.<sup>107</sup>

Lon Fuller makes a similar argument: “[T]he notion of ‘unity’ or ‘identity’ has no meaning out of a complete context of thought-operations. ‘Unity’ and ‘identity’ are matters of subjective convenience. Conceptually one may postulate entities whenever it is convenient to do so.”<sup>108</sup> For example, the creation and recognition of firms as legal entities gives them “standing” to sue and be sued in courts in their own (fictional) names. “Standing” is simply a legal term recognizing the ability of a legal person “to be heard by a judge.”<sup>109</sup>

The “naming” of entities is another example of a “real fiction” used for individual humans (and often their pets) with application to business firms as well. A name is invented (by parents or bestowed through custom), and it then becomes “real”—as the name used to refer to the particular individual—through social practice, repetition, and reinforcement (e.g. the use of one’s “name” in the family, in school, and on legal documents). Similarly, the naming of organizations occurs through the “naming devices” of corporate charters or partnership agreements—with the organizational name then reinforced as “real” through social practice, repetition, and reinforcement: such as through contracts in the firm’s “name” used with employees, suppliers, customers, and creditors, as well as in the marketing of products and services by advertising and word-of-mouth.<sup>110</sup>

The legal conception of the firm as an entity also permits a defined and identified collective unit to hold and manage private property, to make contracts with people and other recognized entities, and to enforce or become the target of other legal responsibilities (including specific statutory capacities and obligations). Legal recognition of the business firm as an entity operationalizes the accounting concept of

<sup>106</sup> See Adolf A. Berle, Jr., “The Theory of Enterprise Entity,” 47 *Columbia Law Review* 343 (1947).

<sup>107</sup> Vining, *Legal Identity*, op. cit., p. xii (original emphasis).

<sup>108</sup> Fuller, op. cit., p. 120.

<sup>109</sup> Vining, *Legal Identity*, op. cit., pp. 55–6 (reviewing the origin of the term). See also page 28 and accompanying note 83.

<sup>110</sup> On the deeper philosophy of naming, see Saul A. Kripke, *Naming and Necessity* (Harvard University Press 1980).

a firm as having its own “fisc” and treasury.<sup>111</sup> Law creates an entity (*firma*) that corresponds to the accounting entity (*ragione*) as well as the credit entity (*ditta*).<sup>112</sup>

This does not mean that modern legal and accounting entities are co-extensive. As discussed further below, especially in Chapters 2 and 6, the legal boundaries of the entities called firms vary according to the questions asked. Accounting boundaries, especially in corporate groups with parent-and-subsidary or other complex organizational structures, can vary widely. For example, a firm may use overall consolidated accounting statements for U.S. income tax reporting purposes and, at the same time, use separate subsidiary profit-and-loss statements or other accounting methods to manage subordinate business units within a larger firm structure. Legal determinations are often required to determine the appropriate “enterprise entity” in resolving particular questions and cases.<sup>113</sup> For example, a common thread in some turn-of-the-century financial scandals in the United States (including those involving Enron’s implosion and Goldman Sachs’ enabling of a hedge fund short in the housing market), involved the highly creative and legally questionable use of off-balance sheet accounting “entities” for various kinds of transactions.<sup>114</sup> The simpler point here is that a foundational concept of the firm as a legal entity is necessary for these kinds of questions even to arise (and then to be answered).

In addition, the designation of an entity is important for recognizing responsibility for harmful actions or, in legal terms, “liability.” Business participants may use legal entities to limit their liability, perhaps most notably through legal policies favoring limited liability for the shareholders and creditors of corporations. Commentators sometimes focus too closely on the limits to personal liability extended to shareholders (and managers).<sup>115</sup> Creditors who finance business entities through arms-length contracts also enjoy limited liability for the potentially harmful actions of the firms to whom they lend—as long as they do not assume effective managerial control of the enterprises that they finance.<sup>116</sup>

<sup>111</sup> For a review of the importance of accounting in this connection, see Orts, “A Short History of the Business Enterprise,” *op. cit.* For discussion of accounting concepts with respect to the delineation of the business firm, see also Kenneth S. Most, “Sombart’s Propositions Revisited,” 47 *Accounting Review* 722 (1972); Basil S. Yamey, “Accounting and the Rise of Capitalism: Further Notes on a Theme by Sombart,” 2 *Journal of Accounting Research* 117 (1964); James O. Winjum, “Accounting and the Rise of Capitalism: An Accountant’s View,” 9 *Journal of Accounting Research* 333 (1971).

<sup>112</sup> Werner Sombart, “Medieval and Modern Commercial Enterprise,” in *Enterprise and Secular Change: Readings in Economic History* (Frederic C. Lane ed.) (Richard D. Irwin, Inc., 1953), p. 31. See also Thorstein Veblen, *The Theory of Business Enterprise* (Mentor 1932) (1904), pp. 49–67 (discussing “loan credit” as an important feature of business enterprise).

<sup>113</sup> See, e.g., Berle, *op. cit.*, pp. 348–50 (discussing the example of determining the appropriate “entity” in parent-subsidiary cases with reference to consolidating accounting statements as a guide for legal results).

<sup>114</sup> See Bratton and Levitin, *op. cit.*

<sup>115</sup> See, e.g., Berle, *op. cit.*, p. 343 (1947) (noting that the “primary business advantage” of the corporation is the “insulation of individual stockholders composing the corporation from liability for the debts of the corporate enterprise,” as well as “the distribution of responsibility” among corporate managers and officers).

<sup>116</sup> For a classic case illustrating a situation where a creditor becomes liable to third parties for exercising managerial control under agency law, see *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309

The concept of “asset partitioning” helps to explain the use of the legal entity in limiting the liability and risk of capital providers. Essentially, the recognition of the firm as an entity and the firm’s ability to own assets in its own name allow for setting financial priorities between creditors and equity owners for claims on these designated assets. The legal entity of the firm may also “shield” creditors and equity owners from personal liability in some circumstances.<sup>117</sup> According to the legal scholars Henry Hansmann and Reinier Kraakman, there are two general types of asset partitioning. “Affirmative asset partitioning” refers to a priority that *creditors of the firm* are given to the assets dedicated to the firm and owned by the firm as an entity. In the event of financial trouble, the creditors of the firm get priority over both the equity owners of the firm and any personal creditors of the equity owners. For example, if a single firm with a single owner has assets of \$1 million, and the owner goes personally bankrupt, then the creditors of the firm can make claims against the \$1 million dedicated to the firm ahead of claims made against the owner personally. “Defensive asset partitioning” refers to an entity “shield” that is recognized to protect the *equity owners of the firm* from personal liability for claims made against them by creditors of the firm in excess of a firm’s own dedicated assets.<sup>118</sup> Adapting the previous example, imagine that the single firm with designated assets of \$1 million produces defective products that result in a liability of \$5 million. A corporate entity will “shield” the owner’s personal assets against claims exceeding the \$1 million amount invested in the firm.

Taking advantage of legal “asset partitioning,” the creditors and shareholders of a corporate enterprise put only the amount of funds invested in the corporation at risk: they do not usually have to worry about additional liability for harms or obligations that may exceed the amount of capital owned by the corporation in the event of financial failure or bankruptcy. And creditors enjoy some security of a first claim on a firm’s dedicated assets. Different business forms, which are further described in Chapter 5, allow for more or less protection in terms of the legal strength of “partitioned” assets in an entity.<sup>119</sup>

There are exceptions to this rule of limited liability even with respect to corporations, which are usually thought to provide the strongest form of asset partitioning.<sup>120</sup> (Criteria that justify exceptions to permit “piercing the entity” to find

N.W.2d 285 (Minn. 1981). Agency law and limited liability are further discussed in Chapters 2 and 4.

<sup>117</sup> See Henry Hansmann and Reinier Kraakman, “The Essential Role of Organizational Law,” 110 *Yale Law Journal* 387 (2000).

<sup>118</sup> *Id.*, pp. 393–6; see also Paul G. Mahoney, “Contract or Concession? An Essay on the History of Corporate Law,” 34 *Georgia Law Review* 873, 876–7 (2000) (referring to the same idea as “forward” and “reverse” partitioning). In work with another author, Hansmann and Kraakman substitute “entity shielding” for “affirmative asset partitioning.” Hansmann, Kraakman, and Squire, *op. cit.*, pp. 1362–3.

<sup>119</sup> Hansmann and Kraakman, “The Essential Role of Organizational Law,” *op. cit.*, pp. 394–7.

<sup>120</sup> See, e.g., Berle, *op. cit.*, pp. 352–4 (reviewing cases disregarding corporate entities when used for illegal, fraudulent, or “objectionable” purposes); Clark, *op. cit.*, pp. 35–92 (describing “limits to limited liability” for shareholders, such as in fraudulent conveyance law and “piercing the corporate veil” cases); Conard, *op. cit.*, pp. 424–3 (reviewing various criteria for exceptions to limited liability); Franklin A. Gevurtz, *Corporation Law* (West Group 2000), pp. 69–111 (same).

liability are discussed in Chapter 4.) One can achieve the legal results of asset partitioning, however, only by recognizing and respecting the “entity” of a business enterprise. Other legal methods of asset partitioning are not feasible, mostly for reasons of transaction costs in terms of the extensive contracting that would be otherwise required.<sup>121</sup>

Joseph Vining is therefore on the mark when he writes: “Limitation of the liability that would otherwise flow from private law analysis—the limitation that is a characteristic feature of modern industrial and commercial organization—is largely the recognition and separation of entities.”<sup>122</sup> Hansmann and Kraakman conclude also that the recognition of entities is “essential” for the organization of business enterprise.<sup>123</sup>

More broadly speaking, the designation of firms as entities raises questions of their governance, decision-making authority, and control. Many issues in the law of enterprise organization involve “the recognition of entity” with respect to these dimensions as well.<sup>124</sup> In contrast to some contemporary authors who treat the idea of firms as entities strictly from an economic perspective, Vining observes that attributes of “power” and “authority” are involved as well as “wealth” whenever dealing with “entities beyond the material or individually human.”<sup>125</sup>

Some legal complexities and difficulties arise in terms of different kinds of entities that may possess more or less economic or social “reality.” For example, corporate subsidiaries are recognized as legal entities and used in the structures of holding companies and large multinational enterprises.<sup>126</sup> (Historically, there was resistance to the idea that corporations or other business enterprises such as trusts should be allowed to hold stock in other corporations or entities, but these kinds of multi-entity corporate groups became solidly established over time and “grew to occupy a commanding role in American industry and eventually in the world economy as well.”<sup>127</sup>) These legally complex enterprises are usually managed in a relatively centralized fashion.<sup>128</sup> Toyota, for example, exercises relatively unified management control of its business from its central headquarters in Japan, even though it has also created a number of legal entities as subsidiaries for manufacturing and sales operations in other locations, such as the United States.<sup>129</sup> Multinational

<sup>121</sup> Hansmann and Kraakman, “The Essential Role of Organizational Law,” op. cit., pp. 406–23.

<sup>122</sup> Joseph Vining, *From Newton’s Sleep* (Princeton University Press 1995), p. 320.

<sup>123</sup> Hansmann and Kraakman, “The Essential Role of Organizational Law,” op. cit., pp. 387, 390, 440.

<sup>124</sup> Vining, *From Newton’s Sleep*, op. cit., p. 320.

<sup>125</sup> Id., pp. 319–20.

<sup>126</sup> See, e.g., Conard, op. cit., pp. 165–9; Eric W. Orts, “The Legitimacy of Multinational Enterprise,” in *Progressive Corporate Law* (Lawrence E. Mitchell ed.) (Westview Press 1995), pp. 248–9, 251–2.

<sup>127</sup> Blumberg, op. cit., p. 58.

<sup>128</sup> However, there are exceptions. Corporate conglomerates and other business firms, for example, are sometimes managed in a purposefully *decentralized* manner in order to devolve operational decision-making authority in the firm to lower managerial levels in the organization.

<sup>129</sup> See, e.g., René Belderbos and Leo Sleuwaegen, “Japanese Firms and the Decision to Invest Abroad: Business Groups and Regional Core Networks,” 78 *Review of Economics and Statistics* 214, 216 (1996).

business enterprise structures thus raise interesting issues of “corporate geography.”<sup>130</sup>

Corporate law in most jurisdictions recognizes subsidiaries as useful entities for various purposes, such as establishing domestic corporate residence or citizenship for doing business and limiting the extent of liability for the corporate parent.<sup>131</sup> Policy justifications for this extension of limited liability to parent–subsidiary and other complex entity structures may include the encouragement of international trade as well as flexibility for larger firms to enter into new corporate ventures with different combinations of investors. The “primary motives” for parent–subsidiary structures may also include: “increased facility in financing; the desire to escape the difficulty, if not the impossibility, of qualifying the parent company as a foreign corporation in a particular state; the avoidance of complications involved in the purchase of physical assets; the retention of the good will of an established business unit; the avoidance of taxation; the avoidance of cumbersome management structures; [and] the desire for limited liability.”<sup>132</sup> Parent–subsidiary corporations often create entity-within-entity structures, however, which go beyond policy justifications of “asset partitioning” to protect individual participants. Strong arguments have been made that courts and legislators should subject parent–subsidiary and other entity-within-entity structures to greater scrutiny when they are invoked to limit the liability for harm caused by a larger enterprise and attributable to decisions made for the benefit of the participants in the larger business as a whole. This approach would follow an “enterprise entity” or “single enterprise” theory for finding liability.<sup>133</sup>

Jurisdictional issues are also important when considering whether and when to extend liability to corporate parents. These issues arise both at the national and global levels.<sup>134</sup> And questions of “piercing the entity” in parent–subsidiary

<sup>130</sup> For an introduction to the field, see Richard Walker, “A Requiem for Corporate Geography: New Directions in Industrial Organization, the Production of Place and the Uneven Development,” 71 *Geografiska Annaler: Series B, Human Geography* 43 (1989).

<sup>131</sup> See, e.g., Blumberg, *op. cit.*, pp. 58–60 (recognizing limited liability in parent–subsidiary structures but noting that it appears to have evolved as “a historical accident”); Orts, “The Legitimacy of Multinational Enterprise,” *op. cit.*, pp. 254–8 (reviewing the use of subsidiaries for purposes of establishing corporate citizenship in different jurisdictions).

<sup>132</sup> William O. Douglas and Carrol M. Shanks, “Insulation from Liability Through Subsidiary Corporations,” 39 *Yale Law Journal* 193, 193 (1929).

<sup>133</sup> See, e.g., Berle, *op. cit.*; Conard, *op. cit.*, pp. 428–9; Douglas and Shanks, *op. cit.*, pp. 210, 217–18; Note, “Liability of a Corporation for Acts of a Subsidiary or Affiliate,” 71 *Harvard Law Review* 1122 (1958). See also Robert J. Rhee, “Bonding Limited Liability,” 51 *William and Mary Law Review* 1417, 1456–8 (2010) (favoring a “theory of enterprise liability” determined by a practical “control” test). But see, e.g., Stephen B. Presser, *Piercing the Corporate Veil* (Clark, Boardman, Callaghan 1992), pp. 1–53 to 1–57 (arguing that economic principles justify extending limited liability to corporate parents); Stephen B. Presser, “The Bogalusa Explosion, ‘Single Business Enterprise,’ ‘Alter Ego,’ and Other Errors: Academics, Economics, Democracy, and Shareholder Limited Liability,” 100 *Northwestern University Law Review* 405, 420–7 (2006) (rejecting “single enterprise” and other theories of parent liability).

<sup>134</sup> See, e.g., Janet Cooper Alexander, “Unlimited Shareholder Liability Through a Procedural Lens,” 106 *Harvard Law Review* 387 (1992); Henry Hansmann and Reinier Kraakman, “A Procedural Focus on Unlimited Shareholder Liability,” 106 *Harvard Law Review* 446 (1992); Jennifer A. Schwartz, Comment, “Piercing the Corporate Veil of an Alien Parent for Jurisdictional Purposes:

situations arise also in bankruptcy law.<sup>135</sup> The point here is not to resolve all of these complex legal questions, but only to point out that the recognition of business “entities” is essential in all of them.

Another example shows how a legal entity can have virtually no “real” institutional existence at all. In triangular mergers in the United States—a legal procedure by which three corporate entities are used to merge or consolidate two companies—a new legal entity is often created as a subsidiary in order to accomplish the merger. The newly formed entity then simply disappears after the merger is concluded. For example, a target corporation *X* may be merged into a subsidiary *Y* of an acquiring corporation *Z*. Once merged into subsidiary *Y*, target *X* as a separate entity is dissolved, leaving only corporation *Z* and its subsidiary *Y*. (See Figure 1.1 for a schematic representation.) The reality of the third entity here appears only formally in the law’s imagination—a fiction that is nevertheless useful to accomplish the practical ends of the two primary institutional players (namely, *X* and *Z* corporations).<sup>136</sup> The transient and ephemeral nature of the entity used to achieve a triangular merger suggests one reason to avoid adopting a *real entity* institutional theory as complete.<sup>137</sup> As long as this method of corporate combination accomplishes objectives that are otherwise deemed effective, fair, and sound as a matter of public policy, however, there appears to be no reason to fear the use of fictional legal entities in this fashion.<sup>138</sup>

A Proposal for a Standard That Comports with Due Process,” 96 *California Law Review* 731 (2008); William A. Voxman, Comment, “Jurisdiction over a Parent Corporation in Its Subsidiary’s State of Incorporation,” 141 *University of Pennsylvania Law Review* 327 (1992).

<sup>135</sup> For a classic debate on this topic, see Jonathan M. Landers, “A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy,” 42 *University of Chicago Law Review* 589 (1975); Jonathan M. Landers, “Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy,” 43 *University of Chicago Law Review* 527 (1976); Richard A. Posner, “The Rights of Creditors of Affiliated Corporations,” 43 *University of Chicago Law Review* 499 (1976). See also Richard Squire, “Strategic Liability in the Corporate Group,” 78 *University of Chicago Law Review* 605 (2011) (revisiting this debate in light of current practices).

<sup>136</sup> For explanation of triangular mergers, see Clark, *op. cit.*, pp. 430–3 (summarizing reasons for them, including avoiding liability, avoiding shareholder votes that may otherwise be required, and tax considerations). See also Klein, Coffee, and Partnoy, *op. cit.*, pp. 120–2.

<sup>137</sup> This refers to the overly strong versions of an “institutional entity theory” such as adopted by Gierke. See pages 15–16 and accompanying notes 27–8. See also Otto von Gierke, *Community in Historical Perspective* (Mary Fischer trans., Antony Black ed.) (Cambridge University Press, 1990) (1868); Otto von Gierke, *Political Theories of the Middle Age* (Frederick Maitland trans.) (Cambridge University Press 1987) (1913).

<sup>138</sup> Klein, Coffee, and Partnoy use the triangular merger example in contradistinction to their argument against what they call the “reification” of the business enterprise. Influenced strongly by economic models of the firm, these scholars argue against the use of reification (or the recognition of a business as an entity) for analytical purposes “except when the complexity of the actual relationships becomes so unmanageable as to make it necessary to reify.” Klein, Coffee, and Partnoy, *op. cit.*, p. 117. I agree that this analytical perspective with its focus on individual business participants is useful, but I disagree with it to the extent that this view seems to reject recognition of legal persons and entities as descriptive concepts and sees them as unfortunate “exceptions” rather than as basic concepts needed for understanding of the business enterprise as an institution. See *id.*, pp. 117–18. See also G. Mitu Gulati, William A. Klein, and Eric M. Zolt, “Connected Contracts,” 47 *UCLA Law Review* 887, 890–3 (2000) (arguing against “reification” and the use of “entities” in legal analysis of firms and adopting a version of the economic “nexus of contracts” theory of the firm, which essentially

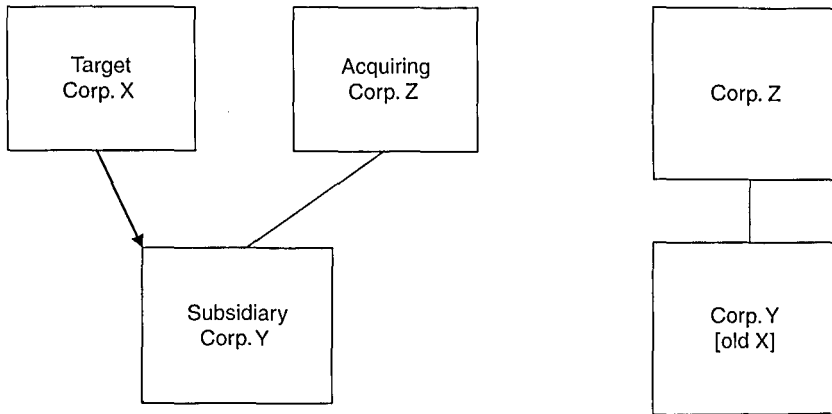


Fig. 1.1 Triangular corporate merger (schematic)

A third example of the use of legal entities refers to options for the “form-shifting” of business enterprises or, more colorfully, their propensity for “shapeshifting.”<sup>139</sup> Given a menu of different legal options (which are reviewed further in Chapter 5 below), a firm can “shapeshift” from one form to another in terms of its governance structure (e.g. from a partnership to a corporation) and capital structure (e.g. from a closely held corporation with only a few shareholders to a publicly held corporation with many shareholders). Corporate shapeshifting, as the legal scholar Frank Partnoy describes the phenomenon, is “a transformation of corporate form involving the creation or use of a new legal entity and one or more changes in structure, including capital structure and the allocation of control rights.”<sup>140</sup> Business forms other than corporations can also shapeshift—including, for example, sole proprietorships, partnerships, or limited liability companies transforming into corporations (or vice versa). The general “choice of business form” problem for a start-up enterprise is only an initial choice and can be later altered. One basic option includes an initial decision to “incorporate” as a small start-up business to gain various legal advantages. More complex transactions can include a decision to “go private,” that is, when a large corporation with many public shareholders changes into a privately held corporation (often accomplished with the assistance of private equity firms which specialize in the performance of this sort of legal and financial alchemy). Or a firm may decide to use “special purpose entities” for capital accounting purposes.<sup>141</sup> Partnoy includes “public company regulatory arbitrage” by hedge funds and the use of various financial techniques to change a firm’s capital structure as additional examples of corporate shapeshifting.

denies the usefulness of the concept of a firm as an entity). I contest the “connected contracts” thesis in Chapter 2.

<sup>139</sup> Frank Partnoy, “Shapeshifting Corporations,” 76 *University of Chicago Law Review* 261 (2009).

<sup>140</sup> *Id.*, p. 262.

<sup>141</sup> See *id.*, pp. 264–6.

These techniques often use newly formed and legally recognized entities for these changes, such as “special purpose entities” and “structured finance.”<sup>142</sup> These kinds of special entities have recently come under sustained legal fire as essentially fraudulent to the extent that they are used to misrepresent the true lines of economic control and responsibility in particular transactions.<sup>143</sup>

Whether different kinds of shapeshifting transactions should be legally allowed or encouraged requires an appeal to policy considerations, such as whether they are fairly done (with respect to the treatment of various business participants) and whether they contribute to overall social welfare. As Partnoy observes, it is not self-evident that the constant and often rapid shapeshifting of legal entities provides economic value to society as a whole or whether it often functions instead as a method to enrich some business participants at the expense of others. As Partnoy observes: “On one hand, shapeshifting can reflect the efficiency of markets as corporate structures move to their most highly valued shape. . . . On the other hand, shapeshifting can reflect the extraction of private value or the transaction costs associated with inefficient legal rules.”<sup>144</sup> In particular, there is good reason to be skeptical of “cyclical shapeshifting”—such as a pattern of going public through an initial public offering, then going private, then going public again, et cetera.<sup>145</sup> Repeated or frequent shapeshifting may indicate wealth transfers among different groups within a firm rather than building long-term economic value for all participants and society as a whole. At least, the ability to make these kinds of changes in business structures illustrates another instance of the importance of “entities” (and accounting for them) in a legal theory of the firm.

### Legal persons

If the conception of business firms as artificial and fictional entities may seem relatively passive or abstract—described in terms of accounting-like “partitions” of assets and legalistic manipulation of entities to achieve various business purposes—then thinking of firms as “legal persons” adds an active and more energetic quality to a legal theory of the firm. Legal personality brings the somewhat abstract ideas of firms as “fictions” and “entities” back to practical reality. As Joseph Vining explains, the “problem of legal persons” is a subset of the “larger problem” involving the “process of defining and designating entities.”<sup>146</sup>

Again, there is nothing to fear in the ensuing legal discussions concerning what “persons” and “entities” to recognize. The legal work of “communicating and agreeing” about the recognition of legal persons is constantly “shifting and changing” and “is as common as it is fascinating.”<sup>147</sup> Authoritative “restatements” and “summaries” of law in the United States support a broad view of the recognition of “persons.” The American Law Institute in its *Principles of Corporate*

<sup>142</sup> Id., pp. 266–9, 283–7.

<sup>143</sup> See Bratton and Levitin, op. cit.

<sup>144</sup> Partnoy, op. cit., pp. 287–8

<sup>145</sup> Id., pp. 269–70, 278.

<sup>146</sup> Vining, *Legal Identity*, op. cit., p. xii.

<sup>147</sup> Id.



*Governance* adopts the following broad definition: “‘Person’ means (a) an individual, (b) any form of organization, including a corporation, a partnership or any other form of association, any form of trust or estate, a government or any political subdivision, or an agency or instrumentality of government, or (c) any other legal or commercial entity.”<sup>148</sup> Similarly, the American Law Institute’s *Restatement (Third) of Agency* defines “person” to include any “organization or association” or “other legal entity that has legal capacity to possess rights and incur obligations.”<sup>149</sup>

Business firms are not mere disembodied entities but rather collective groups of “people in action.”<sup>150</sup> Thinking of the firm as a legal person animates it with the ability to exercise power and authority through human representatives. The representatives of firms include those given the ordinary everyday power and authority to make decisions, namely, managers, officers, and directors. In the United States, the “business judgment rule” bestows significant discretion to corporate managers and directors to exercise independent decision-making authority on a wide range of decisions under ordinary circumstances.<sup>151</sup> Other countries also allow for a similar delegation of broad authority to managers and directors of firms.<sup>152</sup>

Basic founding documents, such as partnership agreements and corporate charters, combine with authorizing legislation, such as partnership laws and corporation codes, to provide the legal pillars for the institutional “persons” of firms.<sup>153</sup> Usually, managers and executives speak for the person of the firm. Depending on the circumstances, other groups can also speak for the interests of the firm: creditors in the case of bankruptcy or shareholders in the case of fundamental disputes regarding major changes in business structure or challenges to managers’ or directors’ decisions, or protection of their voting rights. With some exceptions, however, creditors do not represent firms, and the protection of their interests is limited to contracts made directly with the managers and designated leaders of the firm. (In bankruptcy, the situation changes because creditors are given priority in terms of governance and distribution of assets in case of liquidation or reorganization.) Also, shareholders do not represent firms, unless the percentage size of their financial stake gives them effective control (such as in some closely held corporations), in which case the majority shareholders are effectively also the managers. Shareholders of large public corporations usually have a role in corporate governance limited to selecting a board of directors and exercising oversight through access to corporate records and, in some cases, bringing derivative litigation in the name

<sup>148</sup> American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994), sect. 1.28.

<sup>149</sup> American Law Institute, *Restatement (Third) of Agency* (2006), sect. 1.04(5).

<sup>150</sup> Conard, *op. cit.*, pp. 442–5.

<sup>151</sup> See, e.g., Clark, *op. cit.*, pp. 123–5; Klein, Coffee, and Partnoy, *op. cit.*, pp. 156–61.

<sup>152</sup> Other countries have adopted the equivalent of the business judgment rule. See Klaus J. Hopt, “Comparative Corporate Governance: The State of the Art and International Regulation,” 59 *American Journal of Comparative Law* 1, 39–40 (2011) (noting adoption of the rule by judicial decision or statute in Germany, Switzerland, Japan, and Australia).

<sup>153</sup> See *Restatement (Third) of Agency*, *op. cit.*, sect. 1.03, cmt. c (observing that authority within business firms “originates both with the statute through which the organization achieves a legally recognized form and with the organization’s constitutional documents”).

of the corporation challenging actions of directors or officers as violations of their corporate duties.<sup>154</sup> In almost all everyday situations, then, executives and other managers represent the firm as a person. Firms as legal persons—composed (almost always) of collectively owned assets and teams of people who work together—gain social meaning and reality through the actions of their representatives.

Firms of any significant size and complexity depend, then, on their executive *leadership*. The leaders of firms express their organizational purposes, set their objectives, and represent the firm's collectively organized interests.<sup>155</sup> In complex firms with some degree of hierarchical organization, leadership is a quality that can be exercised in a bottom-up as well as a top-down manner.<sup>156</sup> (This assertion that leaders express a firm's purposes and objectives is subject to the caveat, however, that the firm's founding documents or "private legislation" can define and limit these purposes and objectives. Although firms depend on leaders to represent them, leaders would have nothing to represent without a foundational recognition of the firm as an organizational legal person. And internal "constitutional" limitations on leadership authority and power can be included in the founding documents of a firm.)

Understanding the firm as a legal person with human representatives that speak and act on its behalf reflects common sense as well as traditional legal interpretations. Presidents and prime ministers lead nation-states. Generals lead armies. Deans and principals lead schools. Although it is true that leaders of organizational persons represent the interests of other human beings who compose the collective entity, it is also true that these leaders speak, in their leadership roles, on behalf of the legal person itself—representing the organizational entity. The idea of business representation and leadership does not depart from this general pattern. Chief executive officers lead corporations. Managing partners lead law and accounting firms. Strictly speaking, it is difficult if not impossible to imagine a country, an army, a school, or a business firm without some embodiment of a leader or a leadership group. Leaders represent organizational legal persons. Each of them is delegated responsibility for advancing the purposes and speaking on behalf of the organizational "entity." Business firms are no different than any other organization in this respect, except that they specialize in commerce.

The selection of leadership for organizations also implicates governance structures. Here it is sufficient to observe that the governance structures of private organization are open for significant variation selected by the major business participants (such as the founding owners writing a corporate charter) in contrast

<sup>154</sup> See *Principles of Corporate Governance*, op. cit., sects. 3.01, 3.02, 5.10, 7.01 to 7.17 (describing roles of managers, directors, and controlling shareholders, as well as shareholder derivative lawsuits).

<sup>155</sup> For a classical treatment of institutional leadership in a manner consistent with the account of firms given here, see Philip Selznick, *Leadership in Administration: A Sociological Interpretation* (University of California Press 1958).

<sup>156</sup> See, e.g., Michael Useem, *Leading Up: How to Lead Your Boss So You Both Win* (Crown Business 2003) (discussing strategies for leadership from within an organization aimed a higher levels).

to the governance structures of nation-states (such as the U.S. Constitution). These variations of legal forms of firms are further examined in Chapter 5.

The social theory of Thomas Hobbes provides useful insights with respect to the idea of legal personality and its practical representation in the world. For Hobbes, corporations (or, in his day, “merchant companies”) as well as commonwealths are “made by words.”<sup>157</sup> They do not exist except through human speech, language, and action. In fact, legal persons of all kinds do not exist, according to Hobbes, in any a priori sense. For Hobbes, language precedes the naming of persons. Arguably, this view fits with a number of other legal categorizations of persons—such as the difference between “citizens” and “aliens” (based on nationality claims). This view fits also with strongly fictional versions of legal personality, that is, those that maintain that law can designate almost anything as a “legal person.”<sup>158</sup> On this view, a legal person is entirely dependent on law for its existence. If one takes away the law that defines a legal person, “there is no more left than the smile of the Cheshire Cat after the cat had disappeared.”<sup>159</sup>

Even natural individual human beings, the foundational “persons” recognized in the bottom-up participant theories of the firm, are created through speech, language, and social action. (In contrast, the persons assumed in economic versions of participant theories of the firm are usually radically undertheorized. The individuals assumed in methodological individualism are often mere ciphers.<sup>160</sup>) For Hobbes, “persons are essentially spokespersons who can give their word to others and thereby ‘personate’ themselves.”<sup>161</sup> The ability to speak a language is one prerequisite. The ability to reason is another.<sup>162</sup> Human beings who speak and reason have the coincident ability to “personate” and represent themselves to other human beings.

This view corresponds to a contemporary philosophical view that would restrict reference to “legal persons” only to rational, communicative human beings.<sup>163</sup> Etymology supports this interpretation as well. In Latin, *persona* refers to “a theatrical mask.” Its roots are from *per* meaning “through” and *sonare* meaning “sound.”<sup>164</sup> A “person,” then, represents himself or herself to others through sound, speech, and language.

<sup>157</sup> See Philip Pettit, *Made with Words: Hobbes on Language, Mind, and Politics* (Princeton University Press 2008), pp. 70–81, 115–16.

<sup>158</sup> For a review of current approaches in this vein, see Ngairé Naffine, “Who are Law’s Persons? From Cheshire Cats to Responsible Subjects,” 66 *Modern Law Review* 346, 350–4 (2003).

<sup>159</sup> *Id.*, p. 353, quoting Bryant Smith, “Legal Personality,” 37 *Yale Law Journal* 283, 294 (1928).

<sup>160</sup> See Note, “What We Talk About When We Talk About Persons: The Language of a Legal Fiction,” 114 *Harvard Law Review* 1745, 1768 (2001) (observing that legal discussions about “persons” remain “grossly undertheorized”). But see Naffine, *op. cit.* (categorizing current legal and philosophical theories of “legal persons”).

<sup>161</sup> Pettit, *op. cit.*, p. 2 (describing Hobbes’ “theory of personhood”).

<sup>162</sup> *Id.*, pp. 24–54, 141, 144–6.

<sup>163</sup> See Naffine, *op. cit.*, pp. 362–5 (citing proponents of this view including Michael Moore and Elizabeth Wolgast).

<sup>164</sup> Pettit, *op. cit.*, p. 59. But see Max Radin, “The Endless Problem of Corporate Personality,” 32 *Columbia Law Review* 643, 645–7 (1932) (agreeing with this etymology but arguing that “person” is used more commonly in the modern sense of “a human being”). Following Dewey, Radin argues for a

So-called “dumb” animals are not ordinarily considered persons in this sense because they do not have capacity for language and reason (though they may speak and communicate in a more rudimentary fashion, e.g. dogs barking or cats meowing).<sup>165</sup> Babies, young children, and severely mentally ill or incapacitated human beings arguably fall into the same category. In Hobbes’ words, “children, fools, and madmen” are excluded from the ability to act as “natural” persons.<sup>166</sup> However, if animals, incapacitated or immature people, and other “entities” (such as fetuses or even frozen embryos) are deemed to have basic legal rights (such as the right not to be treated cruelly or the right to inherit property), then these rights can be “represented” by full-capacity human beings who can use language as well as rational thought. Like firms or other organizational legal persons, animals and incapacitated or immature human beings can gain status as “legal persons” through the representation of capable human beings who can exercise language, reasoning, and legal argument on their behalf.<sup>167</sup>

The next step is the representation of a collective person—not of oneself (or an animal or incapacitated human being), but rather the representation of a collective group of people. For Hobbes, this representation is accomplished in a participant-based process.<sup>168</sup> The creation of a collective person is enabled by “rallying behind the words of a collective representative or spokesperson.”<sup>169</sup> This is the origin, for Hobbes, of “the ability of people to incorporate—to come together and act as a single corporate [or other organizational] person.”<sup>170</sup> The philosopher Philip Pettit nicely describes these two steps as “using words to personate” (that is, for people to represent themselves through language, thought, and communication in society) and “using words to incorporate” (that is, the ability for people to create and represent collective organizations).<sup>171</sup> The use of “corporation” here is used in a general rather than a technical legal sense referring to a specific modern business form. The *corpoptio* (corporation) as distinguished from a *congregatio* (congregation) refers to an organizational entity that “exists, in a sense, over and beyond its members,” but nevertheless “needs members to speak and act for it.” When representatives of a *corpoptio* do so—“when people act in that role”—“they put aside their own identities.” They become *universi* (representatives) in this role and “cease to perform as *singuli* or individuals.”<sup>172</sup> On this view, the construction of organized “legal persons” beyond the singly speaking, reasoning human being

pragmatic use of “corporate personality” as “a matter of necessity and convenience,” while recognizing its “nominalist,” flexible character. *Id.*, pp. 652, 665–7, citing Dewey, *op. cit.*

<sup>165</sup> Pettit, *op. cit.*, p. 60.

<sup>166</sup> *Id.*, p. 56 (quoting Hobbes).

<sup>167</sup> See also Naffine, *op. cit.*, pp. 357–61, 365–7.

<sup>168</sup> For a contrary philosophical view that collective organizations precede the individual human being in terms of the ontological creation of “persons,” see Roger Scruton and John Finnis, “Corporate Persons,” 63 *Proceedings of the Aristotelian Society, Supplementary Volumes* 239 (1989). In my view, this philosophical disagreement recapitulates, though at a deeper level, the theoretical debate about whether the recognition of firms begins as a “bottom-up” or “top-down” process. Perhaps the best answer is the institutional one given here of “both.”

<sup>169</sup> Pettit, *op. cit.*, p. 2 (describing Hobbes’ “theory of group agency”).

<sup>170</sup> *Id.*, p. 70.

<sup>171</sup> *Id.*, pp. 55–81.

<sup>172</sup> *Id.*, p. 70.

becomes possible through a secondary institutional process of representation and the legal recognition of groups.

One does not have to accept the deeper philosophical claims that Hobbes makes about the nature of language and meaning to agree with his points about legal personality and organization. Just as human beings can through language and reason “personate” themselves, they can by the same means “personate” or represent collective groups. These groups can be public (such as the Hobbesian Leviathan of the sovereign political state). Or they can be private, including business firms, as well as nonprofit organizations with educational, religious, political, philanthropic, or other social objectives. Fundamentally, these “group persons” cannot exist without some form of legal representation or “personification.”<sup>173</sup>

Rather than a misty obfuscation that prevents clear analysis of the component parts of firms, then, legal personality is an essential component of any realistic legal theory of the firm. An attribution of legal personality is needed for business firms to have social meaning: not only with respect to procedural abilities to exert “standing” in courts, but also practical abilities to conduct ordinary, everyday transactions through representatives—or, in legal terms, “agents”—by means of contracts, through the instrumentalities of private property, and within the constraints imposed by the organization’s own internal rules and society’s external laws.

The concept of legal persons acting through designated representatives raises important issues of governance and formulation of “collective purpose.” Governance of firms refers to the operation of both (1) voluntary, internally imposed rules created by founding documents and other agreements made by business participants (such as corporate charters and bylaws); and (2) externally imposed legal rules (such as the requirement that a large public corporation must have a board of directors). These governance rules allow for the firm to act as an “organizational principal” and to delegate authority to managers and its other “agents.” (Recognition of organizational principals and the role of agents are also foundational for a legal theory of the firm as discussed in detail in Chapter 2.)

The idea of a “collective purpose” or “collective intention” of an organizational person does not refer to metaphysical versions of a “general will.” In a practical sense, these ideas refer only to the rules set in place by voluntary organizational agreements (such as charters or bylaws) and external law (including statutes and court decisions), as well as the expressions made by representatives exercising their authority according to these rules and practices. Leaders, managers, and other agents who are delegated governance authority through these procedures possess a recognized ability to speak, act, and otherwise communicate on behalf of the firm.

Notions of collective purpose or collective intention of business firms—and the methods used to ascertain them—deserve further attention from legal scholars. A resurgence of general interest in these topics has occurred in philosophy,

<sup>173</sup> For an examination of “group persons” in this “juristic” sense, see Andrew Vincent, “Can Groups Be Persons?” 42 *Review of Metaphysics* 687, 704–12 (1989).

sociology, and linguistics.<sup>174</sup> Firms surely differ with respect to the kinds of collective purposes or intentions in different situations. Most firms are probably more cohesive in this respect than the collective intentions of modern legislatures such as the U.S. Congress.<sup>175</sup> For purposes here, however, it is sufficient to observe that interpretations of the organizational intentions and purposes of firms—as expressed in bylaws, shareholder resolutions, employment handbooks, managerial orders, etc.—have important legal, moral, and operational consequences.

Recognizing legal personality as an important dimension of theories of firm worries some contemporary commentators. According to one leading text, for example, recognizing a business firm as a legal “entity” leads down a slippery slope in which it also “becomes a putative person.” In this fashion, they say, “reification sometimes leads to anthropomorphism—that is, treating the corporation [or other firm] as if it were a human being.”<sup>176</sup> Economists tend to worry even more than jurists about legal personality, probably because the idea poses a threat to their view that methodological individualism is the only true path to social knowledge.<sup>177</sup> If firms are legal persons acting in markets along with individuals as argued here, however, then neoclassical economic models of the firm require revision.

It is true that thinking of firms as “entities” encourages thinking about them in terms of “persons” because the ideas are related. It is also true that an uncritical extrapolation of the idea of a “person” or “personality” to business enterprises can lead in troublesome directions. For example, the legal scholar Joel Bakan’s examination of the corporation as a person derives its approach to “corporate personality” from clinical psychology. He concludes from this analysis that modern business corporations qualify as “pathological” according to standard tests used to evaluate individual human personalities.<sup>178</sup>

<sup>174</sup> See, e.g., Michael A. Bratman, *Faces of Intention: Selected Essays on Intention and Agency* (Cambridge University Press 1999); Margaret Gilbert, *Sociality and Responsibility: New Essays in Plural Subject Theory* (Rowman and Littlefield 2000); Raimo Tuomela, *The Importance of Us: A Philosophical Study of Basic Social Notions* (Stanford University Press 1995). Cf. Abby Wright, Comment, “For All Intents and Purposes: What Collective Intention Tells Us about Congress and Statutory Interpretation,” 154 *University of Pennsylvania Law Review* 983 (2006) (examining how the U.S. Congress as a “collective entity” can express a “collective purpose” in its statutes).

<sup>175</sup> See Wright, *op. cit.*, pp. 997, 1015–24 (observing how “it is perfectly natural to speak of a club planning an event or a company designing a new product,” but Congress “can be said to have shared intentions” only in a more limited sense).

<sup>176</sup> Klein, Coffee, and Partnoy, *op. cit.*, p. 118. For an argument that one should not worry so much about making various distinctions when dealing with legal concepts and principles that occur along a spectrum of possibilities, see Frederick Schauer, “Slippery Slopes,” 99 *Harvard Law Review* 361 (1985).

<sup>177</sup> See, e.g., Jensen and Meckling, *op. cit.*, p. 311 (“the personalization of the firm implied by asking questions such as ‘what should be the objective function of the firm,’ or ‘does the firm have a social responsibility,’ is seriously misleading,” and “thinking about organizations as if they were persons with motivations and intentions [is erroneous]”).

<sup>178</sup> Joel Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (Free Press 2004). See also the documentary with the same title and based on the same material by Mark Achbar, Jennifer Abbott, and Joel Bakan (Zeitgeist Films 2004). Consonant with my general thesis here, Bakan views the corporation as “an institution” (though he does not discuss other forms of business enterprise). Bakan, *op. cit.*, p. 1.

This approach may have a rhetorical value in calling attention to the importance of the role of business corporations in connection with responsibility for some serious social problems. It may also highlight some “inhumane” consequences of corporate laws and call into question laws and norms that may encourage or mandate “profit only” or “wealth maximization” orientations to business management. However, it is not analytically useful in terms of theories of the firm to transfer concepts from individual clinical psychology into the realm of organizational personality. The social problems that the legal recognition of organizational persons may help to generate—and, more precisely, the rules and social practices applicable to the management and governance of these persons—are better addressed from the perspectives of law, economics, politics, philosophy, and other social disciplines, rather than diagnosed through an extension of individual psychology. *Social* psychology is probably relevant, especially with respect to the public perceptions of business firms, social behavior in securities trading, and perhaps other business-related behavior, but an in-depth discussion of this disciplinary perspective is left outside the scope of this book. In addition, it is appropriate to inquire how organizational structures and incentives of business enterprise affect the individual psychology of human beings who make decisions within the firm and on behalf of the firm’s objectives. In this respect, critics are correct to point out that a relentless and uncompromising pursuit of profit in some business firms will lead to damaging consequences—or, in economic jargon, “negative externalities.”<sup>179</sup> Legal reform and other social action seeking guidance from other disciplines, however, are the more likely effective remedies. After all, one cannot prescribe medication or confinement to a hospital for a so-called “pathological” corporation.

At the same time, once one realizes and guards against the possibility of misinterpreting the meaning of “legal person” (that is, by remembering that it is a flexible legal idea adopted to achieve certain social ends and purposes), it becomes apparent that thinking about business enterprises as legal persons is very useful. The idea of the legal person has been extended for convenience to recognize, animate, and “personify” other entities without generating confusion. For example, inanimate ships are recognized as “persons” in admiralty law. No less an authority than Oliver Wendell Holmes concludes: “It is only by supposing the ship to have been treated

Bakan’s view that the “corporation’s legally defined mandate is to pursue, relentlessly and without exception, its own self-interest, regardless of the often harmful consequences it might cause to others,” however, is not supported by most legal sources. *Id.*, pp. 1–2. Some economic theories of the firm come close to advocating this extreme view, but legal accounts are usually more moderate, such as the American Law Institute’s qualification of the “objective” of “corporate profit and shareholder gain” by the mandate to act “within the boundaries set by law” and to “take into account ethical considerations.” See Preface, pages xii and accompanying note 13. At least, this authoritative statement of the corporate objective suggests that Bakan’s claim that the corporation is “a psychopathic creature” that “can neither recognize nor act upon moral reasons to refrain from harming others” is overstated. Bakan, *op. cit.*, p. 60. For a critique along similar lines, see also Ian B. Lee, “Is There a Cure for Corporate ‘Psychopathy?’” 42 *American Business Law Journal* 65, 65–73 (2005).

<sup>179</sup> See Bakan, *op. cit.*, pp. 60–1, 70–3.

as if endowed with personality, that the arbitrary seeming peculiarities of the maritime law can be made intelligible, and on that supposition they at once become consistent and logical.”<sup>180</sup> One can say the same about much of the law of business enterprise. Of course, judges and legislators do not pretend that ships or business firms are truly animate objects; they are instruments of people acting collectively. But “[w]hatever the hidden ground of policy may be,” as Holmes continues, “their thought still clothes itself in personifying language.”<sup>181</sup> The moral of the story follows: The recognition of legal persons is perfectly fine and often useful, as long as one keeps in mind the policy reasons for thinking in this manner and the social consequences that are likely to obtain. One need not agree with proposals to extend the recognition of legal persons further afield—such as to include wild animals, other features of the natural environment (such as wilderness preserves), or other “unconventional entities”—to appreciate and accept the usefulness of ascriptions of legal personality to business firms.<sup>182</sup>

Non-Western legal systems also recognize the legal personality of business firms. In Islamic law, for example, commercial enterprises are recognized to possess a legal personality through the development of concepts of *dbimma* (“juristic container within a person”) and *waaf* (“properties left in perpetuity”), both of which allow for a segregation of assets in firms.<sup>183</sup> Chinese law also recognizes business firms—including state-owned enterprises—as endowed with separate legal personalities.<sup>184</sup> As one legal scholar has noted, “in the Confucian view, the collective was morally prior to the individual. Hence, for traditional Chinese law, collective legal personality was a given.”<sup>185</sup>

These developments indicate another important feature of recognition of the legal personality of firms: a demarcation between firms and the political state (which, under most theoretical accounts is seen as a legal person too, again as in Hobbes’ *Leviathan*).<sup>186</sup> A world of legally recognized organizational persons pro-

<sup>180</sup> O. W. Holmes, Jr., *The Common Law* (Little Brown 1881) (Legal Classics Library reprint ed. 1982), pp. 26–7. See also Blumberg, *op. cit.*, pp. 212–14.

<sup>181</sup> Holmes, *op. cit.*, p. 30.

<sup>182</sup> For an argument for the recognition of entities in the natural environment, see Christopher D. Stone, “Should Trees Have Standing?—Toward Legal Rights for Natural Objects,” 45 *Southern California Law Review* 450 (1972). See also Christopher D. Stone, “Should Trees Have Standing? Revisited: How Far Will Law and Morals Reach? A Pluralist Perspective,” 59 *Southern California Law Review* 1, 8 (1985) (arguing for “a more expansive inquiry into the legal and moral status of . . . unconventional entities generally—not merely lakes and mountains, but robots and embryos, tribes and species, future generations and artifacts”); *Sierra Club v. Morton*, 405 U.S. 727, 741–3 (1972) (Douglas, J., dissenting) (maintaining that standing should be recognized for the representation of “ecological unit[s]”).

<sup>183</sup> See Mahdi Zahraa, “Legal Personality in Islamic Law,” 10 *Arab Law Quarterly* 193, 202–6 (1995). See also Nabil Saleh, “Arab International Corporations: The Impact of the Shari’a,” 8 *Arab Law Quarterly* 179, 180–2 (1993) (recognizing legal personality deriving from *dbimma* and *waaf*, but noting that these entities do not confer limited liability under Islamic law).

<sup>184</sup> Tingmei Fu, “Legal Person in China: Essence and Limits,” 41 *American Journal of Comparative Law* 261 (1993).

<sup>185</sup> Teemu Ruskola, “Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective,” 52 *Stanford Law Review* 1599, 1606–7 (2000).

<sup>186</sup> On theories regarding the political state as a legal person, see Vincent, *op. cit.*, pp. 705–6, 708–9.



vides an institutional layer that separates large political nation-states from individual people.<sup>187</sup> In this respect, business firms as well as other human associations arguably compose an intermediate organizational level between nation-states and individuals known as “civil society.” (Whether and how business firms should be considered as belonging to the institutions of “civil society” in political and social theory is an important topic, but one lying outside the scope of this book.)

As Dewey, Hart, Fuller, and other theorists have pointed out, legal persons extend only as far as the law allows. This is true of individual people as well as organizations. For example, an individual “citizen” is accorded the full protection of laws within the jurisdiction of a nation-state. A non-citizen or “alien” is often denied certain rights and legal recognition.<sup>188</sup> An extreme historical example of the denial of recognition of legal personality of human beings appears in the institution of slavery or, even worse, instances of genocide.<sup>189</sup> The point of raising these comparisons here is simply to show that the idea of a legal person is not somehow a “natural” category extended to cover only individual human beings. It is inevitable that the granting of specific rights and responsibilities—such as the powers to sue and be sued, enter into contracts, and own property—bestow recognition of business firms as “persons” in a rudimentary legal understanding of the term. To avert one’s eyes from this social reality is to adopt an extreme and untenable position that firms do not exist in legal imagination and legal practice. This basic point was made by the Oxford jurist William Martin Geldart a century ago:

The object of arrangement and classification is to bring together what is like, to separate what is distinct. But to tell us at one moment that only persons are the subjects of legal rights and duties . . . that they are “deemed” to be persons by the law, is merely to play fast and loose with the language. If corporate bodies are *really* like individuals the bearers of legal rights and duties, they must have something in common which qualifies them to be such; and if that is not personality, we may fairly ask to be told what it is. Or if the rights and duties attributed to them are not really theirs, we may again fairly ask to be told whose they are.<sup>190</sup>

Once firms are recognized legally as persons, real consequences follow in practice.

From an institutional perspective, many questions involving the legal personality of firms remain open. Some issues—such as whether a firm can appear in court and

<sup>187</sup> The nature of institutional legal persons deserves much greater academic discussion than it currently receives. For exceptions, see Meir Dan-Cohen, *Rights, Persons, and Organizations: A Legal Theory for Bureaucratic Society* (University of California Press 1986); Meir Dan-Cohen, “Between Selves and Collectivities: Toward a Jurisprudence of Identity,” 61 *University of Chicago Law Review* 1213 (1994).

<sup>188</sup> For an examination of the topic in U.S. law, see Gerald L. Neuman, *Strangers to the Constitution: Immigrants, Borders, and Fundamental Law* (Princeton University Press 1996). See also Frederic R. Coudert, “The Rights and Remedies of Aliens in National Courts,” 5 *American Society of International Law Proceedings* 192 (1911) (discussing the historical trend toward recognizing rights of aliens).

<sup>189</sup> See, e.g., Milton Meltzer, *Slavery: A World History* (Da Capo Press, rev. ed., 1993); Samantha Power, *A Problem from Hell: America and the Age of Genocide* (Basic Books 2002).

<sup>190</sup> W.M. Geldart, *Legal Personality* (Oxford University Press 1924), p. 10 (reprint of inaugural lecture delivered at Oxford in 1910) (original emphasis).

be represented by a lawyer—are now relatively well settled, though hard questions remain with respect to some details of this representation. For example, jurisdictional questions about whether or not a firm should count as a full-fledged “citizen” arise in a manner analogous to individuals.<sup>191</sup> Also, lawyers who represent firms have ethical responsibilities to represent the business enterprise as a whole, which is often a difficult task given the complicated structures of modern firms.<sup>192</sup> Questions of the attribution of some human characteristics to firms as persons, such as whether firms may be describing as having a “race” for certain legal purposes, provide yet another example.<sup>193</sup>

Other substantive issues, such as whether and to what extent constitutional rights applicable to individuals should apply as well to business firms—and whether and to what extent criminal laws should apply to firms—continue to be contested as well. Objections have been made to expanding both constitutional law and criminal law to business firms, at least with respect to business corporations.

In U.S. constitutional law, the argument has been made that constitutional rights are meant to protect individual people only—not organizational persons.<sup>194</sup> This argument has not been persuasive over time, however, and constitutional rights for corporations (and other business firms) have been recognized in various areas, though not universally.<sup>195</sup> (Chapter 7 revisits this question with respect to the corporate constitutional rights to political free speech.)

With respect to whether criminal law should apply to business firms, there are two schools of thought.<sup>196</sup> On one view, organizational persons do not possess the requisite intention (*mens rea*) needed for criminal culpability, and criminal law should therefore apply only to individual human beings who have this capacity.<sup>197</sup> A few civil law countries reject the idea of corporate or enterprise-level criminality, though the general trend is to recognize such liability.<sup>198</sup> A second view approves

<sup>191</sup> See, e.g., Blumberg, *op. cit.*, pp. 168–201; Robert R. Drury, “The Regulation and Recognition of Foreign Corporations: Responses to the ‘Delaware Syndrome,’” 57 *Cambridge Law Journal* 165 (1998).

<sup>192</sup> See Geoffrey C. Hazard, Jr., “Ethical Dilemmas of Corporate Counsel,” 46 *Emory Law Journal* 1011 (1997); William H. Simon, “Whom (Or What) Does the Organization’s Lawyer Represent? An Anatomy of Intraclient Conflict,” 91 *California Law Review* 57 (2003); E. Norman Veasey and Christine T. DiGuglielmo, “The Tensions, Stresses, and Professional Responsibilities of the Lawyer for the Corporation,” 62 *Business Lawyer* 1 (2006).

<sup>193</sup> See Richard R. W. Brooks, “Incorporating Race,” 106 *Columbia Law Review* 2023 (2006) (discussing recent cases holding that “race” can be legally attributed to business firms).

<sup>194</sup> See, e.g., *Wheeling Steel Corp. v. Glander*, 337 U.S. 562, 576–81 (1949) (Douglas, J., dissenting).

<sup>195</sup> See Blumberg, *op. cit.*, pp. 30–5; Mayer, *op. cit.*; Ribstein, *op. cit.*; Note, “Constitutional Rights of the Corporate Person,” *op. cit.*

<sup>196</sup> See John C. Coffee, Jr., “No Soul to Damn: No Body to Kick’: An Unscandalized Inquiry into the Problem of Corporate Punishment,” 79 *Michigan Law Review* 386, 407 (1981).

<sup>197</sup> See, e.g., William S. Laufer, “Corporate Culpability and the Limits of Law,” 6 *Business Ethics Quarterly* 311, 313 (1996) (“Many philosophers, ethicists, and criminologists question whether corporate entities should be criminally . . . responsible for the actions of employees.”)

<sup>198</sup> See, e.g., Coffee, *op. cit.*, p. 444; see also V.S. Khanna, “Corporate Criminal Liability: What Purpose Does It Serve?” 109 *Harvard Law Review* 1477, 1490–1 (1996) (noting strict European legal standards for imposing corporate criminal liability and observing that Germany is a holdout to the trend toward adopting a regime of corporate criminal liability).

criminal liability for business firms and other organizations on policy grounds of deterrence as well as retribution.<sup>199</sup>

Despite some of the strong objections to constitutional and criminal law extensions to include firms as legal persons, it is probably fair to say that in many jurisdictions, such as in the United States, new subfields have arisen to include what might be called *corporate constitutional law* and *corporate criminal law*. Or, more precisely, in terminology that encompasses the contemporary variety of available legal forms of firms, we might speak of the constitutional law and criminal law of business persons.

The questions in these subfields can also interrelate. For example, assuming that criminal law applies to business corporations, different U.S. constitutional rights protecting them as criminal defendants may apply—or not. The Supreme Court has held that the Fifth Amendment’s protection against “double jeopardy” (trying a person for the same crime twice) applies to firms such as corporations.<sup>200</sup> But the Court held that a business firm may not invoke the Fifth Amendment’s right against “self-incrimination.”<sup>201</sup>

Adopting an institutional legal perspective does not resolve all of the questions about whether and how the legal fictions, entities, and persons of business firms should be recognized for various purposes. It also does not resolve many complex and important questions about how these firms, once recognized, should be legally treated. At least, though, an institutional legal theory of the firm provides a foundation for beginning to evaluate and answer these questions—again from the perspectives of different potential policy goals and principles. An institutional theory of the firm asserts that concepts of “fictions,” “entities,” and “persons” are foundational to understanding business enterprises. And this is not a new claim.<sup>202</sup>

<sup>199</sup> See, e.g., Note, “Developments in the Law—Corporate Crime: Regulating Corporate Behavior through Criminal Sanctions,” 92 *Harvard Law Review* 1227, 1231–41, 1365–8 (1979). But see Khanna, *op. cit.* (arguing against corporate criminal liability as unsatisfactory on deterrence grounds and favoring alternatives of civil enforcement).

<sup>200</sup> See, e.g., *United States v. Martin Linen Supply Co.*, 430 U.S. 564 (1977).

<sup>201</sup> See, e.g., *Doe v. United States*, 487 U.S. 201 (1988). See also Blumberg, *op. cit.*, pp. 38–40; *Eastern Enterprises v. Apfel*, 524 U.S. 498, 557 (1998) (Breyer, J., dissenting); *Hale v. Henkel*, 201 U.S. 43 (1906) (discussing theories of corporation in application of constitutional principles in criminal context).

<sup>202</sup> For historical perspective, see *Corporate Personality in the 20th Century* (Ross Grantham and Charles Rickett eds.) (Hart Publishing 1998) (collecting essays discussing one of the earliest English cases recognizing firms as separate “entities” and “persons,” *Salomon v. Salomon & Co.*, [1847] A.C. 22, HL, which held that a sole proprietor may invoke the corporate form against claims for personal liability from creditors). *Salomon* has been described as “a celebrated case” which “haunts every discussion of corporate entity and limited liability.” Bernard F. Cataldo, “Limited Liability with One-Man Companies and Subsidiary Corporations,” 18 *Law and Contemporary Problems* 473, 478 (1953). See also Paul Vinogradoff, “Juridical Persons,” 24 *Columbia Law Review* 594, 595–7 (1924).

# Business Persons

*A Legal Theory of the Firm*

ERIC W. ORTS

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