THE CORPORATION IS A SOCIAL INSTITUTION

by

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LL.B., University of Western Ontario, 1997
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A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF
MASTER OF LAWS

in
THE FACULTY OF GRADUATE STUDIES
(LAW)

THE UNIVERSITY OF BRITISH COLUMBIA
August 2006

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ABSTRACT

Corporate law theory in Anglo-American countries has long been dominated by economic analysis. While significant efforts have been made to critique the economic theory of the corporation and a number of alternate “progressive” theories have been offered – there is still no single theory that stands in opposition to the Nexus of Contracts theory.

This thesis utilizes historical analysis to show that before 1930 there were two dominant and opposing theories of the corporation: Contractual theory (or early economic theory), which conceptualized the corporation as merely a collection of freely contracting individuals; and Entity theory (or early sociological theory), which conceptualized the corporation as a real entity with an existence distinct from its members. The competition between these two contrasting theories created a balance in the corporate law debate between the economic and social aspects of corporations. But Entity theory fell out of favour in Anglo-American countries and the balance was lost.

The effects of that loss are evident in modern Anglo-American societies with our disproportionate preference for private interests over public interests. Our fascination with short term profits, our readiness to make lay-offs and rampant mergers and acquisition activity are a few examples of this phenomenon.

This thesis argues for the revival of the social theory of the corporation to restore balance to the corporate law debate. Using advances in sociology and in particular developments from organizational theory and institutional analysis, the building blocks of an updated social theory of the corporation are outlined.
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PREFACE

THREE STRIKES AND YOU'RE OUT

This book was motivated by my experiences in the practice of corporate law. I graduated from law school in the late 1990's. Although I did not recognize it at the time, I was a well trained corporate lawyer from the law and economics school.\(^1\) I knew the mantra: the corporation, at all times, was to be run in the best interest of shareholders. This idea is referred to as "shareholder primacy". Corporate transactions, such as hostile takeover bids, mergers, acquisitions and other shareholder maximization transactions (such as employee lay-offs) were all justifiable on the basis that focusing on returns to shareholders ensured that corporations were always operating efficiently. If they were not, shareholders would replace ineffective corporate managers and force the redeployment of underperforming corporate assets to more productive uses. The theory made everything seem so simple. The problem was that the real world turned out to be a lot different than the theory described.

The story of my career as a corporate lawyer is best described using the metaphor: three strikes and you're out. When I graduated law school, I was lucky enough to attain an articling position at a well respected Bay street corporate law firm. I practiced there for a very short period of time. But, it was long enough for me to realize that there was something wrong with what I had been taught in law school. Two deficiencies, in particular, became clear to me. First, most corporate transactions aimed at increasing the profits of a corporation were not successful. Ineffective corporate managers were not often replaced, and assets, though redeployed, rarely seemed to be put to more productive

\(^1\) This is a particular approach to corporate law that is based on the Nexus of Contracts theory of the firm. It is described in more detail in Chapter 3 — “The Nexus of Contracts Theory of the Corporation.”
uses. Second, in my mind, it was very hard to reconcile the fact that in the same transaction, a senior manager could be paid ten of millions of dollars in “parachute” and stock option payments to leave the company, while at the same time, ten of thousands of employees who wanted to stay, were getting let go in “cost-cutting measures”. Were they really getting let go to cut costs? To redeploy assets to more productive uses? Or were they being let go to fund the payments to the outgoing executives?

I left the firm to join a Canadian software and technology company that was listed on the Toronto Stock Exchange. I became the General Counsel of the company shortly after I arrived. It was a wonderful company, full of community feeling, and a place that everyone would be happy to work at. Canadian from its inception it valued people and customers first and profits were a clear second. While its products may have fallen a little behind the times – it was a wonderful place to work. Unfortunately, about 18 months after I joined, the company was sold in what looked like a friendly transaction, but which was ostensibly a hostile takeover bid. Even though the company was not losing money, it was not generating enough returns for its major shareholder, and, so, it was sold to a larger Canadian information technology company. Unfortunately, the end results are all too familiar: large financial payments were made to exiting executives, employees were laid off and the integration of the companies was a failure. I left. I understand that the company was sold twice more in the ensuing years and that it was forced to shut down half of its business. I believe it is now owned by an American company. Strike one – against the practice of corporate law.

From there I became the corporate counsel for another Canadian technology company that was listed on the Toronto Stock Exchange. Again, I chose it because it was
a wonderful place to work. It was founded by a Canadian entrepreneur, who had bought a patent from a larger corporation, and grown it, from a few people working in a garage, to a company with over 400 employees that made world class technology products. The sense of pride and community at the company was incredible and it had a real ‘family’ atmosphere. It was clearly the type of place that could choose people over profits and, unfortunately, it did. By chance, it chose to buy a beautiful new building for its employees just before its business took an unexpected short term downturn. A temporary cash flow problem resulted and the company was unable to find funding. About 18 months after I arrived, the company was sold in an auction process to a large U.S. corporation. The results were the same: large financial payments were made to exiting executives, employees were laid off, and I am not really sure how well the integration went because, knowing what the outcome was likely to be, I left before it started. The most disappointing thing about this transaction was the effect that it had on the employees, at both the executive level and the non-executive level. The community feeling of the company evaporated overnight, trust disappeared, there were instances of marital breakdown, family stress, divorce, adultery, depression, drug abuse, alcoholism, greed etc. as people succumbed to the pressure and uncertainty that is involved in these types of transactions. Living through these situations with people that you know, or worse care for, is very difficult. Sometimes legal practitioners who do not have to live at the company that is being sold can be too removed from the actual consequences to understand the impact that these activities have on people. Anyone who has worked in a corporation knows that it is not just a ‘legal fiction’. It is an organization made up of real people, each with their own motivations, hopes, aspirations, dreams, idiosyncrasies etc.
When a decision is made to ‘maximize profit’ – you are not just moving decimal places around – you are making an impact on the lives of real people. It is important not to forget that there are social and psychological consequences to the human beings involved in shareholder maximization transactions. Strike two.

I then went to another great company as a corporate counsel. It was, and still is, Canada’s largest health and life sciences company. I chose it because of its core values, the mentors that they offered me, and the fact that it was so large that it would be an unlikely target for a ‘shareholder maximization’ process – or, so I thought. Again, the story is eerily similar. This company was a Canadian success story. It had been founded by three entrepreneurs in the 1970’s and had grown to a C$1.6 billion revenue company with about 10,000 employees and operations worldwide. Many of its employees had been with the company for the entire working careers and the culture was characterized by a strong community feeling. Unfortunately, it made a crucial mistake. During the late 1990’s, it decided that it was a growth company and promised investors that it would return annually 15% on its equity. The problem was that historically it had only ever delivered 9-10% return on equity. The result was that it attracted institutional shareholders whose expectations that could not be met. About two years after I arrived, the shareholders became dissatisfied with the financial performance of the company, even though the company continued to make money, albeit not the promised 15% return on equity. The founders were forced to leave, a new CEO was brought in from the U.S. with the sole purpose of focusing on return to shareholders, large layoffs ensued, and plans were developed to break the company up into at least two parts. Immediately the community feeling of the company evaporated. Good people started to leave and the
standard results looked to be on the horizon. The fate of this company is still in the air as of the time of printing. Strike three and I was out.

At that point, I came to a realization. Was it coincidence that I managed to choose three companies early in my career that were to be sold or affected by shareholder maximization transactions? Or, was there something more systematic going on here? The realization that I had was this: in the current economic system in North America, with its focus on generating profits for shareholders, it is impossible for any public company that values people over profits to exist for any significant period of time. Inevitably, the company will be forced to choose its people over profits, and its financial performance will suffer. If the company is publicly traded, a short term dip in financial performance is not permissible, even if it is temporary, and the company will be subject to some sort of shareholder maximization process, to return the company to ‘profitability’. Therefore, in the current system, the existence of ‘good’ companies is only temporary and all ‘good’ companies that are publicly traded are likely to be sold or torn apart at some point in the future.

Personally, I realized that I could either continue to choose good companies and fight to protect them one at a time – or I could focus my efforts on trying to change the system – so that companies like the ones described above can not only exist in our society, but be treasured. The result is this book. I hope that it proves useful in helping people understand how the current economic system in North America came about, how our current corporate law and corporate theory are structured, and how extreme they all are in their politics. I hope it also provides a useful picture of what the alternatives are.
The focus of the book is corporate law, but its implications are far wider. Society is about people – not profits. As a society, if we continue to value profits over people, we risk grave consequences. Karl Polanyi warned us of this in 1957 in his book: *The Great Transformation*. If Polanyi was right in his analysis, the stakes are high. We risk losing our society. As Canadians, we need to start making policy choices that are consistent with the preference of people over profits. How can we do that? This book offers some thoughts, theories and tools that might be helpful.

Finally, I would be remiss if I did not mention the indebtedness that I have to all the great thinkers that have gone before me whose work is cited in this book. There is nothing new in this book. It is really just a collection of great ideas that people need reminding about.

*Michael Cody*
*August 31, 2006*
I would like to take this opportunity to acknowledge some of those who assisted me in the completion of this thesis.

I cannot say enough about Professor Janis Sarra. Not only was she my supervisor, but she was also a mentor and role model for me. She is the kind of person and academic that we all marvel at. The support and encouragement that she provided me was invaluable and the opportunities that she opened up for me, I can never repay her for. I am in her eternal gratitude.

I am also fortunate to have had Professor Ron Davis as my second reader on this thesis. His incisive comments helped provide focus to a project that had a tendency to grow out of all proportion.

I would also like to acknowledge Professor Wesley Pue for his encouragement throughout the year and his support of all ideas subversive. In addition, I would like to thank Joanne Chung who was our Graduate Secretary but who also was my mom away from home.

Thanks go out to everyone else who at one point or another provided comments on drafts of this thesis including: Brandi Stocks, Jessica Fletcher and Rebecca Proctor.

Finally, I would never have gotten this thesis done without the support of my good friend Rob Russo who helped to ensure that it was accepted by FOGS on the first try.
DEDICATION

This thesis is dedicated to Jessica. Thank you for helping me find my passion.
CHAPTER 1: INTRODUCTION

The thesis of this book is that the corporation is a social institution. It is a simple insight, but it has profound implications for the way we think about corporations. Currently, in Anglo-American societies we think of the corporation only in economic terms. The corporation is simply a vehicle to fulfill our economic requirements, and, we treat it that way. From the way we conceive of it, to the way we structure it, to the way we operate it, to the way we regulate it, economic theory informs all of our opinions of corporations. But, economic theory is ill suited to current reality, because it makes a series of simplifying assumptions that effectively eliminate human, cultural and social aspects from analysis. This is a dangerous thing to do with a social institution. The outcomes of this type of analysis are apparent all around us: Profit is more important than people, mergers and acquisitions are rampant, short term results are more important than stable long term sustainability, massive downsizing and lay-offs are common and the economy is in a constant state of instability.

The economic conception of the corporation is wrong. If it ever was correct, its time of usefulness has passed. Corporations are no longer simply economic vehicles. They have attained enormous power in Anglo-American societies: they make most everything we use, many of us earn our living working for them, our communities are dependent on them, they control almost all of the financial capital in the economy, and they are involved in providing many of our basic services, including food, health care, education, defense etc. In this context, corporations have become an important social institution: a social structure that provides meaning and stability to our lives. A structure

\[\text{\textsuperscript{2}}\] The term Anglo-American will be used throughout this book to refer to the United States, the United Kingdom, Canada, Australia and New Zealand.
similar, in kind, to the family, the church or the state. We need to re-conceptualize our views of corporations to account for this. We need to change how we conceive of them, how we structure them, how we operate them and how we regulate them. We need to reintroduce the missing human and social aspects of corporations - the aspects that are the most important when we recognize that the corporation is a social institution.

This should not be too hard to accomplish. The economic conception of the corporation is relatively new. In corporate law, it did not become the accepted paradigm until the mid 1980's. In the past, social conceptions of the corporation were quite popular and influential. However, somewhere along the way, those social conceptions of the corporation fell out of favour in Anglo-American societies and the economic conception took over.

This book explains what those earlier social conceptions of the corporation were, how the economic conception of the corporation became dominant, and argues for the revival of a social theory of the corporation. A theory based on sociological analysis and not economic analysis. An approach that focuses primarily on understanding the human and social aspects of how corporations work and the role they play in our society.

Beyond that, this book argues for balance. One of the insights of the social theory of the corporation is that society and human organizations, including corporations, are very, very complex phenomena, and no single theory, economics or sociology, is yet capable of completely explaining them. Therefore, going forward, the progress we make towards truly understanding society, organizations and corporations, will come from balancing and incorporating the insights from all social sciences into one multidisciplinary theory of the corporation.
This book explores these issues by focusing on corporate law and theory upon which it is based. It adopts a contextual approach and examines the rise of corporations, economic analysis, and corporate law from a broad social and historical perspective. This approach is a conscious effort to take a step back from the narrow field of corporate law and place the current issues in corporate law within societal context. The geographic focus of this book is primarily Canada and the United States although reference will be made to Anglo-American countries, and other countries, including Germany, China and Japan. This book is also primarily focused on large publicly traded corporations, although many of the insights will apply to all corporations.\(^3\)

1.1 Corporate Theory

This book is about Anglo-American corporate law. More specifically, this book is about the theory upon which Anglo-American corporate law is based.

All Anglo-American corporate law theories are based on the answers to two related questions:

1. What is a corporation?\(^4\)
2. What is the purpose of corporate law?

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\(^3\) Anglo-American jurisdictions are unique in the fact that they do not distinguish between privately held companies and large public companies within the corporate law. Although the latter is subjected to additional requirements through securities acts and stock exchange regulation. In contrast, in Germany and France, for example, they have different concepts for private and public companies. For a description of these differences see John Kay, The Business of Economics (Oxford: Oxford University Press, 1996).

\(^4\) The view that corporate theory is concerned with providing an explanation for what corporations are is shared by David Millon. See David Millon, “Theories of the Corporation” [1990] Duke Law Journal 201 at 241, where he states: “Legal theories differ from legal rules because legal theories set forth a positive or descriptive assertion about the world – an assertion about what corporations are.” Millon argues that these types of positive statements then lead to normative implications. This book makes the argument that the positive statements do not lead to normative implications because the statements themselves are normative. See Chapter 3 – “Politics and Normative Assumptions.”
In this book, the term ‘corporate theory’ is used to describe theories that attempt to answer these two questions.5

The first question is important to corporate law because the way that the corporation is viewed is often the primary determinant of what the purpose of corporate law is deemed to be. For example, if the corporation is conceived of as a contract among private individuals, then it is likely that the purpose of corporate law will be to act as a standard form contract among those individuals.

The second question is important to corporate law because the view of the purpose of corporate law is the primary determinant of the form corporate law takes. For example, if the purpose of corporate law is to act as a standard form contract among private individuals, then it is unlikely that the corporate law will contain terms that regulate the corporation’s relationship with society.

There is a strong link between the answers to these two questions, corporate theory, and the corporate law. Almost all proposals to reform corporate law are based, knowingly or not, on different answers to these questions, and consequently, different corporate theories. The best way to judge whether any given proposal to reform the current corporate law is an improvement, is to determine whether the answers that are provided by the new corporate theory being offered are better than the answers provided by the current corporate theory. ‘Better’ answers are: more descriptive of reality, better at predicting behavior, and/or more consistent with the normative views of society concerning corporations.6 Historically, change in corporate theory has only occurred

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5 Throughout this book when the term corporate theory is used it is referring to Anglo-American corporate theory.

6 These three criteria are linked to the three aspects of corporate theory. The descriptive aspect describes how corporations and corporate law work in the real world. The illustrative aspect allows the behaviour of
when a new theory arises that offers better answers than the answers offered by the current theory.\textsuperscript{7}

Currently, the dominant theory in Anglo American corporate law, the ‘nexus of contracts’ theory, provides the following answers to the questions:

1. The corporation is a “nexus of contracts” among inputs and outputs in the production process

2. The purpose of corporate law is to act as a standard form contract among those inputs and outputs.\textsuperscript{8}

While these answers are not very descriptive of reality, it is alleged that they are relatively good at predicting behaviour, and they are (or were) extremely consistent with the normative view of Anglo-American societies concerning corporations.\textsuperscript{9}

The purpose of this book is to re-examine the two corporate theory questions and determine if there are answers to those questions that are ‘better’ than the answers provided by the ‘nexus of contracts’ theory. Are there answers that are more descriptive of reality, better at predicting behavior and more consistent with society’s normative views of corporations? If there are better answers, do those answers justify a change in corporate theory? Even more so, do they justify a change in the corporate law?

\textsuperscript{7} For example, Concession theory was replaced by Entity theory and Contractual theory when it became clear that corporations formed naturally and were not dependent on the state for their existence. For a description of this see Chapter 2 – “Evolution Not Invention” and Chapter 3 – “Fiction/Concession Theory”, “Entity Theory” and “Contractual Theory”.

\textsuperscript{8} This position argues that corporate law exists because it offers efficiency gains to the contracting parties. For a complete description of the nexus of contracts theory see Chapter 3 – “The Nexus of Contracts Theory of the Corporation”.

\textsuperscript{9} For a complete assessment of these criteria applied to the nexus of contracts theory see Chapter 4 – “The Rise of Economics in Corporate Law.”
This reassessment of corporate theory is timely. The recent high profile corporate governance failures in both Canada and the United States have highlighted and reinforced existing concerns about the structure of the Anglo-American corporate governance system.\textsuperscript{10} The timing of this inquiry is further heightened due to the ongoing corporate governance convergence debate, in which a number of prominent U.S. corporate law scholars have argued that the Anglo-American corporate governance system, with its focus on shareholder primacy, should be adopted by all jurisdictions worldwide. This argument is based on the belief that the U.S. corporate governance system has proven itself to be the most efficient.\textsuperscript{11}

Before such convergence claims are made, Anglo-American scholars must be confident that the dominant Anglo-American corporate theory is the best that we can offer, and that the resulting corporate law structure to be exported is appropriate. This book argues that neither is the case.

\subsection*{1.2 Themes of the Book}

There are two main themes that run throughout this book: Politics and Balance.

\subsection*{1.2.1 Politics}

The contention of this book is that the answers to the two corporate theory questions are largely political (or normative) and, therefore, corporate theories are

\textsuperscript{10} The corporate governance failure at Nortel Networks in Canada and Enron in the United States are examples.

normative theories. Normative theories are simply statements about the way we want the world to 'be'. They are in contrast to positive theories, based on observation, that are scientific theories about the way the world 'is'. There is a big difference between the two. The answers to the two corporate theory questions are not universal truths that can be discovered through academic or theoretical analysis. The answers that are provided depend on the normative assumptions that are first made when the questions are approached. This normative aspect of corporate theory inevitably leads debates about corporate law into the political sphere because corporate theory has distributive effects in our society.

A reader cannot wade deeply into the corporate law literature without coming to the realization that the debate in corporate theory is really political. Lyman Johnson has argued that corporate law scholars need to admit to themselves when they approach corporate law problems that what they are struggling with is really the political, social and economic power in society:

Why isn't corporate law flocked to, begged for by new law teachers the way the subject of constitutional law is? I think in part it is because constitutional law teachers are more honest in saying they are dealing with political, economic and social power, and how that power is exercised and controlled in a democracy... In corporate law, the sphere of which is, after, all, the governance of immensely

12 The fact that corporate theories are normative has been pointed out by a number of legal scholars, especially feminist legal scholars. For example, Janis Sarra has written: "An important step in this exploration is to challenge the apparent neutrality of the shareholder wealth maximization norm of corporate governance and expose its normative content." See Janis Sarra, "The Gender Implications of Corporate Governance Change" (2002) 1 Seattle Journal for Social Justice 457 at 461.

13 For an example of this type of argument see Lynn Dallas, "Working Towards a New Paradigm" in Lawrence Mitchell, eds. Progressive Corporate Law (Boulder: Westview Press, 1995) at 44, where she argues that corporate law is distributive regardless of the claims by law and economics scholars that corporate law is value free and non-distributive: "Economists offer both definitions of allocative efficiency [Kaldor Hicks and Pareto Optimality] as appropriate goals because they are considered to be value neutral: that is, they do not concern themselves with the distribution of wealth. But this assertion itself contains a value judgment: that wealth distribution can be ignored in measuring societal welfare. These concepts treat societal welfare as equally maximized where one percent of the population owns ninety-nine percent of the wealth, as where there is a more equal distribution of wealth, an assertion that has substantial normative implications."
influential business organizations, the power dimension of our subject is not confessed but submerged, and so our area is regarded by our own colleagues (wrongly) as being of a rather limited scope . . . Those within the legal academy . . . must rediscover corporate law and its central place not only in the law school curriculum but in our social lives.\textsuperscript{14}

D.P. Derham went a step further and argued that corporate theories have been used as political tools in the past to achieve desired social and political ends:

It must be observed at this stage that all four theories, and their variations, \textit{have been used for social and political ends – particularly on the continent of Europe.} [Emphasis added]\textsuperscript{15}

The outcome of the realization that corporate theories are normative is that the devotion in Anglo-American corporate law to the Nexus of Contracts theory is not based on the theory’s intellectual superiority, but more because of a broader normative allegiance in society to economic theory. This allegiance is the result of a partnership between politics and economics in Anglo-American countries that is best exemplified by the neo-liberal movement. It is not possible to evaluate the Nexus of Contracts theory in any meaningful way without keeping this broader political context in mind.

The political nature of the debate in corporate law is evidenced by the fact that labels are used to describe proponents of both sides of the debate including: ‘right wing’, ‘leftist’, ‘conservative’ and ‘communitarian’.\textsuperscript{16} The purpose of using labels is to invoke an emotional response that will make people overlook ideas.\textsuperscript{17} For example, when

\textsuperscript{16} For examples of the use of the terms see Stephen Bainbridge, "Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship" (January 1997). Available at SSRN: http://ssrn.com/abstract=10335. Bainbridge uses the terms “leftist” and “communitarian” on page 23. The term “conservative” is used on page 24 and the term “right-wing” is used on page 22.
\textsuperscript{17} See John Ralston Saul, \textit{The Unconscious Civilization} (Concord, Ont.: House of Anansi Press, 1995) at 176, where he uses an historical analysis to show how language can affect the analysis of a problem: “Before Benjamin Franklin began to think about lightning, the received wisdom had it identified as a super
approaching the corporate law debate how would you feel about reading the ideas of a ‘progressive’ corporate law scholar? Chances are it would depend on your politics – but most of us would feel excited about the possibilities of ‘progress’. What if the same scholar and the same ideas had been labeled by someone else as ‘communitarian’? Are you as excited? Less excited? What emotional response does that label bring to you? This second label is obviously associated with words that are generally viewed negatively in Anglo-American countries, words like: ‘communism’.

The best example of how these labeling tactics have been used in the corporate law debate is Stephen Bainbridge’s 1997 book review of Larry Mitchell’s collection of essays: Progressive Corporate Law. In the book review, Bainbridge, after having admitted that his basic criticism with the essays was political and not intellectual, went on to systematically label each author in the collection of essays as ‘communitarian.’ He did this even though each of the authors referred to themselves as progressive corporate law scholars and only David Millon referred to himself as communitarian:

Although Progressive Corporate Law’s scholars are united in their rejection of the contractarian model and of Economic Man, they have achieved less unity in offering an alternative theory of the firm. To the extent a common theme can be identified it is the tendency toward a leftist version of communitarianism. David Millon’s chapter most explicitly embraces communitarianism as an alternative to contractarianism. . . Several of Progressive Corporate Law’s other authors write from a perspective that is communitarian in all but name. Lynne Dallas, for example, offers a so-called power coalition model whose rhetoric is essentially communitarian. Larry Mitchell denies being a communitarian, although he admits to sympathy towards that view.¹⁸[Emphasis added]

natural phenomenon. For that reason, gunpowder was often stored in churches, to give it divine protection. Church bells were rung during thunderstorms to ward off the bad spirits. Between 1750 and 1784, lightning struck 385 German churches killing 103 bell-ringers. In 1767 lightning struck a Venetian church whose vaults were filled with gunpowder. The explosion killed 3,000 people. In other words, there was ample proof that divine protection did not ward off lightning. But so long as there was no language to destroy the received wisdom, it remained in place. Our experiences today with the invisible hand of the marketplace are similar. What we require is the language to demonstrate its comical nature.”¹⁸ Supra note 16 at 21-22.
In order to make the reader aware of the politics of corporate theory, this book provides a framework for analyzing the normative assumptions behind each corporate theory and categorizes each Anglo-American corporate theory according to that framework.

1.2.2 Balance

The conclusions offered in this book largely conform to one major theme: Balance. In particular, the argument is made for a restoration of the balance between the social and economic aspects of corporate theory. It is part of a larger argument that is being made for the restoration of the balance between the social and economics aspects of our society. Currently, Anglo-American societies have become dominated by their economic aspects through their devotion to the neo-liberal ideal of the 'self-regulating market'. This is not the first time in history that this has happened. It happened during the 19th century with the movement by market liberals to create a self-regulating market. That movement had disastrous consequences.

In 1944, Karl Polanyi wrote about the dangers that lurk when balance is lost and the social aspects of society become subordinate to its economic aspects. This had never occurred before the 19th century market liberalism movement. Prior to that time, the economy and the market were always subordinate to the social aspects of society. Politics and religion were always more important and the market was 'embedded' in society. Polanyi argued that very bad things occur when the market becomes

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19 See Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 2001). Originally published in 1944. On page 71 he wrote: "This cursory outline of the economic system and markets, taken separately, shows that never before our own time were markets more
disembedded from society and society becomes subordinate to it.\textsuperscript{20} For example, the results of the last attempt by the market liberals to create a self regulating economy were the First World War, the great depression and the rise of fascism and communism.

Polanyi argued that no attempt to create a self-regulating market can ever be successful because the consequences to society are so grave that the government and/or citizens always intervene.\textsuperscript{21} The socially disruptive consequences of the ‘self-regulating market’ are the commodification of everything, including things that should not be commodified: like people (labor) and the environment (resources).\textsuperscript{22} The commodification of these items almost assures the destruction of society and the environment. Polanyi summarizes his thesis in the following way:

Our thesis is that the idea of the self-adjusting market implied a stark utopia. Such an institution could not exist for any length of time without annihilating the human and natural substance of society; it would have physically destroyed man and transformed his surroundings into a wilderness.\textsuperscript{23}

He described the effects of the self-regulating market on people and the environment as a ‘satanic mill’:

To allow the market mechanism to be the sole director of the fate of human beings and their natural environment indeed, even of the amount and use of purchasing power, would result in the demolition of society. For the alleged commodity ‘labor power’ cannot be shoved about, used indiscriminately, or even left unused, without affecting also the human individual who happens to be the bearer of this peculiar commodity. In disposing of man’s labor power the system would, incidentally, dispose of the physical, psychological, and moral entity than accessories of economic life. As a rule, the economic system was absorbed in the social system, and whatever principle of behaviour predominated in the economy, the presence of the market pattern was found to be compatible with it.”

\textsuperscript{20} Ibid at 60, where he writes about the disembedding of the market: “Ultimately that is why the control of the economic system by the market is of overwhelming importance to the whole organization of society: it means no less than the running of society as an adjunct to the market. Instead of economy being embedded in social relations, social relations are embedded in the economic system.”

\textsuperscript{21} Ibid at 80.

\textsuperscript{22} For Polanyi, a commodity is something that is produced for sale on a market. Labor, land etc. are fictitious commodities because they were not originally produced for sale on a market, see Ibid.

\textsuperscript{23} Ibid at 3.
‘man’ attached to that tag. Robbed of the protective covering of cultural institutions, human beings would perish from the effects of social exposure; they would die as the victims of acute social dislocation through vice, perversion, crime, and starvation. Nature would be reduced to its elements, neighbourhoods and landscapes defiled, rivers polluted, military safety jeopardized, the power to produce food and raw materials destroyed. Finally, the market administration of purchasing power would periodically liquidate business enterprise, for shortages and surfeits of money would prove as disastrous to business as floods and droughts to primitive society. Undoubtedly, labor, land, and money markets are essential to a market economy. *But no society could stand the effects of such a system of crude fictions even for the shortest of time unless its human and natural substance as well as its business organization was protected against the ravages of this satanic mill.*

Polanyi described the reaction against the self-regulating economy as the ‘double movement’: The laissez-faire movement to create the self-regulating market and the countermovement to protect society. Polanyi argued that the welfare state was the outcome of the last counter movement. One of the errors in Polanyi’s theory was that he had assumed that the counter-movement had been successful and that the idea of the self-regulating market was dead.

The truth is that the idea of the self-regulating market is alive and well in Anglo-American societies and it is the dominant political ideology. This fact has been pointed out by many social commentators including John Ralston Saul. Saul’s diagnosis is similar to Polanyi’s – if no counter movement soon develops – we are headed for a wave of negative nationalism that inevitably will end in war. The difference between Polanyi’s approach and John Ralston Saul’s approach, is that Saul has called for a balanced countermovement this time.

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24 Polanyi *supra* note 19 at 76-77.

25 For the argument that the modern neoliberal movement is just another attempt by market liberals to create a self-regulating market see John Ralston Saul, *The Collapse of Globalism and the Reinventing of the World* (Toronto: Viking Canada, 2005); see also Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge: Cambridge University Press, 2002).

26 See Saul *Ibid* at 245 where he talks about the two potential responses to globalization and the self regulating market: negative nationalism and positive nationalism. He advocates a positive nationalism that
As a result of the political alliance between politics and economics, Western capitalism, together with its shareholder oriented corporation, has lost its balance and Anglo-American societies have become subordinated to the market. For example, most Anglo-American societies now measure their success based almost exclusively by economic measures. Gross domestic product (GDP) has become the measurement of progress, as opposed to some other more meaningful measures, like lower crime rates, poverty levels, levels of drug abuse, addiction, suicide etc.27

One example of this loss in balance can be found in Anglo-American corporate law. In the past, corporate law was balanced by a debate between competing corporate theories formed using opposite normative assumptions: social theories on the one side and economic theories on the other. That is no longer the case. Anglo-American theory has become dominated by economic analysis.28 The most widely accepted economic theory of the corporation is the Nexus of Contracts theory. It is a normative theory that is based on at least three key normative assumptions:

1. Individuals act only in their own self-interest – the “rational choice theory”,

27 In fact, there are many other potential balanced measures of progress that we are capable of using that take into account societal factors other than just economics. The measures include: The Index of Sustainable Economic Welfare, which is described at <http://www.foe.co.uk/campaigns/sustainable_development/progress/>; The Genuine Progress Index, which is described at <http://www.rprogress.org/projects/gpi/>; Wellbeing Index, which is described at <http://www.australianunity.com.au/au/info/wellbeingindex/>; The UN's Human Development Index, which is described at <http://hdr.undp.org/reports/global/2005/pdf/HDR05_HDI.pdf>; The World Bank's Wealth of Nations <http://web.worldbank.org/WEBSITE/EXTERNAL/NEWS/0,,contentMDK:20648103~pagePK:34370~piPK:34424~theSitePK:4607,00.html>; UN's System of Integrated Environmental and Economic Accounts, which is described at <http://unstats.un.org/unsd/envAccounting/seea.htm>; and Dashboard of Sustainability, which is described at <http://www.iisd.org/cgsdi/dashboard.asp>.

28 For a description of the process by which corporate theory became dominated by economic analysis see Chapter 4 – "The Rise of Economics in Corporate Law".
2. The individual is the correct political, social, economic or legal unit of analysis in society and not the group, and

3. The corporation is a private entity that should be free from public regulation.\textsuperscript{29}

While significant efforts have been made to critique the economic Nexus of Contracts theory of the corporation, and a number of alternate progressive theories have been offered, there is still no single theory that stands in opposition to it. That was not always the case. Before 1930, there were two dominant and opposing theories of the corporation: Contractual Theory (or early economic theory), which conceptualized the corporation as a collection of freely contracting individuals\textsuperscript{30}; and Entity theory (or early sociological theory), which conceptualized the corporation as a real entity with an existence distinct from its members. The competition between these two contrasting theories created a balance in the corporate law debate between the economic and social aspects of the corporation. But, Entity theory fell out of favour in Anglo-American countries and that balance was lost.\textsuperscript{31} The effects of that loss are evident in modern Anglo-American society, with our disproportionate preference for the individual over the group, private interests over public interests and economic concerns over social concerns.

This book argues for the revival of the social theory of the corporation to restore balance to the corporate law debate. Using early sociological theories as a base and updating them using the latest advances in sociology and, in particular, developments from organizational theory, the building blocks of an updated social theory of the

\textsuperscript{29} For a complete description of the assumption underlying the nexus of contracts theory see Chapter 3 – “Nexus of Contracts Theory” and Chapter 4 – “The Critique of Economics, Law and Economics and the Economic Conception of the Corporation.”

\textsuperscript{30} For a description of Contractual theory see Chapter 2 – “Contractual Theory”.

\textsuperscript{31} Another way to characterize this problem is that in Anglo-American countries Contractual theory appropriated the benefits of Entity theory without also adopting the corresponding obligations.
corporation are outlined. The social theory of the corporation provides the following answers to the two questions of corporate theory:

1. The corporation is a social institution. It is an organization of human beings that has become so important as an organizational type that it has become institutionalized and now provides meaning and stability to social life.

2. The purpose of corporate law is twofold:

   • To facilitate the formation, survival and evolution of corporations, and
   • To provide stability to society, markets and corporations by managing the relationships amongst the corporate participants in a way that is consistent with the normative views of the society in question.

The social theory of the corporation is a normative theory and it is based on normative assumptions that are opposite to the assumptions of the Nexus of Contracts theory:

1. Humans are social beings whose behaviour is affected by their social circumstances,

2. Groups are a valid and natural political, social, economic or legal unit of analysis in society, and

3. Corporations are public institutions that can rightly be subjected to government regulation.

The argument in this book relating to corporate law is but a small portion of the larger arguments that Polanyi and Saul were making about society. The argument is simply that the economic system in Anglo-American societies, and with it the corporate law, has gone out of balance and balance needs to be restored. This can be done by reintroducing the human and social characteristics of organizations and markets into corporate theory. On the larger scale, it can be done by ensuring that the market is subordinated to society. However, in so doing, we need to be careful not to react too far.
Replacing neo-liberalism’s rejection of any legitimate concerns about others or society with a theory or system that only takes into account social relationships and groups – would just be creating a whole new problem. They key is that society and corporations are about individuals and groups; private interests and public interests; and social and economic aspects. We just have to find the right balance.

There is nothing in this book that is anti-capitalist, anti-democratic, anti-market or anti-corporate. It is not a rejection of market economies. It supports properly regulated economies. This book is simply an attempt to remind us that society is about people not profits.

1.3 Chapter Outline

The fact that the corporation is a social institution, the need for the revival of the social theory of the corporation and the superiority of a multi-disciplinary approach to corporate theory is illustrated in this book using a seven-part analysis.

Chapter 2 shows that the corporation is a social institution. It is a social structure that provides stability and meaning to social life. The most important insight of this finding is that the corporation should be analyzed using social theories, including sociology and organizational theory etc. and not just economic theories.

Chapter 3 provides a historical survey of corporate theories to show that the idea that the corporation is a social institution is not new. In the past, corporations were viewed as social institutions and earlier corporate theories that acknowledged this were built on insights from sociology. Examples of these theories include Entity theory and
Early Sociological theory. However, for some reason, during the course of the 20th century, these social theories of the corporation lost their prominence in Anglo-American societies and economic theories of the corporation became dominant. Chapter 3 also shows that corporate theories are normative. It does this by offering a framework by which the normative assumptions behind each corporate theory can be understood and by classifying each Anglo-American corporate theory using the framework.

Chapter 4 explores two insights from Chapter 3 in more detail. First, the process by which economic theories rose to dominance in Anglo-American societies is explained by showing that the Nexus of Contracts theory of the corporation came to dominate Anglo-American corporate law largely because of its normative assumptions and not because of its intellectual superiority. Second, the normative basis of the Nexus of Contracts theory of the corporation is exposed by examining the attributes of the theory that were supposedly value neutral and which made allegedly made the theory intellectually superior.

Chapter 5 begins to introduce the relevance of sociology and organizational theory to corporate theory - starting with organizational theory. The chapter shows that there has always been a strong link between organizational theory and corporate theory. In also shows that most of the advances in corporate theory in the last half-century came first as advances in organizational theory. More recently, organizational theory has advanced to a new perspective on organizations called the “natural open systems” perspective. Unfortunately, corporate theory has not kept pace and it is still using the previously popular “rational open systems” perspective. The natural open systems perspective is an improvement over the rational open systems perspective because it is
more descriptive of reality and is able to account for more of the complexity of social phenomena. The need for a new “natural systems” theory of the corporation in corporate theory is highlighted.

Chapter 6 continues the process of showing the relevance of social theories to corporate theory by focusing on economic sociology. This chapter outlines the building blocks of an updated version of the social theory of the corporation. The updated theory is built on the foundations of the early sociological corporate theories, the natural open systems view of organizations, and the latest developments from economic sociology regarding the sociological view of actors, organizations and markets. It is illustrated that the social theory of the corporation has the potential to be better than the current Nexus of Contracts theory of the corporation.

Chapter 7 explains the need for a multidisciplinary theory of the corporation. One of the most important insights of the social theory of the corporation is that social life is very, very complex and no single theory can completely explain it. The need to incorporate insights from all of the social sciences in order to explain as much of this complexity as possible is highlighted and the difficulties of this incorporation exercise are discussed. A ‘Layered Approach’ is offered to overcome these difficulties.

Finally, a conclusion is offered that explains that the time is right for renewed interest in a law and society approach to corporate law that draws on insights from sociology and organizational theory as the first step away from a strictly economic analysis of the corporation and toward a multidisciplinary theory of the corporation.
CHAPTER 2: THE CORPORATION IS A SOCIAL INSTITUTION

2.1 Introduction

The corporation is a social institution.

It is not just an economic institution. It never was a person. It never was a metaphysical entity with a will of its own, and it definitely never was a “nexus of contracts”. All of these abstract theories were just creations of well intentioned jurists who were trying to fit the complexity of human organizations into existing legal systems built on individual rights. Forgotten, in that process, was the fact that the corporation is not an abstraction at all. It exists in the real world. It is an organization of human beings. It always has been.

As an organizational form the corporation has become so important in Anglo-American societies that it has become a social institution. The corporation is one of the primary ways that we organize ourselves and find meaning and stability in society. It is

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32 Anglo-American countries have legal systems that are built on individual rights. This is a legacy from Roman law. The systems themselves are not capable of assigning rights to groups – so the natural solution was to turn groups into people. This has been pointed out by Morton Horwitz: “In a legal system whose categories were built around individual activity, it was not at all easy to assimilate the behaviour of groups”. See Morton J. Horwitz, “Santa Clara Revisited: The Development of Corporate Theory,” (1985-86) 88 W. Virginia Law Review 173 at 183. See also Meir Dan-Cohen, Rights, Persons and Organizations: A Legal Theory for Bureaucratic Society (Berkeley: University of California Press, 1986).

33 The view that the corporation is an organization is shared by many sociologists and organizational theories. For a sociological argument that corporations are different than other organizations see Richard Swedberg, The Principles of Economic Sociology (Princeton: Princeton University Press, 2003) at 98 where he argues there are four differences between corporations and other organizations: 1) their main goal is to make a profit, 2) they are treated differently in law, 3) they have their own institutional features, and 4) economic interests play a crucial role in firm behaviour. This arguments in this book directly contradict each of these assertions. Corporations are no different than other social organizations: 1) Their main goal is survival not profit, 2) they should not be treated differently in law, 3) they have similar institutional features to other organizations, and 4) Anglo-American societies have systematically overvalued the effects that economics has on firm behavior.

34 David Millon makes the argument that the actual social reality of corporations has not changed over time but that what has changed is our interpretation of them. See Millon supra note 4 at 249: “Corporations had not changed, but their meaning did.”
not alone in this status. In fact, it is the latest in a long line of such social institutions that have included, throughout history, the family, the town, the guild, the church and the state.

2.2 Historical References to the Corporation as a Social Institution

The contention that the corporation is a social institution is not a new one: commentators have long recognized this reality. References to the corporation as a social institution can be found in the corporate law, economics and management literature. For example, in the first paragraph of their 1932 classic *The Modern Corporation and Private Property* Adolph Berle and Gardiner Means wrote the following:

Corporations have ceased to be merely legal devices through which the private business transactions of individuals may be carried on... The corporation has, in fact, become both a method of property tenure and a means of organizing economic life. Grown to tremendous proportions, there may be said to have evolved a "corporate system" — as there was once a feudal system — which has attracted to itself a combination of attributes and powers, and has attained a degree of prominence entitling it to be dealt with as a major social institution.  

Examples from the corporate law literature include: Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property* (New York: Harcourt Brace & World, Inc, 1968) (originally published in 1932). Examples from Berle and Means are included in the text; Kellye Testy also has made an argument that the corporation may be the dominant institution in modern society: "...have paved the way for corporations to rival the state, and certainly the church, in institutional power and influence." Kellye Testy "Linking Progressive Corporate Law with Progressive Social Movements" (2002) 76 Tulane L. Rev. 1227 at 1228; and Mary Stokes: "Firstly, it is accepted that the modern public company has become an organization whose significance rivals that of the state. It is the primary institution for organizing and employing much of capital and labour resources and the primary supplier of goods and services in our community." Mark Stokes, "Company Law and Legal Theory" in Twining, ed., *Legal Theory and Common Law* (New York: Basil Blackwell, 1986) at 176. Examples from the economic literature include: John Kay: "The corporation is therefore, naturally perceived as a social institution, with public responsibilities, and a proper public interest in defining the ways in which it is run and governed." Kay supra note 3 and Alfred Eichner, *Toward a New Economics: Essays in Post-Keynesian and Institutionalist Theory* (New York: M.E. Sharpe, Inc. 1985) at 10-28. Examples from the Management literature include Peter Drucker, *The Concept of the Corporation* (New York: John Day Co., 1972) (originally published in 1946). Examples of references from Drucker are included in the text.

35 Examples from the corporate law literature include: Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property* (New York: Harcourt Brace & World, Inc, 1968) (originally published in 1932). Examples from Berle and Means are included in the text; Kellye Testy also has made an argument that the corporation may be the dominant institution in modern society: "...have paved the way for corporations to rival the state, and certainly the church, in institutional power and influence." Kellye Testy "Linking Progressive Corporate Law with Progressive Social Movements" (2002) 76 Tulane L. Rev. 1227 at 1228; and Mary Stokes: "Firstly, it is accepted that the modern public company has become an organization whose significance rivals that of the state. It is the primary institution for organizing and employing much of capital and labour resources and the primary supplier of goods and services in our community." Mark Stokes, "Company Law and Legal Theory" in Twining, ed., *Legal Theory and Common Law* (New York: Basil Blackwell, 1986) at 176. Examples from the economic literature include: John Kay: "The corporation is therefore, naturally perceived as a social institution, with public responsibilities, and a proper public interest in defining the ways in which it is run and governed." Kay supra note 3 and Alfred Eichner, *Toward a New Economics: Essays in Post-Keynesian and Institutionalist Theory* (New York: M.E. Sharpe, Inc. 1985) at 10-28. Examples from the Management literature include Peter Drucker, *The Concept of the Corporation* (New York: John Day Co., 1972) (originally published in 1946). Examples of references from Drucker are included in the text.

36 Berle and Means supra note 35.
In concluding the book they take their assumptions one step further:

“In still larger view, the modern corporation may be regarded not simply as one form of social organization, but potentially (if not yet actually) as the dominant institution of the modern world. . . . The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of social organization.”

Similarly Peter Drucker wrote about the corporation as a social institution in his famous 1946 book *The Concept of the Corporation*:

To understand that the modern large corporation is the representative social institution of our society; that it is above all an institution that is a mere human organization and not just a complex of inanimate machines; that is based upon a concept of order rather than upon gadgets; and that all of us as consumers, as workers, as savers, and as citizens have an equal stake in its prosperity, these are the important lessons that we have to learn. To make it possible for this new social institution to function efficiently and productively, to realize its economic and social potential, and to resolve its economic and social problems is our most urgent task and our most challenging opportunity.

More recently, commentator Joel Bakan has re-iterated this view of the corporation as an institution:

A key premise is that the corporation is an institution – a unique structure and set of imperatives that direct the actions of people within it. It is also a legal institution, one whose existence and capacity to operate depends on the law.

One of the key insights in this last quote is that institutions can have different characters. This is important to remember. While the argument of this book is that the corporation is a social institution, it does not deny that the corporation is also an economic institution. In fact, corporations are social institutions, economic institutions and legal institutions all

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37 Ibid at 309.
at the same time. The problem is that our current dominant corporate theory views the corporation as an economic institution alone.

2.3 Social Institutions – Sociology and Organizational Theory

The recognition of the corporation as a social institution is significant because the term “social institution” has a very specific meaning in sociology and organizational theory. Sociologists have long recognized that the corporation is a social institution and have analyzed it in an appropriate way with sociological analysis. Richard emphasized this:

Sociologists, as opposed to economists, have tried from early on to analyze firms as social institutions or social organizations, and there exists today a long tradition of sophisticated sociological analysis of this type.  

Early sociologists who treated the corporation as an institution included all three of the founding theorists of sociology Max Weber, Karl Marx and Emile Durkheim.  

Sociology defines a social institution in the following way:

Institutions are social structures that have attained a high degree of resilience. Institutions are composed of cultural-cognitive, normative, and regulative elements that, together with associated activities and resources, provide stability and meaning to social life. [emphasis added]

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40 Swedberg supra note 33 at 88.
41 For a description of the early treatment of firms as social institutions by these sociologists, with a specific emphasis on Weber see Ibid at 88-93.
42 W. Richard Scott, Institutions and Organizations (2 ed.) (Thousand Oaks: Sage, 2001) at 48. Another sociological definition of institution was provided by Richard Swedberg: “[I]nstitutions can be understood as distinct configurations of interests and social relations, which are typically of such importance that they are enforced by law.” Swedberg, supra note 33 at 1. Yet another useful definition is provided by Carlo Trigilia: Institutions are “a set of social norms which orient and regulate behavior and which are based on sanctions which seek to guarantee compliance on the part of individuals.” See Carlo Trigilia, Economic Sociology: State, Market and Society in Modern Capitalism (Oxford: Blackwell Publishing, 2002) at 4.
As the emphasis in the quote indicate the purpose of social institutions is to maintain stability in society. Society consists of sets of interrelated social institutions, including the family, religion, the education system, the political system etc. Institutions are sets of formal stable relations. They are rules that define individual roles in specific areas of society and they normally have built in mechanisms of enforcement. Collectively, they define who we are and what we do. Gore describes the importance of social institutions in the following way:

We are born and socialized into the existing institutions, such as family, church, school, and workplace. These are the basis of our identity formation and perception of self-interests. Our rule-following or institutionalized behaviour (which represents the bulk of the routine choices we make in a day) requires a shared back-ground knowledge so taken for granted that it becomes part of our collective identity. This is the cultural reinforcement of existing institutions, which explains why even strategically oriented individuals chronically reproduce or acquiesce to social structures that are not in their best interests.

This definition is wider than the way in which the term “institution” is used in common language. Normally, the term “institution” is used to refer to an organization like the government, hospitals, schools etc. This definition is also very different from the way that institutions are defined in economics. Economics has a very narrow and western centric definition of institution that defines institutions as the structures that contribute to economic growth. For example, Douglass North has defined an institution as:

\[ \text{See Lynne Zucker, “Organizations as Institutions” in Samuel B. Bacharach, ed., Research in the Sociology of Organizations: A Research Annual Vol. 2 (London: Jai Press Inc., 1983) at 21 where the author argues that the major consequence of institutionalization is maintenance of the institution over time and resistance to change.} \]


\[ \text{Gore Ibid at 25.} \]
[A] set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interests of maximizing the wealth or utility of principals.\textsuperscript{46}

The sociological definition of an institution is broader and is not limited only to rules that promote economic growth.

Lynne Zucker was one of the first organizational theorists to argue that organizations themselves are institutions:

Organizations are the preeminent institutional form in modern society. They organize and structure the daily lives of most people. . . Organizations are everywhere, involved in almost every possible sphere of human action.\textsuperscript{47}

In the context of sociological analysis, an organization is simply a group of people who are acting together for some common purpose – whether it is a specified goal, survival of

\textsuperscript{46} Douglass North, \textit{Structure and Change in Economic History} (New York: Norton, 1981) at 201. This definition is associated with the new institutional approach in economics (NIE). It is based on a number of economic assumptions. The main assumptions that are implicit in that approach are that: (1) the construction of a market economy is the primary desired goal for a society, 2) economic growth is a desirable social goal, and 3) political liberalization is a desired social goal. These assumptions are very common law centric assumptions about the goals of society and, in effect, they predetermine the outcome of the analysis that economic legal scholars conduct. Examples of NIE institutions are enforceable contract rights and private property rights. The goal of NIE analysis is to argue that domestic institutions that are different from western institutions should be replaced by western institutions in order to stimulate economic growth. By definition, the advantage of identifying the domestic institution, in the first place, is lost because of the inability of the theoretical framework to understand the institution in its own local and cultural context. In effect, the NIE definition of institution predetermines the outcome of NIE analysis. In a simplistic way it is like conducting an analysis to determine who is more American: the Chinese, the Japanese or the Americans? Or even more to the point, having acknowledged the importance of ‘institutional analysis’ – or the ‘cultural differences’ between the Chinese, the Japanese, and the Americans, the researcher still runs a competition to determine who is most American? What if, instead of the primacy of economic goals, those other societies also have social goals that they take into account when deciding how to structure their societies? Such as the health of their people in terms of life expectancy, suicides rates, rates of drug abuse, violence etc.? How are the differing social goals of the societies studied factored into this economic analysis? They can not be. Therefore, in order for institutional analysis to be useful, it needs to be used outside of the economic paradigm, so that the institutions identified in the analysis can be understood from the cultural perspective of the society that created them and not through the lens of Anglo-American economic analysis.

\textsuperscript{47} Zucker \textit{supra} note 43. For a more detailed description of the institutionalization of the modern corporation see Chapter 5 – “Why do Organizations Exist?”.
the organization or furthering the interests of its members within the organization’s
environment.\textsuperscript{48}

In describing organizations as institutions Zucker points out the dual nature of the
term “institutionalization”.\textsuperscript{49} She argued that it was both a process by which actions
become taken for granted, and also a structure in society that sets limits to what is
possible. She described this dual meaning in the following way:

\begin{quote}
[I]nstitutionalization is both a process and a property variable: it is a
phenomenological process by which certain social relationships and actions come
to be taken for granted, that is part of the “objective situation”, while at the same
time it is the structure of reality defining what has meaning and what actions are
possible.\textsuperscript{50}
\end{quote}

Another way to describe this phenomenon is that organizations, that have become
institutions, are not simply constrained by their institutional environment, but are often
able to define their own position in it:

Despite widespread recognition of the central position and role of organizations in
modern life, scant attention has been paid to the power that organizations have to
alter the forces, which affect them, whether internal or environmental.\textsuperscript{51}

For example, in Japan, lifetime employment and cross-shareholding patterns affect the
structure of the corporation. However, the corporation as a social institution is also able
to affect society at large, including changing the institutions of lifetime employment and
the cross-shareholding structures.\textsuperscript{52}

\textsuperscript{48} See Chapter 5 – “Definition of Organization” and Scott supra note 42 at 27-30 where three definitions of
organizations are offered, each depending on the perspective adopted by the theorist: Rational, Natural and
Open. The definition offered here represents each of the three different perspectives.
\textsuperscript{49} This premise is not accepted by all sociologists. For the opposite argument that organizations are not
institutions see Trigilia supra note 42 at 2.
\textsuperscript{50} Zucker supra note 43 at 2.
\textsuperscript{51} Ibid.
\textsuperscript{52} For a discussion of this process see Michael Cody. “The Arrival of Hostile Takeover Bids in Japan:
Convergence or Selective Adaptation?” (forthcoming).
The view that the corporation is a social institution is starting to receive more widespread acceptance outside of sociology. For example, in 2003, The Social Science Research Council sponsored a program called “The Corporation is a Social Institution” at Berkeley. The goal of which was to develop a stronger, conceptually richer and potentially more interdisciplinary approach to the study of the nature of firms and other business institutions.\textsuperscript{53}

2.4 \textit{The Corporation is a Social Institution: The Statistical Evidence}

How do we know that the corporation has become a social institution? Because it has clearly become one of the primary ways that we find “stability and meaning” in modern Anglo-American societies. The corporation provides stability and meaning in Anglo-American societies by virtue of the size and power it has attained.

When Berle and Means wrote their book back in 1932 they commented on the dominance of the corporate form at that time:

In conclusion, then, the huge corporation, the corporation with \$90,000,000 of assets or more, has come to dominate most major industries if not all industry in the United States. A rapidly increasing portion of industry is carried on under this form of organization. There is apparently no immediate limit to its increase. It is coming more and more to be the industrial unit with which American economic, social, and political life must deal.\textsuperscript{54}

Things have changed dramatically since then. 1932 was just the tip of the iceberg. Since then, the size and power of the largest corporations have grown at an astounding rate. As a result, instead of analyzing the dominance of the corporate form in relation to a particular industry, as Berle and Means did in 1932, we now have to analyze the

\textsuperscript{53} For more information on this program go to <http://www.ssrc.org/fellowships/corporation>

\textsuperscript{54} Berle and Means \textit{supra} note 35 at 44.
dominance of the corporation as compared to nation states. For example, Lynn Dallas has commented that the most powerful corporations are now bigger than countries:

"Transnational corporations account for 50% of the world's largest economies and the total income of the ten largest transnational corporations exceeds that of one hundred of the world's poorest economies." 

To provide a better representation of just how large modern corporations have become, the revenue of the largest corporations can be compared with the gross domestic product of the world's countries. Table 2-1 contains the 2006 GDP of the 55 largest IMF member countries. Table 2-2 contains the 2006 revenue data for the top 15 companies on the Fortune 500. Table 2-3 shows the area where the two lists overlap. The data is shocking. Exxon-Mobil and Wal-Mart, the two largest companies on the 2006 Fortune 500 list with revenues of $339 billion and $315 billion respectively, are the 22<sup>nd</sup> and 23<sup>rd</sup> largest economies in the world. They are larger than the developed nations of Norway, Denmark, Greece, Ireland and Finland.

The largest corporations also continue to grow at an alarming pace. When Berle and Means were talking about the "enormous" size of corporations back in 1932, they were talking about corporations that had 'more than $90 million' in assets - corporations that were about 1/1000<sup>th</sup> the size of the corporations that we have now. Table 2-4 provides the revenue data for the largest company on the Fortune 500 list at five year intervals between 1955 to 2006. It shows that the largest company on the Fortune 500 list has doubled in size approximately every ten years. It also shows that corporations started to rival the state in terms of size and power in the 1980's when the largest corporations revenues grew to around $80 or $90 billion dollars or about the size of

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modern day Egypt or the Philippines. These large corporations also show no signs of slowing their pace of growth. At the present rate, we would expect the largest of them to reach about the same size as the world’s 16th biggest economy, the Netherlands, by 2015 and about the size of the world’s 8th or 9th biggest economies, Canada and Spain, by about 2025. Obviously this projection is not very scientific. But, it illustrates just how dominant corporations are becoming in the modern world. It also illustrates that the corporation has to be viewed as a social institution because it really has started to rival the state as the dominant institution in modern society. For example, it is hard to argue that Wal-Mart with revenues of $315 billion dollars and 166,000 employees is not a social institution.

Alan Hutchinson has also done a similar analysis for companies in Canada. He showed that in 2003 the revenues of the largest 500 private and public corporations in Canada was equivalent to approximately 81.8% of Canada’s GDP. Even more disturbing is his finding that the revenues for the 10 largest corporations in Canada are now larger than the combined incomes of all the provincial and territorial governments.

2.5 The Dominance of the Corporation - The Commentators

What effect does the dominance of corporations have on our lives? If you live in North America chances are almost everything you do is related to corporations in one way or another. They are omnipresent in your day-to-day life,. They make your food, drink and clothes, they provide your communications and your transportation. Chances

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56 See Alan Hutchinson, The Companies We Keep: Corporate Governance for a Democratic Society (Toronto: Irwin Law, Inc. 2005) at 86.
57 Ibid at 87.
are that you work for a corporation, and some, if not most, of your friends work there too.

If you are really unlucky, you may see your colleagues at work more than you see your family.

The classic quote of the intrusive nature of the corporation into everyday life in North America was written by Lawrence Mitchell in the introduction to his 1995 book *Progressive Corporate Law*:

> It has become a significant social and to some extent, political institution as well. It is fair to say, I think, that no institution other than the state so dominates our public discourse and our private lives. In our world, corporations make most everything we consume. Their advertising products fill almost every waking moment of our lives. They give us jobs, and sometimes a sense of identity. They define communities, and enhance both our popular and serious culture. They present investment opportunities that send our children to college, and provide for our old age. They fund our research. This awesome collective power also leads to the problems created by corporations. They pollute our environments. They impoverish our spirits with the never-ending messages of the virtues of consumerism. They provide a living, but often not a meaning. And sometimes they destroy us; our retirement expectations are unfunded, our investment hopes are dashed, our communities are left impoverished. The very power that corporations have over our lives means that, intentionally or not, they profoundly affect our lives.\(^{58}\)

Joel Bakan has also described the power of corporations in our lives:

> Over the last 150 years the corporation has risen from relative obscurity to become the world's dominant economic institution. Today corporations govern our lives. They determine what we eat, what we watch, what we wear, where we work, and what we do. We are inescapably surrounded by their culture, iconography, and ideology. . . Increasingly, corporations dictate the decisions of their supposed overseers in government and control domains of society once firmly embedded within the public sphere.\(^{59}\)


\(^{59}\) Bakan *supra* note 39 at 5.
2.6 **Implications of the Corporation as a Social Institution**

There are a number of important implications that result from the finding that the corporation is a social institution.\(^{60}\) Firstly, the corporation should be analyzed using social theories and not just economic theories. Secondly, social institutions are complex phenomena and, therefore, they require complex theories to explain them. Thirdly, social institutions evolve from previous forms of social institution and they cannot be ‘created’, ‘designed’ or ‘invented’. Finally, social institutions cannot be owned in the traditional sense of property ownership.

2.6.1 **Sociology and Organizational Theory**

If the corporation is a social institution, then it needs to be analyzed as one.\(^{61}\) It can no longer be analyzed as simply an economic institution. That means leaving the field of economic analysis and drawing on the incredible amount of theory and data that has been generated about organizations and social institutions in sociology and, in particular, economic sociology and organizational theory. To date, most of this literature has been vastly underrepresented in modern corporate law literature. It is a curious fact that modern Anglo-American corporate law- that is in essence the law of a particular type of organization - has thus far been so uninterested in the broader developments in the social sciences that relate to how organizations are created, maintained and change.\(^{62}\) In

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\(^{60}\) Viewing the corporation as a social institution is consistent with the Natural and Open perspective in organizational theory. For a description of this perspective see Chapter 5 – “The Link Between Organizational Theory and Corporate Theory”.

\(^{61}\) For example, see Berle and Means *supra* note 35 at 309 where they state: “The institution here envisaged calls for analysis, not in terms of business enterprise but in terms of social organization”.

\(^{62}\) Notwithstanding this statement, there is no doubt that portions of organizational theory have made their way into corporate theory. The most notable examples are transaction cost theory and agency theory that became the basis for the Nexus of Contracts model of the corporation and resource dependence theory that became the basis for the power coalition theory of the corporation. For a description of the link between
fact, using the analytical tools of these organizational theories it is possible to construct an updated social theory of the corporation. This theory is outlined in Chapter 6.

2.6.2 Complexity Over Simplicity

Social organizations and the social world are very, very complex. Policy makers in modern society have become addicted to economic analysis because they want to 'know' the answers, and economic analysis, with its simplifying assumptions, purports to know those answers. Policy makers have developed the bad habit of not being able to admit that they do not completely understand what is going on. The truth is that we really do not fully understand what is going on, either in society, in the market, or within organizations or corporations – regardless of what one hears otherwise. That is because the social world, socially constructed markets and social organizations are very, very complicated places.

To illustrate the complexity of social systems it is useful to examine the systems classification scheme that was developed by Boulden during the 1950's. Systems theory was developed after World War II. It was based on the observation that the sciences and social sciences were increasingly becoming compartmentalized and that key concepts in any one science could have relevance across a number of other disciplines.

In particular, systems theorists pointed out that:

[M]ost important entities studied by scientists – nuclear particles, atoms, molecules, cells, organisms, ecological communities, groups, organizations, societies, solar systems- are all subsumable under the general rubric of system.

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corporate theory and organizational theory see Chapter 5 – “The Link between Organizational Theory and Corporate Theory.”

63 See John Ralston Saul, The Unconscious Civilization (Toronto: Anansi, 1995) at 62 where he states: “Who among our leaders does not fear living with the conscious realization that they do not know?”

64 Scott uses Boulden’s chart to illustrate the complexity of organizations see Scott supra note 42 at 82.

65 Ibid at 82.
A system is simply a combination of parts that are interrelated. Boulden's systems classification chart (Table 2-5) identifies nine levels of systems in increasing complexity divided into three general types: physical systems, organic systems and human and social systems. Progressing from level 1 to 8 the systems become more complex and the relationships among the various parts become more loosely coupled, or in other words, there is more free choice or random variation in the system. As system complexity increases the system ceases to act mechanically. Level 7 is a human being or a system capable of free choice. Level 8 is the most complicated system that we are aware of. It is level 7 systems with free choice interacting with each other. Obviously, it becomes very difficult to predict behavior or outcomes in a level 8 system. Level 9 is simply systems we have not yet identified. Scott explains the increasing complexity of the systems and the characteristics of each general type in the following way:

The parts of which all systems are composed vary from simple to complex, from stable to variable, and from nonreactive to reactive to the changes in the system to which they belong. As we move from mechanical through organic to social systems, the parts of which systems are composed become more complex and variable. In addition, relations among the parts vary from one type of system to another. . .In mechanistic systems, the interdependence among parts is such that their behaviour is highly constrained and limited. The structure is relatively rigid, and the system of relations determinant. In organic systems, the connections among the interdependent parts are somewhat less constrained, allowing for more flexibility of response. In social systems, such as groups and organizations, the connections among the interacting parts are relatively loose; less constraint is placed on the behaviour of one element by the condition of others. Social organizations, in contrast with physical or mechanical structures are complex and loosely coupled systems. [Emphasis added]

This systems chart offers an important insight into corporations and corporate law. The corporation is a social institution: an organization of human beings that are interacting with each other. That makes it a level 8 system. A very complex system. As such, we

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66 Ibid at 83.
67 Ibid.
should be skeptical of simple theories that attempt to explain all of the behaviour in a
corporation with one concept. For example: the rational choice theory of economics. As
we progress our general understanding of our social world, we should expect our theories
and conceptions of organizations (and corporations) to become more complex as well.
They should ‘move up’ the systems chart. In this regard, complexity is a good thing.
Constantly striving for simplicity of analysis when dealing with complex systems is a
recipe for misunderstanding what is going on. Currently, we have theories that are able
to explain social systems with level 4 understanding. Therefore, we truly do not
completely understand how social organizations function yet. But, it does not mean that
our theories are not useful. We just have to use them only for the purposes for which they
are useful (explaining small portions of the more complex system) and not accept them as
universal theories of understanding. For example, neoclassical economics, with its
simplifying assumptions, is really a level 2 or 3 system because it attempts to turn human
beings and social organizations into mechanical systems. The theory of rational choice
assumes that every individual with the same choice will always make the same decision.
Economics is full of these kinds of closely coupled mechanistic predictions. For
example, if a producer produces more goods then the price of those goods will fall. That
kind of direct cause and effect relationship is characteristic of a simple system. The
problem is that social phenomena like corporations, the market and society do not
function that way. Can a simple theory like economic theory really accurately predict
human or social behaviour? Part of the argument in this book is that it cannot.

Therefore, our corporate law, the law which governs one of our most important
social institutions, needs to be complex, not simple. This argument has been made by
Fiona Patfield who believes that we have to resigned ourselves to the complexity of corporate law:

"Company law is complex because it is concerned with the structuring and organization of economic power. If we want our company law to play any sensible role at all then we must resign ourselves to the fact of its conceptual complexity. Laws about complex subjects in complex societies should be so otherwise they run the risk of becoming entirely marginal and irrelevant to those matters which they purport to govern."\(^68\)

Complex does not mean unclear. Law can be clear without having to be simple. Patfield also describes this:

"The fact that corporate law may not be able to be simplified without losing much of its legitimacy does not mean that it cannot be clear. Considerable confusion seems to exist between the concepts of simplification and clarity. They are not the same thing; attempting to simplify a complex area of law will not lead to clarity; but clarity should make a complex area of law simpler to use."\(^69\)

The current problems with clarity in corporate law come from the fact that it is so voluminous and it makes little distinction among the enormous variety of business organizations that use the corporate form. The updated social theory of the corporation discussed in this book is not simple. It also does not make the claim that it can predict the behaviour of individuals or organizations at all times. Part of the reality of understanding human social organizations is becoming comfortable with the fact that not everything can be predicted.

2.6.3 Evolution as Opposed to Invention

Social institutions cannot be created, designed or invented. They evolve naturally out of previous social institutions.\(^70\) Lynne Zucker has shown that to change an institution

\(^{69}\) Ibid at 4.
\(^{70}\) Scott supra note 42 at 81.
takes time. She has also shown that changes usually begin with organizations that are outliers located on the fringes, and then are adopted across populations of organizations when they prove successful.  

This is an important insight for scholars who are unhappy with the current shareholder primacy paradigm in Anglo-American countries. Drastic change cannot be "engineered": at least not without massive social upheaval. Therefore, change needs to be nurtured slowly by encouraging desired organizational types and if and when they are successful, having those organizational practices copied by other organizations.  

There is no short cut. The converse of this is also true. Social institutions do not last forever. Contrary to the beliefs of some scholars that we have witnessed the 'End of History' with liberal democracy or the shareholder oriented corporation, history shows that social institutions are always replaced with new ones.  

Joel Bakan has reminded us of this:

By the turn of the century, the corporation had become the world's dominant institution. Yet history humbles dominant institutions. Great empires, the church, the monarchy, the Communist parties of Eastern Europe were all overthrown, diminished, or absorbed into new orders. It is unlikely that the corporation will be the first dominant institution to defy history. It has failed to solve and indeed has worsened some of the most pressing problems: poverty, war, environmental destruction, ill health. And growing numbers of people -- activists, Main Street Americans, the globe's poor and disenfranchised, and even business leaders -- believe that rationalized greed and mandated selfishness must give way to more human values. Though the collapse of corporate capitalism is not imminent, people are increasingly uneasy with the system.

Despite claims to the contrary, the corporation was not invented. If the corporation was an invention, the time and place of the first corporation should be easily

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71 See, Zucker supra note 43.
72 Ibid at 2.
74 See Hansmann and Kraakman supra note 11.
75 See Bakan supra note 39 at 140.
76 Statements that the corporation was invented abound. For example see Mitchell supra note 58 at xii where the author states: "Corporate law as we know it is a product of this century. It is an invention that
identifiable. It is not. The corporation evolved slowly on a piecemeal basis out of earlier social institutions: most notably the merchant organizations of the 1500-1600s, including guilds, banks, merchant adventurers and chartered trading companies. Samuel Williston has described the process in the following way:

The outline sketch just given of the growth of business corporations shows that they are not a spontaneous product, but are rather the result of a gradual development of earlier institutions, running back farther than can be traced. [Emphasis added]

The roots of the corporation can be traced back as far as humans have been organizing themselves into groups. Arthur Kuhn wrote:

The association of persons into groups for the achievement of a common purpose is as old as civilization itself. It started with the family or clans, then grew into cities which then led to states or nations.

In fact, there is a lot of literature that traces the development of the corporation from earlier social institutions in the United Kingdom and the United States. Most of this has well served its times . . . like all successful inventions, it has undergone technological improvements and adaptations . . . And its inventors, the aggregate of state legislatures, courts and lawyers, have been adept at ensuring that the product has given the customers – managers and stockholders – what they want.”

The invention claims stem from the idea that a corporation is a creation of the law. This is simply not true. This is an old idea that stems from concession theory.

For commentary on this process see Berle and Means supra note 35 at 119.


It has been argued that one of the earliest references to a type of corporation was in the Code of Hammurabi (3000 B.C.) see Henry Henn, Handbook of the Law of Corporations and Other Business Enterprises (St. Paul, Minn.: West Publishing Co., 1961) at 10. The roots of the corporation can also be seen in the universitas and collegia of Roman law. See See Otto Gierke, trans. Frederick Maitland, Political Theories of the Middle Ages (Cambridge, Cambridge University Press: 1951) at xxii . The corporate form was further developed within the Catholic church during the Middle Ages used in connection with monasteries, military orders etc. see John P. Davis, Corporations: A Study of the Origin and Development of Great Business Combinations and of their Relation to Authority of the State, 2 Volumes (New York, Lenox Hill: 1905). Reprinted: (New York, Burt Franklin: 1971) at 161. From there the concept was imported into the Italian merchant state banks in the 1500s which is the first time that economics really starts to play a role in the functioning of the corporation. Until that time the corporation was simply a group of individuals acting together for a common purpose, see Arthur Kuhn, A Comparative Study of the Law of Corporations (New York: Columbia University, 1912). And finally into the merchant trading companies and chartered companies in the 1600s in the Netherlands and the U.K. see John P. Davis (1905) Ibid at 66-114.

Kuhn, Ibid at 13.

See footnotes 262, 263, and 264.
work was written between 1880 and 1930 and was inspired by the German jurist Otto Gierke and his great historical work on the development of the German Fellowship.  

The fact that the corporation was not an invention was illustrated best by Armand Dubois in his 1938 study of the formation of businesses in England during the period of the Bubble Act.  

In 1720, in response to the rampant speculation in joint-stock companies that resulted in the South Seas Bubble, the English parliament passed the Bubble Act. It prohibited the formation of joint stock companies. It was in place for about 140 years. Using original sources, Dubois conducted an extensive study of joint-stock companies in England, from passing of the Bubble Act in 1720, to the invention of the statutes of general incorporation in the 1800’s. In the study, he came to the conclusion that more joint-stock companies were created during the time that they were prohibited by the Bubble Act, than had ever been formed before. The reason was that businessmen still wanted to form organizations that had the characteristics of joint stock companies, and so they went to their lawyers and structured organizations that were similar, but that did not run afoul of the Bubble Act.  

The general incorporation statutes that were adopted in England at the end of the Bubble Act period were just statutory versions of the structures that lawyers had developed for their clients during the time the Bubble Act was in effect. The government had realized that they could not stop the formation of the organizations and so attempted to gain back control over them. This

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82 See footnote 241.
84 Dubois also attributes this period of time as the rise of the corporate lawyer – because businessmen who wanted to go into business together needed to rely on the skills of a solicitor to ensure that they did not run afoul of the Bubble Act. See Dubois Ibid.
finding is crucial because it highlights that corporate law does not create corporations but rather just affirms groups or institutions that have already naturally evolved.

The development of the corporation as a social institution leads to another observation: “corporate governance” is not a new concept. As long as there have been social institutions there have been governance issues, whether it be within the Church or the State. Corporate governance is just the latest in a long line of governance issues that relate to the exercise of public power.

2.6.4 Ownership Interests

Finally, one can ‘own’ a social institution. They can only have interests in it. Lynne Dallas has asked this question:

Are corporations mere commodities that can be bought and sold, or are they political and social institutions that must be handled in a different way?

No one ‘owns’ a family or the church or the state. In fact, there are many institutions in the world that function quite well without the concept of property ownership. The fact that we associate property ownership with corporations is simply a function of the theories that we use to explain them.

85 For an example of this type of argument, see John Kay, The Business of Economics (Oxford: Oxford University Press, 1996) at Chapter 13 – there are no page numbers. “The issue has existed for as long as there have been social institutions.”
86 See Patfield supra note 68 and Dallas supra note 55 at 490-500.
2.7 Conclusion

This chapter showed that the corporation is a social institution. The fact that the corporation is a social institution gives rise to two very important questions about the current conception of the corporation in Anglo-American societies: First, if it is so obvious that the corporation is a social institution, then why do we conceive of it only as a privately owned economic institution? Second, was the corporation ever conceptualized as a social institution in the past? The next two chapters answer those questions. Chapter 3 surveys the history of corporate theory to show that in the past the corporation has been conceptualized as a social institution. Chapter 4 then describes why the economic conception of the corporation became so dominant in Anglo-American jurisdictions.
TABLE 2-1

THE LARGEST COUNTRIES IN THE WORLD IN 2006
ORGANIZED BY GROSS DOMESTIC PRODUCT

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>GDP (in millions)</th>
<th>Rank</th>
<th>Country</th>
<th>GDP (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>12,485,725</td>
<td>28</td>
<td>South Africa</td>
<td>239,144</td>
</tr>
<tr>
<td>2</td>
<td>Japan</td>
<td>4,571,314</td>
<td>29</td>
<td>Greece</td>
<td>222,878</td>
</tr>
<tr>
<td>3</td>
<td>Germany</td>
<td>2,797,343</td>
<td>30</td>
<td>Ireland</td>
<td>199,722</td>
</tr>
<tr>
<td>4</td>
<td>China</td>
<td>2,224,811</td>
<td>31</td>
<td>Iran</td>
<td>196,409</td>
</tr>
<tr>
<td>5</td>
<td>United Kingdom</td>
<td>2,201,473</td>
<td>32</td>
<td>Finland</td>
<td>193,491</td>
</tr>
<tr>
<td>6</td>
<td>France</td>
<td>2,105,864</td>
<td>33</td>
<td>Portugal</td>
<td>183,436</td>
</tr>
<tr>
<td>7</td>
<td>Italy</td>
<td>1,766,160</td>
<td>34</td>
<td>Argentina</td>
<td>181,662</td>
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<tr>
<td>8</td>
<td>Canada</td>
<td>1,130,208</td>
<td>35</td>
<td>Hong Kong, SAR</td>
<td>177,723</td>
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<tr>
<td>9</td>
<td>Spain</td>
<td>1,120,565</td>
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<td>Thailand</td>
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<tr>
<td>10</td>
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<td>United Arab Emirates</td>
<td>133,768</td>
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<td>17</td>
<td>Belgium</td>
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<td>18</td>
<td>Switzerland</td>
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<td>Chile</td>
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<td>19</td>
<td>Turkey</td>
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<td>Hungary</td>
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<td>Sweden</td>
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<td>New Zealand</td>
<td>108,547</td>
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<tr>
<td>21</td>
<td>Taiwan (ROC)</td>
<td>346,141</td>
<td>48</td>
<td>Algeria</td>
<td>102,026</td>
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<tr>
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<td>Saudi Arabia</td>
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<td>49</td>
<td>Nigeria</td>
<td>99,147</td>
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<tr>
<td>23</td>
<td>Austria</td>
<td>307,036</td>
<td>50</td>
<td>Romania</td>
<td>98,566</td>
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<td>24</td>
<td>Poland</td>
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<td>Philippines</td>
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<td>25</td>
<td>Norway</td>
<td>296,017</td>
<td>52</td>
<td>Egypt</td>
<td>93,045</td>
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<td>26</td>
<td>Indonesia</td>
<td>276,004</td>
<td>53</td>
<td>Ukraine</td>
<td>81,664</td>
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<tr>
<td>27</td>
<td>Denmark</td>
<td>259,746</td>
<td>54</td>
<td>Peru</td>
<td>78,576</td>
</tr>
</tbody>
</table>

Source: The 55 largest countries of the 180 members of the International Monetary Fund from World Economic Outlook Database, April 2006.
<table>
<thead>
<tr>
<th>Rank</th>
<th>Corporation</th>
<th>Revenue (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exxon-Mobil</td>
<td>339,938</td>
</tr>
<tr>
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<td>Wal-Mart</td>
<td>315,654</td>
</tr>
<tr>
<td>3</td>
<td>General Motors</td>
<td>192,604</td>
</tr>
<tr>
<td>4</td>
<td>Chevron</td>
<td>189,481</td>
</tr>
<tr>
<td>5</td>
<td>Ford Motor Company</td>
<td>177,210</td>
</tr>
<tr>
<td>6</td>
<td>Conoco-Phillips</td>
<td>166,683</td>
</tr>
<tr>
<td>7</td>
<td>General Electric</td>
<td>157,153</td>
</tr>
<tr>
<td>8</td>
<td>Citigroup</td>
<td>131,045</td>
</tr>
<tr>
<td>9</td>
<td>American International Group</td>
<td>108,905</td>
</tr>
<tr>
<td>10</td>
<td>IBM</td>
<td>91,134</td>
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<tr>
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<td>Hewlett-Packard</td>
<td>86,696</td>
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<td>12</td>
<td>Bank of America</td>
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<tr>
<td>13</td>
<td>Berkshire Hathaway</td>
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<tr>
<td>14</td>
<td>Home Depot</td>
<td>81,511</td>
</tr>
<tr>
<td>15</td>
<td>Valero Energy</td>
<td>81,362</td>
</tr>
</tbody>
</table>

Source: Fortune 500 database found at http://money.cnn.com/magazines/fortune/fortune500_archive/full
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<tr>
<th>IMF Member Country Rank</th>
<th>Country</th>
<th>GDP (in millions)</th>
<th>Fortune 500 Rank</th>
<th>Corporation</th>
<th>Revenue (in millions)</th>
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<td>4</td>
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<td>189,481</td>
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<td>35</td>
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<td>177,723</td>
<td>5</td>
<td>Ford Motor Company</td>
<td>177,210</td>
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<td>Thailand</td>
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<td>Berkshire Hathaway</td>
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<td></td>
<td>15</td>
<td>Valero Energy</td>
<td>81,362</td>
</tr>
</tbody>
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## TABLE 2-4
REVENUES OF LARGEST COMPANY ON FORTUNE 500
SELECTED YEARS 1955-2006

<table>
<thead>
<tr>
<th>Year</th>
<th>Company</th>
<th>Revenues (in millions)</th>
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<tbody>
<tr>
<td>2006</td>
<td>Exxon-Mobil</td>
<td>$339,938</td>
</tr>
<tr>
<td>2005</td>
<td>Wal-Mart</td>
<td>$288,189</td>
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<td>2000</td>
<td>General Motors</td>
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<tr>
<td>1995</td>
<td>General Motors</td>
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<td>1990</td>
<td>General Motors</td>
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</tr>
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<tr>
<td>1955</td>
<td>General Motors</td>
<td>$9,823</td>
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</table>

TABLE 2-5
BOULDING'S SYSTEM TYPES

NOTE: This page has been removed because of copyright restrictions. The page that was removed was Table 2-5. It was an adaptation of a table from W. Richard Scott, *Organizations: Rational, Natural and Open Systems* (New Jersey: Upper River Saddle, 2003) at 84. The table outlined Boulden's systems classification scheme.
CHAPTER 3: THE HISTORICAL DEVELOPMENT OF CORPORATE THEORY

3.1 Introduction

This chapter provides an outline of the historical development of corporate theory in Anglo-American jurisdictions from 1880 to the present day. The chapter has three goals. Its primary goal is to re-introduce the rich intellectual tradition of early corporate law theory from the 1880’s to 1930’s and show that the view that the corporation is a social institution is not new. The second goal of this chapter is to show that corporate theories are normative theories and not positive theories. This will be accomplished by identifying the underlying normative assumptions of each of Anglo-American corporate theory. This analysis will also show that the current dominant theory of the corporation (the Nexus of Contracts theory) is extreme in its normative assumptions when compared to all previous theories. The final goal of this chapter is to explain the insights or improvements that each theory offered to corporate theory when it was developed. This is important because in Chapter 6 an updated version of the social theory of the corporation is offered. This updated theory will be constructed, in part, by using the insights gained from the historical review of corporate theory outlined in this chapter.

Even though a number of corporate law scholars have previously provided detailed summaries of the historical development of corporate theory, the summary provided in this chapter is worthwhile because it summarizes both the historical and

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89 Because of space limitations, only brief summaries of the theories are provided in this chapter. To the extent possible the key sources for each theory have been outlined in the footnotes to allow the reader to delve more deeply into any particular theory.
modern theories of the corporation together and categorizes them all by their underlying normative assumptions.  

The analysis in this chapter is presented in five parts. Part 1 discusses the relevance of corporate theory. Part 2 explains the analytical approach adopted in this chapter. Part 3 outlines the historical development of Anglo-American corporate theory. This part is divided into two sections: the historical corporate theories between 1880 and the 1970's and the modern corporate theories from the 1970's to the present. Part 4 shows that corporate theories are normative and summarizes the normative findings of the historical survey of corporate theories. Part 5 concludes by arguing that modern corporate theory is in need of an updated version of the social theory of the corporation to restore balance.

### 3.2 The Relevance Of Corporate Theory

Before engaging in a survey of corporate theories, it is worthwhile to ask the question: Is corporate theory relevant? Does it actually have an impact on the real

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91 The answer to this question is affected by the type of legal system. The civil system in use on the European continent (especially in France and Germany) has a long history of theorizing about abstract concepts because of the need for the theories in the interpretation of the civil code. Anglo-American
world? The answer is that corporate theory is very relevant. It impacts the real world through its reflexive relationship with the practice of corporate law. Each simultaneously influences the other. For example, corporate theory is used by judges and practitioners to interpret novel situations and novel situations, in turn, affect the way we approach corporate theory. Corporate theory is also relevant for another reason: It is only by examining corporate theory that we become aware of the normative foundation of corporate law. This normative foundation allows corporate theory to be used for two purposes: legitimizing corporate behaviour and as a metaphor to attain specified political ends.

The best way to illustrate the relevance of corporate theory is to examine the arguments that have been made that corporate theory is not relevant. Three such arguments will be examined: John Dewey and H.L.A. Hart’s critiques of corporate theory and the doctrinal criticism of corporate theory.

jurisdictions based on the common law have placed less of an emphasis on theory and more of an emphasis on providing practical doctrinal answers to corporate law problems. The result is that many of the early corporate theorists were from the European continent. For a description of the difference in the use of theory between the continent and Anglo-American jurisdictions see Hallis supra note 90 at xv-xvi and Millon supra note 90 at 201. The difference results from the use of codes of general principles in European countries that require jurists to make decisions based on theories of society and the way things should be, in contrast, to common law jurisdictions where jurists focus on getting the predictable result for the case at hand without focusing on the theory behind the provisions in question.

The view that corporate theory is relevant is shared by Morton Horwitz and David Millon. See Horwitz supra note 90 and Millon supra note 90. Millon at 204 states: "My starting point is agreement with Horwitz that the various theories of the corporation that have enjoyed prominence since the 19th century have influenced thinking about how the law should treat corporate activity."

Roscoe Pound has argued that corporate theory does affect the real world. He wrote the following in response to John Dewey’s legal realist critique of corporate theory: "It is true, as has been said, that with a little skill or lack of scruple we can reach almost any practical result from any particular theory. But because juristic ingenuity can abuse these theories it does not follow that we should disregard them. Many serious practical consequences depend on them." See Pound supra note 90 at 211.
3.2.1 John Dewey – The Legal Realist Critique

The first major critique of the relevance of corporate theory came from the legal realists during the 1920’s and, in particular, from John Dewey. Dewey argued that corporate theory (it was called the theory of corporate personality at the time) was useless because with a little ingenuity each theory of corporate personality could be used to support the claims of both sides of the debate.

Each theory has been used to serve the same ends, and each theory has been used to serve opposing ends.

At the time, Dewey’s argument was considered to be valid and it was very influential in contributing to the lack of interest in corporate theory from the 1930’s to its re-emergence in the 1980’s.

However, Dewey’s argument was wrong. Corporate theories cannot support opposing positions because they are normative, or, in other words, they are specifically designed to achieve an end state of affairs. This insight was offered by Stephen Bottomley in response to Dewey’s criticism of corporate theory. He argued that corporate theory was relevant because it is only through analyzing corporate theory that we begin to understand the philosophical and political assumptions that underlie our corporate law:

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96 Dewey also made an argument about the use of definitions in corporate theory. This argument has been left out of the discussion here because it is very similar to the definition argument made by H.L.A. Hart which is discussed later. In short, Dewey asserted that there were two types of definitions: metaphysical definitions that try to determine the true nature of things (what is this thing?) and pragmatic definitions that talk about consequences (what does this thing do?). Dewey believed that only the second type of definition was useful because the first definition leads to empty conclusions. The theory of corporate personality, in his view, was not relevant because it was attempting to answer the question: what is this thing? See Dewey *ibid* at 660-662. For a discussion and critique of Dewey’s definition based argument see Hager *supra* note 90 at 636.
97 Dewey *ibid* at 669.
"The broad and basic purpose of examining corporate theory is to develop a framework within which we can assess the values and assumptions that either unite or divide the plethora of cases, reform proposals, legislative amendments and practices that constitute modern corporate law. This law has not sprung up overnight. We need some way of disentangling the differing philosophical and political perspectives from which it has been constructed. Indeed, the great benefit of theoretical enquiry is to reveal the existence of these differences in the first place.\[Italics\]

Roscoe Pound took this argument a step further and warned there is a danger when one corporate theory becomes dominant because actors have a tendency to try and make all activity consistent with the theory regardless of the results.\[ Italics\]

3.2.2 H.L.A. Hart

The second major criticism leveled against the relevance of corporate theory was offered by H.L.A. Hart in his essay on legal definitions. In that essay, Hart argued that definitions of abstract concepts like ‘rights’ or ‘corporations’ were not useful because they had no counterpart in real life.\[100\] Instead of attempting to define abstract concepts, legal theorists should instead be engaged in a discussion about the circumstances in which legal rules apply.\[101\] In the case of corporations, it would be the circumstances where corporateness is recognized.\[102\] For example, instead of defining a corporation as a person, it should be stated that in certain circumstances the law recognizes certain entities as having the same rights and obligations as a person. Then time can be spent illuminating those circumstances. Hart provided an example of what his criticism looked like for the definition of a corporation:

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99 See Pound supra note 90 at 220 where he states: “But if a theory is widely held, a tendency to strain precepts to bring them into accord with it, sometimes against the pull of experience in another direction, may have ill consequences.”
101 Ibid
102 Ibid
If we put aside the question ‘What is a corporation?’, and ask instead ‘Under what types of conditions does the law ascribe liabilities to corporations?, this is likely to clarify the actual working of a legal system and bring out the precise issues at stake when judges, who are supposed not to legislate, make some new extension to corporate bodies of rules worked out for individuals.  

Hart described the dangers in corporate theories that propose to know the true nature of the corporation:

“These statements confuse the issue because they look like eternal truths about the nature of corporations given us by definitions; so it is made to appear that all legal statements about corporations must square with these if they are not to be logically inconsistent.”

There are three responses to Hart’s criticism of corporate theory. First, it is very surprising that Hart included the word ‘corporation’ in his list of abstract concepts like ‘rights’. Anyone who lives in a modern society knows that corporations do actually exist in the real world. The corporation is an organization of human beings and not an abstract concept.

Second, Hart’s criticism is only valid when the answer to the question of what a corporation is ends with a fictitious answer, like: the corporation is a person. But, as this book shows, the investigation into the question: ‘What is a corporation?’ does not need to end with a fictitious answer. The inquiry can be a very relevant inquiry about the difference between a corporation (a group of people) and an individual (a natural person), and the way that difference affects a particular legal situation.

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103 Ibid at 43.
104 Ibid at 45. This statement is similar to the statement made by Roscoe Pound about the dangers of a dominant theory.
106 See Marcel Planiol, Treatise on the Civil Law (St. Paul: West Publishing, 1959) at 784 when he states: “As soon as this phantom of fictitious persons is thrown over, a mass of difficulties will cease to exist. They arise from the preptual parallel drawn between fictitious person and living persons. Most of the questions that call for solution upon this point are difficult only because they are incorrectly presented...” He goes on to advocate the form of ownership theory.
other words, the difficulty Hart identified arose from the specific question that
corporate theory was asking at the time: What sort of a person is the corporation? The
difficulty does not necessarily arise when you ask the question: What is a
corporation?\footnote{See Stoljar supra note 105 at 188. One theory of the corporation that has been developed in response to Hart’s criticism was the ‘form of ownership’ theory. Its first advocate was the French jurist Marcel Planiol who used it to justify the concept of ‘foundation’ that is used in France. Form of ownership theory is presented in Planiol \textit{ibid} at 775-830. For a summary of form of ownership theory see Pound \textit{supra} note 90 at 254-261. For a further explanation of form of ownership theory see Stoljar \textit{supra} note 105. In this book, Stoljar undertakes an analysis of associations from the family through to modern corporations in an attempt to determine what a corporation is. Stoljar’s conclusion is that the essence of a corporation is a fund of property that is held by the group for common purposes and administered by managers or trustees. The argument is that property so held forms a separate legal entity and that ‘corporateness’ coincides with the qualities of that separate legal entity. Therefore, for Stoljar, a corporation is an entity of a group of people with a common fund for liability. Stoljar \textit{ibid} at 188. For an example of this argument see C. A. Cooke, \textit{Corporation, Trust and Company} (Manchester, Manchester University Press, 1950) at 189-190 where the author states: “Human institutions are empirical facts which have many aspects . . . and because the institutions are not the creation of law, they undergo}{107}

Finally, Hart’s claim that the only job for the legal theorist is to examine the
conditions under which we recognize corporateness, is also not correct. Such an
approach only allows theory to determine answers to problems that have already
occurred. It would not provide any tools for use in novel situations. It is for the
novel situations that legal theories are developed. Professor Stoljar put it the
following way:

A legal theory worthy of the name is concerned with the coherence and
economy of legal results; which means that its business is not so much with
the very neutral (past or even future) conditions under which a rule may apply
as, rather, with the specified criteria which can sort out the conditions as well
as guide or, if necessary, revise the rules so as to arrive at what we deem more
rather than less correct or consistent conclusions of law.\footnote{Stoljar \textit{ibid} at 188.}{108}

Theory is especially important in corporate law because corporations exist outside of
the legal system as social facts, they are always changing and novel situations are
always occurring.\footnote{For an example of this argument see C. A. Cooke, \textit{Corporation, Trust and Company} (Manchester, Manchester University Press, 1950) at 189-190 where the author states: “Human institutions are empirical facts which have many aspects . . . and because the institutions are not the creation of law, they undergo}
3.2.3 The Doctrinal Analysis of Corporate Law – The Link Between Theory and Practice

The final criticism leveled against corporate theory is that it is not relevant because the link between corporate theory and the practice of corporate law is tenuous at best and history has shown that corporate law theories have been marginally useful. The French jurist Planiol describes this doctrinal aspect of corporate law in the following manner:

The idea of fictitious personality is a purely doctrinal concept. It can be critically examined and destroyed without adversely affecting any of the law’s imperative or prohibitive decisions. All legal rules can continue to be applied and none of them will be violated by a change in doctrine.

In fact, in Canada, Chris Tollefson surveyed Supreme Court of Canada decisions on corporate law and determined that corporate theory had no appreciable effect on the court’s decisions.

The doctrinal criticism of corporate law is that the practice of corporate law needs concrete examples and rules to solve problems. As a result, rules and changes and mutations of form and purpose which are independent of the legal system of thought. When this happens, the law has in turn to revise its ideas and bring into its system that part of the change which has any import toward established legal theory. Only when an institution dies does the law catch up to it; a living institution is always adding new congeries of facts of which the law can only take notice after they have come into being. 'Logic, history and custom and utility, singly or in combination shape the progress of the law.'

This point is supported by J.W. Hurst, see J.W. Hurst, Legitimacy of the Business Corporation in the Law of the United States 1780-1970 (Charlottesville, Univeristy Press of Virginia, 1970) at 11, where, in describing the development of the business corporation in the U.S., he states: "In the whole course of affairs lawyers produced only marginal effect. But the law provided leverage at points critical to other development, and its marginal effects could determine the balance finally struck among a complex of other factors at work to fix our direction and the pace at which we moved." For a description of the doctrinal criticism of corporate theory see Bratton (1989) supra note 90.

Planiol supra note 106 at 784.

See Tollefson supra note 90.
definitions change very slowly over time. Only after a new theory is offered that produces results that are as predictable as the old theory, will the new theory be adopted by legal practitioners. Adolph Berle made a strong statement in favour of this:

[Lawyers . . .] must meet a series of practical situations day to day. They are not, accordingly, in a position to relinquish one position – here, the idea of corporate trusteeship for securities holdings – leaving the situation in flux until a new order shall emerge. Legal technique does not contemplate intervening periods of chaos; it can only follow out new theories as they become established and accepted by the community at large. It is likely that claims upon corporate wealth and corporate income will be asserted from many directions. The shareholder who now has a primary property right over residual income after expenses are met, may ultimately be conceived of as having an equal participation with a number of other claimants. . . . Meanwhile, as lawyers, we had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear.  

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113 One theory of the corporation that responds to all of this criticism of corporate theories is the Bracket theory which proposed to do away with corporateness altogether. The Bracket theory of Corporation otherwise known as symbolist theory was developed by Von Jhering. It rests on the proposition that only human beings can have rights and interests and that a corporation is only a legal device or formula which will enable very complex jural relations to be comprehended simply. This theory conceptualizes the corporation as a bracket (or abbreviation) for all of the various rights and duties which, directly or indirectly, belong to particular individuals. Therefore, you remove the brackets of the corporation and only analyze the relations of the human beings within it. For a description of bracket theory see Derham supra note at 11 and P.W. Duff, Personality in Roman Private Law (New York: Augustus M. Kelley, 1971). It was first published in 1938 at 209. The problem with bracket theory is that it is incapable of explaining how a corporation can survive indefinitely or act in ways that do not involve individual rights. For a description of bracket theory see Pound supra note 90 at 250-254; Stoljar supra note 105 at 186-187 and Maitland (1951) supra note 79at xxiv. The Purpose theory of Brinz rests on the same initial principal of the Bracket theory: That the only persons are real human beings. Therefore, all juristic or artificial (non-human) persons are merely legal devices for protecting or giving effect to some real purpose. The purpose actually owns the property and not he people: “It is a common and continuing purpose, continuously entertained by a continuing body of persons, which owns the capacity and constitutes the legal person.” Every juristic person has a purpose. Purpose theory is also associated with Ernest Barker in his introduction to Gierke’s Natural Law. The best summary of this theory can be found in Duff supra note 113 at 220. Each of Bracket Theory and Purpose Theory are represented on Figure 3-2.

However, there is a link between theory and practice. Theory affects the way novel situations are resolved in practice. Conversely, novel situations from practice affect the development of theory. David Millon refers to this as the reflexive relationship between theory and practice. He has stated that:

Theories about the corporation depend in large part on perceptions of what corporations look like. Law embodies beliefs about what is legitimate, and these beliefs influence the way people behave. Legal theory shapes social practice and practice informs theory – at the same time.

He argues that corporate theory is important because theories influence thinking about how law should treat corporate activity:

The relationship between legal theories of the corporation and corporate doctrine is thus dynamic and interdependent: Each simultaneously influences the other. Our ideas about what corporations are provide us with a critical perspective toward corporate doctrine, while our interpretation of corporate doctrine reveals what appears to be essential or characteristic of corporations.

Because of this reflexive relationship, corporate theory becomes extremely important in times of social crisis where novel situations are constantly arising. This is partly the reason why corporate theory was in vogue in the periods between 1880 and 1930 as the corporation grew in importance and again in the 1980’s as a wave of mergers and acquisitions swept across North America.

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115 Morton Horwitz makes this argument: “Most important controversial legal abstractions do have determinate legal or political significance . . . they do have a “tilt” or influence in determining outcomes.” See Horwitz supra note 90 at 175.

116 See Millon supra note 90 at 242 where he states: “The gradual acceptance of a new legal theory of the corporation (together with other social and political phenomena) encouraged receptivity toward new legal rules, while the new rules (again, together with other factors) themselves encouraged people to think about the corporation in a new way. All this was happening at the same time: The new theory legitimated the new doctrine as the new doctrine was legitimating theory.”

117 Millon ibid at 244.

118 Millon supra note 90 at 204.

119 See Hager supra note 90 at 579.
Corporate theory also has a legitimizing role for social practices. For example, the Nexus of Contracts theory of the corporation played a role in legitimizing the mergers and acquisitions activity of the 1980's.\textsuperscript{120} David Millon, a prominent communitarian scholar, believes that theory has a legitimating role because there are:

determinative normative implications of particular legal theories and their role in the legitimization of legal doctrine and social practice.\textsuperscript{121}

Roscoe Pound looked at the legitimizing role of corporate theory in a different way. He argued that corporate theory can be used as a metaphor to achieve desired political ends because once a theory becomes dominant it can cause all activities to be consistent with it – no matter how ridiculous the results.\textsuperscript{122}

To illustrate the doctrinal criticism of corporate theory, William Bratton has argued that the definition of the corporation has stayed largely the same throughout the history of the corporate theory debate.\textsuperscript{123} However, this is not actually the case. Definitions of the corporation have changed quite significantly since the birth of corporate theory in the 1880's.

Before the beginning of the corporate theory debate the corporation was regarded as a political institution created by the act of incorporation.\textsuperscript{124} In recognition of this belief it was often referred to as a “body politic”. The most widely accepted definition of a corporation from before 1880 is Stewart Kyd’s 1794 definition of a corporation his \textit{Treatise on Corporations}:

\textit{A body politic, or body incorporate,} is a collection of many individuals united into one body, under a special denomination, having perpetual succession

\textsuperscript{120} See Bratton (1989) \textit{supra} note 90.
\textsuperscript{121} See Millon (1990) \textit{supra} note 90.
\textsuperscript{122} See Pound \textit{supra} note 90.
\textsuperscript{123} See Bratton (1989) \textit{supra} note 90 at 1501-1510.
\textsuperscript{124} See Cooke \textit{supra} note 109 at 66 referring to the beliefs of both Lord Coke and Lord Blackstone.
under an artificial form, and vested, by the policy of law, with the capacity of acting, in several respects, as an individual, particularly of taking and granting property, of contracting obligations, and of suing and being sued, of enjoying privileges and immunities in common and of exercising a variety of political rights, more or less extensive, according to the design of its institution, or the powers conferred upon it, either at the time of its creation, or at any subsequent period of its existence.\textsuperscript{125} [Emphasis added]

The reference to the corporation as a ‘body politic’ is indicative of the way in which the corporation was conceived at the time.\textsuperscript{126}

An example of a more modern definition of a corporation can be found in the Encyclopedia Britannica:

[A] specific legal form of organization of persons and material resources, chartered by the state, for the purpose of conducting business.\textsuperscript{127}

You can see that somewhere in the development of corporate theory the ideas that corporations are used only for business purposes and are not just composed of people but also ‘resources’ entered into our modern definition of the corporation.


\textsuperscript{126} A similar definition of the corporation as a body politic was offered by Lord Coke: “A body politic is a body to take in succession, framed (as to that capacity) by policy, and therefore it is called by Littleton a body politic; and it is called a corporation or a body incorporate, because the persons are made into a body, and of a capacity to take and grant, etc.” See Henry O. Talyor, \textit{A Treatise on the Law of Private Corporations} 5\textsuperscript{th} ed. (New York: The Banks Law Publishing Co., 1902) at 6 quoting Coke. Blackstone also called the corporation a body politic: “As all personal rights die with the persons, and as the necessary forms of investing a series of individuals, one after the other, with the same incidental rights, would be very inconvenient, if not impracticable, it has been found necessary, where it is for the advantage of the public to have any particular rights kept on foot and confirmed, to constitute artificial persons who may maintain a perpetual succession, and enjoy a kind of legal immortality. \textit{These artificial persons are called bodies politic, bodies corporate (corpora corporate), or corporations.}” See Sir William Blackstone, \textit{Commentaries on the Laws of England} 8\textsuperscript{th} edition (London: Strahan, Cadell and Prince: 1783). William Shepperd also referred to the corporation as a body politic back in 1675: “A Corporation, or an Incorporation (which is all one) is a Body, in function of law; or, a Body Politick that indureth perpetuallsuccession.” See William Shepperd, \textit{Of Corporations, Fraternities and Guilds} (New York: Garland Publishing, Inc. 1978) at 1. It was originally published in 1675.

\textsuperscript{127} Britannica Online. Found at <http://www.britannica.com/eb/article-9026395>
3.2.4 Summary

In summary, corporate theory is relevant for the following reasons: First, only through the analysis of corporate theory do we become aware of the philosophical and political assumptions that underlie our corporate law system. Second, there is a reflexive relationship between corporate theory and practice. Theory informs practice and practice informs theory. Third, theory plays a role in legitimizing behaviour. Finally, theory is metaphor, it is a political tool to be used to attain a desired state of affairs. As Pound stated: once a theory becomes dominant it can cause all activities to become consistent with it. This is the position that the Nexus of Contracts theory has attained in modern Anglo-American corporate law.

3.3 Analytical Approach

3.3.1 A Contextual Approach: Understanding the Peculiarities of Corporate Theories

This chapter attempts to provide some context to each corporate theory that is summarized. When analyzing corporate theory, context is crucial because legal theory and legal rules are created by, and are situated within, their social, historical, political and economic context. Mark Hager made the following argument in favour the contextual analysis of legal theories:

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128 For examples of arguments highlighting the importance of context to corporate theory see Horwitz, supra note 90 at 176 and Millon supra note 90 at 247 where Millon states: “From the perspective of hindsight, one can see that a particular theory had a particular, limited set of normative implications at a particular time in the past.”
History is therefore highly relevant. Legal concepts have no trans-contextual, logically-deducible meanings, but they do have meanings that are powerful and definite in particular historical settings. \(^{129}\)

Morton Horwitz made a similar argument:

An important task of legal theory, then, is to uncover the specific historical possibilities of legal conceptions—to ‘decode’ their true concrete meanings in real historical situations. We have spent too much intellectual energy in the increasingly sterile task of discussing legal theory in a historical vacuum. That is one of the reasons why Anglo-American jurisprudence constantly seems to get no further than repeated rediscoveries of the wheel. By contrast, in more specific settings, one finds that legal theory does powerfully influence the direction of legal understanding. \(^{130}\)

Context is important to corporate theory for two reasons: First, it assists in understanding why the theory was created; second, it helps keep the intellectual integrity of the theory as time progresses.

Corporate theory when looked at in a vacuum can look quite bizarre. \(^{131}\) However, when corporate theories are placed in their historical context, the peculiar context specific characteristics, and usually problematic portions, of each theory can be stripped away. This approach is able to reveal the insights each theory added to our understanding of what a corporation is and what the purpose of corporate law is. For instance, in 1880 Otto Gierke, the great German jurist, adamantly believed that a group of people actually took on a life of its own and became a real person with an independent ‘will’. How was this possible? Gierke’s theory was a product of the context in which he was writing. Germany, in the 1880’s, was in the midst of an intellectual rebellion against the adoption of Roman law as the law of the then

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\(^{129}\) See Hager (1989) \textit{supra} note 90.

\(^{130}\) Horwitz \textit{supra} note 90 at 220.

\(^{131}\) Morton Horwitz made a slightly different argument in this regard: “When abstract conceptions are used in specific historical contexts they have more limited meanings and more specific argumentative functions.” See Horwitz \textit{supra} note 90 at 176.
form German state. Part of that Roman law was the Concession theory of the
corporation, which stated that corporations only existed after they were created by the
state. Hegelian theory, with its metaphysical underpinnings, was also very influential
in Germany at the time. As a result, it was natural for Gierke to construct a
metaphysical theory to show that corporations form naturally and are not dependent
on Roman Concession theory for their existence.

Another danger occurs when corporate theory is carried forward in time and
its context is forgotten. For example, Fiction theory deemed a corporation to be a
fictitious "person" because, at the time, it was the most convenient way to provide a
corporation with the rights it needed to carry on business (e.g. the right to hold
property, sue and be sued etc.). However, as time went on, people forgot that the
analogy was only a shorthand legal device to grant rights to the corporation and
started to actually treat corporations as if they were people. This forgetfulness, has
allowed corporations to successfully argue for individual rights like the right to equal
taxation and the right to free speech.

When corporate theories are analyzed with this contextual approach, it
becomes clear that most of the major developments in corporate theory were the
result of: First, a reaction against the then dominant corporate theory and the

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132 Hager has also made the argument that early jurists clearly did not think that the corporation was a
person: "One may be tempted to laugh at these arguments and dismiss them as peculiar and unstylish
arguments of legal reasoning. If we do this, I believe we may be laughing at thought patterns not so
different form ones we still at some level deploy. Thinkers from the early twentieth century speak of
organizations as 'persons' and attempt to deduce from this concept rights and responsibilities such entities
should carry. We think it strange that they should attribute such qualities of 'personhood' to inanimate
entities and strange also that they should argue about the logical conclusions impelled by their metaphysical
claims. We may err, however, in too quickly viewing those thinkers as intrinsically more ensnared than we
are by legal metaphysics and logic. They surely understood every bit as well as we do that business
corporations are not human beings." See Hager supra note 90 at 577-578.

133 Corporations successfully argued for the equal taxation in: Santa Clara County vs. Southern Pacific
R.R., 88 U.S. 394 (1886) and the right to free speech in First National Bank of Boston v.Belotti 435 U.S.
765 (1980).
problems that theory presented, and, second, the social, historical, political and economic context of the time.

3.3.2 Politics and Normative Assumptions

An individual’s preferred theory of the corporation is a normative choice and not an analytical choice.\textsuperscript{134} Stephen Bainbridge, a modern contractarian scholar, recognized the political and philosophical nature of the corporate theory debate in his criticism of progressive law scholars: \textsuperscript{135}

Although most corporate law scholarship, including most of that in the law & economics camp, purports to apolitical objectivity, my disagreement with these scholars is explicitly political. . .\textsuperscript{136}

Mark Hager has also argued that corporate theory has serious political implications:

It might seem strange that serious political implications could be seen to flow from something as abstruse as theories of corporate personhood. I hope to show, however, how theoretical discussions of corporate personhood were at one time and may again be thought to carry political meanings of considerable weight.\textsuperscript{137}

Because of its political nature, any investigation into corporate theory inevitably leads to a discussion of fields outside of the law. In 1911, Geldart wrote about the breadth of knowledge that a jurist needs in order to write in the field of corporate theory:

\textsuperscript{134} For an example of the argument that corporate theories are political see Stokes supra note 35 and Dewey supra note 95 at 664-665. On page 665, Dewey states: “Discussions and concepts may have been in form intellectual, using a full arsenal of dialectical weapons; they have been in fact, where they have any importance, “rationalizations” of the positions and claims of some party to a struggle.”

\textsuperscript{135} The term ‘contractarian’ refers to a scholar who supports the Nexus of Contracts theory of the corporation. For a description of this theory see Chapter 3 – “The Nexus of Contracts Theory of the Corporation.”

\textsuperscript{136} Bainbridge supra note 16 at 857.

\textsuperscript{137} Hager supra note 90 at 575.
The question [of legal personality] is at the bottom not one on which law and legal conceptions have the only or final voice: it is one which law shares with other sciences, political science, ethics, psychology, and metaphysics.\textsuperscript{138}

To Geldart's list can also be added the disciplines of economics, sociology and philosophy, at the very least. John Dewey argued that while problems arise when lawyers stray outside of their traditional field of analysis, that it is sometimes required in order to move the law forward:

\begin{quote}
At critical times and in dealing with critical issues, [law] has found it difficult to grow in any other way than by taking over contemporary non-jural conceptions and doctrines.\textsuperscript{139}
\end{quote}

Corporate theory has underlying normative assumptions that are often not clearly stated. These assumptions make it difficult to compare theories. They also allow proponents of one theory to talk past proponents of another theory. Rob Yalden offered that insight in his article discussing the debate between the two dominant modern corporate law theories - shareholder primacy and stakeholder theories:

\begin{quote}
If one stands back and looks at the parameters of this debate, one cannot help but be struck by the fact that each side starts from a very different set of assumptions about whose interests most need protection. If these perspectives are to avoid simply talking past each other, then we need to develop a richer understanding of the theory of the firm that each is starting from and the extent to which our business law framework already reflects ideas fundamental to one or more of these competing theories. Only if we get a clearer sense of the assumptions underlying these perspectives, as well as of the extent to which public policy choices that shape our business law reflect assumptions of this kind, can we then hope to move forward toward both a shared understanding of those choices and a genuinely fruitful debate about the choices that need to be made in the future.\textsuperscript{140} [Emphasis added]
\end{quote}

Stephen Bainbridge shares this view:

\begin{quote}
Contractarians and non-Contractarians no longer have much of interest to say to one another; indeed, they barely speak the same language. To shift
\end{quote}

\textsuperscript{138} Geldart, "Legal Personality" (1911) 27 L. Quarterly Rev. 90 at 94.

\textsuperscript{139} Dewey supra note 95 at 657.

\textsuperscript{140} Yalden, supra note 90 at 2.
metaphors, those of us who adhere to the nexus of contracts model pass those of us who do not like two ships in the night, with only the occasional exchange of broadsides to enliven the proceedings.\textsuperscript{141}

Donaldson and Preston developed a methodology for identifying and understanding the normative assumptions (or the normative core) of a theory in their work on the stakeholder theory of the corporation.\textsuperscript{142} They argued that the stakeholder theory had three uses: descriptive, instrumental and normative. These three aspects of corporate theory are depicted in Figure 3-1. They describe the three uses in the following way:

Each of these uses of stakeholder theory is of some value, but the values differ in each use. The \textit{descriptive} aspect of stakeholder theory reflects and explains past, present and future states of affairs of corporations and their stakeholders. Simple description is common and desirable in the exploration of new areas and usually expands to generate explanatory and predictive propositions. . . \textit{Instrumental} uses of stakeholder theory make a connection between stakeholder approaches and commonly desired objectives such as profitability. Instrumental uses usually stop short of exploring specific links between cause (i.e. stakeholder management) and effect (i.e. corporate performance) in detail, but such linkage is certainly implicit . . In \textit{normative} uses, the correspondence between the theory and the observed facts of corporate life is not a significant issue, nor is the association between stakeholder management and conventional measures as a critical test. Instead, a normative theory attempts to interpret the function of, and offer guidance about, the investor-owned corporation on the basis of some underlying moral or philosophical principles.\textsuperscript{143} [emphasis added]

This insight can be expanded to apply to all corporate theory. All corporate theories have, to varying degrees, the same three aspects: descriptive, instrumental and normative.\textsuperscript{144} All corporate theories ‘describe’ the corporation, its participants and its

\textsuperscript{141} Bainbridge, supra note 16 at 4.
\textsuperscript{143} Ibid at 180-181.
\textsuperscript{144} For example, the Nexus of Contracts theory has been criticized because it is not very descriptive of the real world. Its lack of descriptive ability has been defended because it allows the theory to be more ‘predictive’. Finally, the Nexus of Contracts theory claims to be free of normative assumptions but this has
environment. All corporate theories make ‘predictions’ about corporate behaviour. But most importantly, at the core of every corporate theory is a set of normative assumptions about what the world ‘ought’ to look like. Donaldson and Preston described the normative core of stakeholder theory in the following way:

Although both normative and instrumental analyses may be ‘prescriptive’ (i.e. they may express or imply more or less appropriate choices on the part of decision makers), they rest on the entirely different bases. An instrumental approach is essentially hypothetical; it says, in effect, ‘If you want to achieve (avoid) results X, Y, Z then adopt (don’t adopt) principles and practices A, B or C.’ The normative approach, in contrast, is not hypothetical but categorical; it says, in effect, ‘Do (Don’t do) this because it is the right (wrong) thing to do.’ Much of the stakeholder literature, including the contributions of both proponents and critics, is clearly normative, although the fundamental normative principles involved are often unexamined."145

Some scholars have tried to justify the normative assumptions that make up the normative core of a particular corporate theory based on theoretical arguments. For example, Donaldson and Preston tried to justify the normative core of stakeholder theory using property rights. Freeman made a similar argument in favour of stakeholder theory based on the concept of Rawlsian justice.146 Stephen Bainbridge also made an argument in favour of the Nexus of Contracts theory based on libertarianism.147

However, the normative core of a corporate theory is not justifiable, it is really just a political choice or statement about the way the world ought to be. In order to

been shown not to be the case. For a discussion of the three aspects of the nexus of contracts theory see Chapter 4 - “Critiques of Economics, Law and Economics and the Economic Conception of the Corporation”.

145 Donaldson and Preston supra note 142 at 181. This last portion of this quote is very important. When normative assumptions remain unexamined a theory risks becoming an ideology. For a discussion of this see Chapter 4 - “Value Judgments and Ideology”.


147 See Bainbridge supra note 16.
truly understand each corporate theory, the assumptions within the normative core of each theory must be examined. This chapter identifies the normative assumptions at the core of each corporate theory discussed.

An important insight that results from the treatment of corporate theories as normative statements is that it is not enough to show that the dominant corporate theory is logically inconsistent because the legitimacy of any particular theory does not lie in its logic but in its normative position. Therefore, in order to replace a dominant corporate theory you need to develop a new corporate theory based on a different normative argument and when society’s norms change to adopt that position the new theory will be adopted.

3.3.3 A Better Corporate Theory

The three aspects of corporate theory can also be used to determine whether a particular corporate theory is better than another corporate theory. A corporate theory is better if it is: more descriptive of reality, better able to predict behaviour and outcomes and more consistent with the normative views of the society in which it is located. This criteria will be used throughout this book to compare corporate theories.

148 See Hager supra note 90 at 577: “Social and legal struggles will continue to be iconic, that is, metaphorical, struggles. It is hard to wage such struggles while attempting to avoid or eliminate their iconic dimensions. Legal progressives, however, have sometimes tried to do precisely that by focusing so much on the indeterminate logic of legal conceptions. This is a mistake because antiprogressive conceptions cannot be defeated by mere logical critiques. . . ”

149 Ibid.

150 This view is consistent with the view of contractarian scholar Stephen Bainbridge. Bainbridge supra note 16 argues that in order to replace the “nexus of contracts” model, the new model must: 1) be better than the current model at predicting human behavior, and 2) be consistent with the views of the populace (culture). He stated at 22: “Contractarianism (like law & economics generally) succeeded because it offers
3.3.4 Classification of Corporate Theories Based on Normative Assumptions

A lot of work has been done to identify the assumptions underlying corporate theories. The analysis in this chapter will focus on only three normative assumptions:

1. The conception of human nature adopted,
2. The preferred structure of society, and
3. The ability of society to regulate the activities of corporations.

This classification scheme is a little different than the classification scheme traditionally used for corporate theories. Only the third assumption is used in the traditional scheme. The addition of the first two assumptions is an attempt to get down to the most basic normative assumptions that drive the conclusions of corporate theory. Corporate theories are usually categorized by dichotomies. In this

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151 See Dallas supra note 55. Other works identifying the underlying assumptions of corporate theories include Millon supra note 90; Horwitz supra note 90; Bratton supra note 90; Testy (2002) infra note 396; and Yalden supra note 90.

152 For example, the three dichotomies by which corporate theories are traditionally organized are: (1) Entity/Aggregate: real entity with an existence separate from shareholders vs. aggregation natural individuals without a separate existence; (2) Natural/Artificial: artificial creation of the state vs. natural product of private initiative; and (3) Public/Private: public (regulate relationship between society and corporation within corporate law) vs. private (regulate internal affairs of corporation only in corporate law). For examples of this classification scheme see Bratton supra note 90 at 1471 and David Millon supra note 90 at 201.

153 These two assumptions were used by W. Richard Scott to classify organizational theories. Scott makes the same kind of argument: that there are normative assumptions at the core of every organizational theory. Some of the organizational theories classified by Scott in this way are the theories that inspired our modern
chapter, the assumptions are conceptualized as continuums because the assumptions do not consist of mutually exclusive opposites.

3.3.5 Assumptions about Human Nature

This normative assumption is the most important assumption underlying each of the corporate theories. It deals with the conception of human nature the theory adopts. This question is largely a philosophical question. At one end of the spectrum is the economic conception of human beings as rational profit maximizing individuals that always acts in their own self-interest. At the other end of the corporate theories. For example, Scott classifies transaction cost theory and agency theory which became the basis of the modern Nexus of Contracts theory of the corporation. For a description of Scott's classification scheme see Chapter 5 – "The Link Between Organizational Theory and Corporate Theory."

The existence of this assumption underlying modern economic and socio-economic theories was identified by Lynne Dallas see Dallas supra note 55 where she provides a chart outlining the different assumptions underlying neo-classical economics and the law and socioeconomics approach. One of the entries in the chart is "human behaviour". Under neo-classical economics the entry reads: "Rationality calculative behavior. Cognitive self-interest. Indepenend. Exogenous and fixed preferences." The Law and socioeconomics entry reads: "Bounded rationality. Ranging from calculative to automatic behaviour. Cognitive-affective (emotional) interactions. Self-interest, altruism, morality, belief systems (ideology), faith. Considerations of fairness. Interdependence. Endogenous and evolving preferences." See also Bainbridge supra note 16 where he discusses the major differences between the "conservative" nexus of contracts theorists and the progressive corporate law scholars: "When all the detritus is cleared away, the basic bone of contention between conservative and progressive scholars therefore remains the old problem of the perfectability of human nature. Conservatives are inclined to blame human misery on causes lurking naturally within the souls of men – pride, vanity, jealousy, greed and insatiable or unruly desires. Accordingly, conservatives are skeptical about human perfectibility and suspicious of Utopian projects, not least because they would have to be conducted by imperfect fellow human beings, always dangerously 'unfit to remake the world'... In contrast, progressives believe that education, positive legislation, and alteration of environment can produce men like gods; they deny that humanity has a natural proclivity toward violence and sin."

This conception of human nature has its roots in the philosophical works that are the foundation of neo-classical economics including works by Thomas Hobbes, David Hume and Adam Smith. See Thomas Hobbes, Leviathan (London: Penguin Books, 1985) at 185: "hereby it is manifest, that during the time men live without a common Power to keep them all in awe, they are in that condition which is called Warre, and such a warre, as is of every man against every man."; see David Hume, A Treatise on Human Nature ed. L.A. Selby-Bigge (Oxford: Oxford University Press, 1978) and David Hume, Essays (Indianapolis: Liberty Classics, 1987) at 51: "Though men be governed by interest, yet even interest itself, and all human affairs are entirely governed by opinion"; see Adam Smith, An Inquiry into the Nature and Causes of the The Wealth of Nations, 2 vol. (Oxford: Oxford University Press, 1976) at 26-27: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." Smith believed that individual self-interest furthered the common good through the
spectrum is the social conception of humans as social beings whose decisions are affected by their social relationships.\(^\text{156}\) In this conception, the behaviour of human beings is constrained by a number of factors including their desire to become or remain part of a social group.\(^\text{157}\) In these circumstances, individuals do not always act in their self-interest and are capable of irrational or altruistic behaviour.\(^\text{158}\)

How a corporate theory answers the question of human nature is crucial to how it conceptualizes the corporation: Does it conceive of the corporation as a collection of individuals who will act in their own best interests unless restraints are

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\(^{156}\) This conception of human nature has been identified in corporate theory by J.P. Davis, see Davis supra note 79 at 13 where he argues that man is a social animal and that all social relations have two factors – the content of human activity (the function) and the organization in which it is carried on (the form). Davis argues that forms are continually suffering modification to meet the demands of new or altered social functions – or in other words – we continually evolve new social institutions to meet our ever changing social needs.

\(^{157}\) The concept of “bounded rationality” was developed by James March and Herbert Simon. See, Herbert Simon, *Administrative Behaviour* (New York: Macmillan, 1957) and James March and Herbert Simon, *Organizations* (New York: Wiley & Sons, 1958). ‘Bounded rationality’ refers to the fact that managers make decisions under uncertainty and without the ability to process all information and so the options that they consider are limited. For a description of how this theory affected the study of organizations in sociology see Neil Fligstein, “Organizations: Theoretical Debates and the Scope of Organizational Theory” in Craig Calhoun et al., eds., *International Handbook of Sociology* (London: Sage Press, 2005). The sociological concept of interest was developed as far back as the work of Max Weber and Georg Simmel. It stands for the proposition that interest can only be “conceptualized, expressed, and realized in social terms and through social relations.” For a description of the sociological concept of interest see Swedberg supra note 33 at 3-6.

\(^{158}\) One of the earliest examples is Max Weber’s concept of traditionalism which was formulated as a criticism of the neo-classical economic conception of man as a rational self interested actor. Weber illustrates his concept of traditionalism with the example of an agricultural worker who works less when he gets a raise in wages (instead of working more) because he is working to fulfill his needs and not to maximize his own profits, see Max Weber infra note 668.
put in place? Or, does it conceive of the corporation as an organization of social beings capable of acting together for a common purpose?

### 3.3.6 Assumptions about the Structure of Society

The second assumption deals with conceptions about how society should be structured. At one end of the spectrum is a vision of society that includes only the state and individuals. The result of this conception is that legal rights are held only by individuals. Groups or entities, like the corporation, are incapable of holding legal rights. At the other end of the spectrum is a view of society that includes the state, organized groups and the individual. In this conception, groups are an acceptable unit of analysis in society and groups are capable of holding legal rights. The existence of this assumption was identified by Frederick Hallis in his 1930 book on corporate personality. In analyzing the philosophies underlying the corporate personality debate he wrote:

> Why then should philosophies in the past have oscillated between its two aspects of individuality and sociality? Some have attempted to overcome the anti-thesis of the individual and the social aspects of personality by supporting an extreme individualism, which preserves the unique reality of the individual human being and denies the reality and importance of society. Others have maintained an extreme collectivism which denies the concrete

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159 For an example of this type of argument see Bracket theory supra note 113 and Form of Ownership theory supra note 107.

160 Proponents of this view argue that group rights existed prior to the creation of individual rights and by eliminating group rights one eliminates the ability of an individual to act politically within the state because an individual has no ability to protect him or herself from the power of the state. For example see Otto Gierke, trans. George Heimann, *Associations and the Law: The Classical and Early Stages* (Toronto: University of Toronto Press, 1977) at 76, where Heimann he argues that in Greek society individuals did not have rights other than group rights: “The individual, according to Greek thought, was endowed with his own essence but never with a true legal personality. Whatever his rights and duties, the individual was not himself considered an original centre of autonomy. Rather, his rights and duties derived from his being a part of the whole. An independent private law did not exist.” Greek society was able to assign rights directly to associative groups. See also footnote 70 on page 91.
independence of the individual life and affirms the sole reality of society as a unitary organism. Both have avoided the real problem, which is to explain individuality and sociality as aspects of a single reality, the complete life of personality.\textsuperscript{161}

This assumption is very closely related to the concepts of individualism and collectivism.\textsuperscript{162} This assumption is also very closely linked with the first assumption. For example, it is more likely that a theorist who holds a view of human nature as self-interested will be more likely to view society in an individualistic way and less likely to view society in a collectivist way.

3.3.7 Assumptions about the Ability of the State to Regulate Corporations

The third normative assumption deals with the question of whether or not the corporation is a private or a public entity. In relation to corporate law, it also deals with the question of whether the relationship between the corporation and society is best regulated through the corporate law or through other laws external to the corporate law. At one end of the spectrum is the view that the corporation is a private entity that should not be regulated either within or outside of the corporate law.\textsuperscript{163} At

\textsuperscript{161} See Hallis \textit{supra} note 90 at xx-xxi. Hallis' ability to identify this assumption probably resulted from his exposure to the work of French philosopher Maurice Hauriou who wrote that the essence of an organization was in finding the balance between the group and the individual.

\textsuperscript{162} The terms are used here as they are used in Charles Hampden-Turner and Alfons Trompenaars, \textit{The Seven Cultures of Capitalism} (New York: Doubleday, 1993). Discussions of this assumption can very quickly descend into discussion about liberalism and socialism. Morton Horwitz has identified the individualistic vs. collectivist aspect of corporate theory. See Horwitz \textit{supra} note 90 at 181: "In all the Western countries, therefore, theories of corporate personality were associated with a crisis of legitimacy in liberal individualism arising from the recent emergence of powerful collective institutions." Horwitz has also argued that the debate in about the nature of the corporation is part of a larger debate about the role of the individual and the collective in society. See Horwitz \textit{supra} note 90 at 180. He has also stated that: "The argument between entity and contractual theorists during the 1880's and 1890's was, at bottom, a conflict over whether the individual or the group was the appropriate unit of economic, political and legal analysis." See Horwitz \textit{supra} note 90 at 220.

\textsuperscript{163} This view finds its roots in the work of Adam Smith who wrote in the \textit{Wealth of Nations} that there were only three duties of a sovereign: Defence, justice and the maintenance of a minimal infrastructure including education. Beyond that "everyman, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interests in his own way, and to bring both his industry and capital into competition with those of any other man, or order of men." See Adam Smith \textit{supra} note 155 at 687.
the other end of the spectrum is the view that the corporation is a public entity that can be justifiably regulated within the corporate law.\footnote{Adolph Berle and Gardiner Means talked about the public nature of the modern corporation when they argued that the corporation grew most in fields that had a public character to the activity involved. See Berle and Means supra note 35 at 17 where it is stated: “Thus, in field after field, the corporation has entered, grown, and become wholly or partially dominant. The date of its appearance and the degree of its dominance have in general varied with two factors, the public character of the activity in question and the amount of capital necessary to carry on business. It first came in the fields of public utilities, common carriers, banks and insurance companies (which even in the 1840's were conceded to perform public functions) . . . On the basis of its development in the past we may look forward to a time when practically all economic activity will be carried on under the corporate form. And wherever the corporation has become dominant, it has been in its quasi-public, not its private, role. It does not simply give a legal clothing to the private enterprise of individuals. It adds a new quality to enterprise – the quality of multiple ownership.” This view is also associated with the work of Karl Polanyi, who argued that the economy could not exist without the state and so any argument that supports deregulation of the economy or economic actors is inconsistent with reality see Polanyi supra note 19. Modern proponents of the view that the state is crucial to the formation and maintenance of markets include sociologists Frank Dobbin, Neil Fligstein and Peter Evans. See Frank Dobbin, Forging Industrial Policy: The United States, Britain and France in the Railroad Age (Cambridge: Cambridge University Press, 1994); see also Neil Fligstein, The Architecture of Markets (Princeton: Princeton University Press, 2001); see also Peter Evans, Embedded Autonomy: State and Industrial Transformation (Princeton: Princeton University Press, 1995).}

This assumption was best conceptualized by David Millon in his 1990 article, \textit{Theories of the Corporation}:

In addition to these distinctions there is a third dichotomy that has received a good deal less attention, a public/private distinction. . . According to one view, corporate activity has broad social and political ramifications that justify a body of corporate law that is deliberately responsive to public interest concerns. The alternate viewpoint portrays corporate law as governing little more than the private relations between the shareholders of the corporation and management, which acts as their agents or trustees. Under the first view, corporate law takes on an external perspective, paying explicit regard to the relations between the corporation and the rest of society. The opposing view conceives of corporate law’s focus as internal, dealing primarily with the governance problems that arise inside the corporation. This view would leave to other bodies of law (e.g. labor, anti-trust, debtor-creditor law) the task of regulating the corporation’s external relationships. \textit{Thus, the difference is between a public law, regulatory conception of corporate law on the one hand, and a private law, internal perspective on the other.}\footnote{Millon supra note 90 at 201. Millon believes that this is the crucial dichotomy of the traditional ones used. This dichotomy was also used by Patfield supra note 68 at 8-9 as the only classification required for corporate theories. Furthermore, feminist legal scholar Kellye Testy has identified this dichotomy as one of the most important issues in corporate law that needs attention – because the ‘private’ assumption cannot withstand feminist analysis. See Kellye Testy (2004) infra note 396 at 105.} [Emphasis added]
3.3.8 The Assumptions Chart

Each of the corporate theories discussed in this chapter is plotted according to its normative assumptions on Figure 3-3. The horizontal axis of the figure indicates each theory's position on the second normative assumption: the structure of society. It ranges from very group or collectivist oriented, on the left, to very individual oriented, on the right. The vertical axis indicates each theory's position on the third normative assumption: the public vs. private nature of the corporation. It ranges from very publicly oriented, at the top, to very privately oriented, on the bottom. This chart will be used at the conclusion of this chapter to analyze the historical development of corporate theories. As will be shown in that section, the first normative assumption is left off the Assumptions Chart because it can always be predicted based on the position of the other two assumptions.\(^\text{166}\).

There is nothing empirical about this chart and the location of the where the theories have been plotted can be debated. Nonetheless, the chart is useful because it gives a rough idea of the relative position of the normative assumptions at the core of a particular theory when compared to other corporate theories.

3.4 The Historical Development Of Corporate Theory

The question of what a corporation is has been the focus of debate among academics and jurists for a long time. In fact, there may be no concept in the law that is more controversial or that has attracted more attention. The question has been grappled with by some of the Western world’s greatest jurists and social theorists,

\(^{166}\) This is discussed in more detail in Part 4 of this Chapter – “Corporate Theories are Normative".

Despite all of this attention, modern Anglo-American corporate law is a discipline that is very technically oriented and rules driven. Many, if not most, Anglo-American corporate law students and practicing lawyers have never grappled with, or even been introduced to, corporate theory’s two most important questions: ‘What is a corporation?’ and ‘What is the purpose of corporate law?’

Mary Stokes, an English scholar, wrote about this curious development in 1985:

Students of company law very often complain that the subject is technical, difficult and dull. This is not without some justification. The reason can perhaps be found in the fact that company law as an academic discipline boasts no long and distinguished pedigree. The result is that company lawyers lack an intellectual tradition which places the particular rules and doctrines of their discipline within a broader theoretical framework which gives meaning and coherence to them.\(^{167}\)

It is disappointing that this statement could even be made, because, in fact, there is a vast and rich intellectual tradition of corporate theory. However to be fair, most of the corporate theory literature was written before 1930 and after the late 1980’s. A corporate law academic looking back at the previous 50 years from 1985, could have fairly come to the conclusion that there was very little corporate theory. Much of the early corporate theory from before 1930 remains largely unnoticed in modern corporate theory discussions.\(^{168}\) This is unfortunate because those theories have a lot to offer to our understanding of corporate theory and especially to our understanding of the corporation as a social institution.

\(^{167}\) Stokes *supra* note 35 at 155.

\(^{168}\) The exceptions to this statement are the historical legal work done by Morton Horwitz, David Millon, Gregory Mark, William Bratton and Mark Hager. See note 90.
The great debate on corporate theory began around 1880, as the modern business corporation started to become a significant social and economic influence. Theorists from America, England, Germany and France became preoccupied with what was at the time referred to as the theory of ‘corporate personality’, because it was focused on ascribing legal personality to the corporation. Morton Horowitz described the period in the following way:

Beginning in the 1890’s and reaching a high point around 1920, there is a virtual obsession in the legal literature with the question of corporate personality.\(^{169}\)

Throughout the 1800’s, the typical Anglo-American business organization was owned by individuals or small groups.\(^{170}\) It was managed by those owners and its size was limited by the personal wealth of the owners.\(^{171}\) The industrial revolution changed the structure of business organizations. With the industrial revolution came large industrial projects that required large organizations of people and immense amounts of capital to complete. Examples of these projects included railroads, mines, canals, bridges etc.\(^{172}\) In Anglo-American countries, the business corporation became one of the primary vehicles used to organize these large projects.\(^{173}\)

169 Horwitz supra note 90 at 217.
170 These businesses were mostly carried on as sole proprietorships or partnerships.
171 See Berle and Means supra note 35 at 4.
172 Horwitz has described the changes that were required to the capital of business organizations: “The major changes were in the size and scale of industrial companies. Before 1980, only railroads constituted ‘large, well-established, widely known enterprises with securities traded on organized stock exchanges, while industrials, though numerous, were small, scattered, closely owned, and commonly regarded as unstable.’ Most of the manufacturing enterprises of the 1880s have been described as ‘small’ companies with net worth under $2 million. For the sake of comparison, there were extremely few ‘very large’ companies worth more than $10 million, and even enterprises classified as ‘large’ (worth between $5 million and $10 million) were also ‘fairly rare’. By contrast, ‘each of the countries ten largest railroads had more than $100 million of net worth and the largest of them all, the Pennsylvania Railroad, had over $200 million’,” [footnotes omitted]. See Horwitz supra note 90 at 209.
173 Joel Bakan has argued that the rise of the corporation can be attributed to its ability to aggregate capital see Bakan supra note 39 at 8 where he states: “The genius of the corporation as a business form, and the reason for its remarkable rise over the last three centuries, was – and is- its capacity to combine the capital,
Professor Maitland described this dramatic increase in the use of the corporate form following the industrial revolution:

In the second half of the nineteenth century corporate groups of the most various sorts have been multiplying all the world over at a rate that far outstrips the increase of ‘natural persons’.\(^{174}\)

J.P. Davis also described the phenomenon:

The most important and conspicuous feature of the development of society in Europe and America on its formal or institutional side during the past century (and particularly during the second half of it) has been the growth of corporations.\(^{175}\)

It is interesting to note that this dramatic growth in the number of corporations was largely limited to Anglo-American countries and France.\(^{176}\) The growth did not occur in other Western European countries. Thomas C. Owen, in his book on the development of Russian capitalism, argued that corporations were not used as much in Russia because of the suspicion toward unfettered commercial and industrial

and thus the economic power, of unlimited numbers of people.” For a description on the rise of the modern business corporation see Bakan \textit{supra} note 39 at 5-27. \textit{See also} Berle and Means \textit{supra} note 35 at 14-17 where it is stated: “Following the lead of the railroads, in the last part of the Nineteenth Century and the early years of the Twentieth, one aspect of economic life after another has come under corporate sway. Banking and insurance companies carried the system over from the earlier years of the century. So also did the public utilities, among which it has become practically universal. Thus, in field after field, the corporation has entered, grown and become wholly or partially dominant. The date of its appearance and the degree of its dominance have in general varied with two factors, the public character of the activity in question and the amount of fixed capital necessary to carry on business. . .On the basis of its development in the past we may look forward to a time when practically all economic activity will be carried on under the corporate form. And wherever the corporation has become dominant, it has been in its quasi-public, not its private, role. It does not simply give a legal clothing to the private enterprise of individuals. It adds a new quality to enterprise – the quality of multiple ownership.”\(^{174}\) Maitland \textit{supra} note 79 at xii.\(^{175}\) Davis \textit{supra} note 79 at 1.\(^{176}\) However, it was in America that the growth of organizations and corporations was the most prolific. Alexis de Toqueville, a Frenchman traveling in America found organizations proliferating everywhere: religious organizations, political organizations and economic organizations. He wrote the following in 1835: “Americans of all ages, all conditions and all dispositions constantly form organizations.” Alexis de Toqueville, \textit{Memoir on Pauperism} (London: IEA Health Welfare Unit, 1997) at 114. It was originally published in 1835.
activity.\textsuperscript{177} Owen tracked the growth in the number of corporations in different countries. His results are summarized in Table 3-1. It shows the number of corporations and the number of corporations per million inhabitants in five European countries in 1914. The table shows that United Kingdom had significantly more corporations than any of the other European countries and that countries that were more collectivist oriented were less likely to use the corporate form.\textsuperscript{178}

The corporate personality debate continued actively until the 1930's, when a number of events converged that led to the end of the debate.\textsuperscript{179} This was followed by a very quiet period for corporate theory from the 1930's to the 1980's as 'Managerialism' rose to prominence.\textsuperscript{180} Then in the late 1980's, the corporate theory debate was revived.

The general development of corporate theory is depicted graphically in Figure 3-2 and a summary of each corporate theory is provided in Table 3-2. It is interesting to note that in Anglo-American jurisdictions there has been a narrowing down of acceptable theories. In the early part of this century corporate law scholars identified as many as 16 different theories that tried to explain the corporation.\textsuperscript{181} By the 1950's, the number of theories that were seriously discussed had dropped to the low single digits.\textsuperscript{182} Articles on corporate theory written since 2000, suggest that there are really

\textsuperscript{177} Thomas C. Owen, \textit{Russian Corporate Capitalism from Peter the Great to Perestroika} (New York: Oxford University Press, 1995 at 22.
\textsuperscript{178} The term "collectivist" culture refers to countries like Russia and Japan. They are contrasted against individualistic cultures like the United States, the United Kingdom and other Anglo-American countries.
\textsuperscript{179} These events are discussed in more detail in Chapter 4 — "Corporate Theory Loses its Relevance".
\textsuperscript{180} For this argument see Bratton (1989) \textit{supra} note 90.
\textsuperscript{181} Martin Wolff, "On the Nature of Legal Persons" (1938) 54 Law Quart. Rev 494 at 496. Although, after identifying that there were 16 theories he focuses on only four.
\textsuperscript{182} See Pound \textit{supra} note 90 at 222 where Pound identifies 7 different corporate theories: 1) concession theory (as combined with fiction theory), 2) fiction theory (separated from concession theory), 3) organism
only two significant corporate theories left: the Nexus of Contracts theory of the
corporation and the stakeholder conception of the corporation.\footnote{Kellye Testy (2002) infra note 396 and Rob Yalden supra note 90. Yalden refers to the two schools as “Contractualist” and “Pluralist”.}

For purposes of this chapter the theories are presented in two different groups:
(1) the historical theories up to the 1970’s, and (2) the modern theories of the
corporation developed since the 1970’s, including the Nexus of Contracts theory and
the various progressive corporate law theories.

For the purposes of analysis, the description of each corporate theory is
divided into six different sections:

1. The historical context to the theory
2. A description of the theory with particular attention paid to how the
   theory answered the two questions: What is a corporation? And what
   is the purpose of corporate law?
3. The identification of the normative assumptions at the core of the
   theory
4. The strengths of the theory
5. The criticisms of the theory, and
6. A description of the useful insights that the theory provided.\footnote{This last section will be important when the social theory of the corporation is developed in Chapter 6.}

\subsection{The Historical Corporate Theories (1880 to 1970)}

The significant historical corporate theories are: 1) Fiction/Concession
theory, 2) Real entity theory, 3) Contractual theory, and 4) Managerialism.\footnote{This division of the traditional theories has been used by Stokes supra note 35, Tollefson supra note 90 and Yaron infra note 186. See also Patfield supra note 68 at 7, where she categorizes the traditional
3.4.2 Fiction/Concession Theory

Fiction/Concession theory is the earliest identifiable corporate theory. It conceived of the corporation as an artificial entity whose separate legal personality is granted as a privilege by the state. Fiction/Concession theory is really the combination of two separate theories: fiction theory and concession theory. Fiction theory is based on the idea that the corporation is a fictitious person that exists only when it is created by law. Concession theory is based on the idea that the corporation can be created only by grant of the state.

Fiction Theory – Historical Context

F.C. von Savigny, the strongest proponent of concession theory, argued in 1840 that the fiction theory of the corporation could be traced back to Roman law. This contention has been seriously challenged by scholars who argue instead that there are only scanty references to it in the Roman law and that fiction theory is a

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186 These theories have also been referred to as grant theory, artificial entity theory or creature theory. See Yaron, "Awakening Sleeping Beauty: Reviving Lost Remedies and Discourses to Revoke Corporate Charters" (2002) (unpublished LL.M thesis) and Patfield supra note 68.

187 Stokes supra note 90 at 162. Patfield supra note 68 at 8.

188 For an example of this separation of concession theory into two theories see Pound supra note 90 at 222-240. For a great description of fiction theory (as separate from concession theory) see Pound Ibid at 226-244 and Wolff supra note 181. Dewey has explained that despite their separate historical foundations fiction theory and concession theory "flowed together" see Dewey supra note 95 at 668.

189 The summary of these two basic characteristics is taken from Tollefson supra note 90.

190 See F.C. von Savigny Das System des heutigen romischen Rechts (1840). This interpretation was also adopted by a number of other prominent jurists including Lord Blackstone (see Blackstone supra note 126 at 469); Otto Gierke and F.W. Maitland (see Maitland (1951) supra note 79.
Regardless of its origins, the first clear references to Fiction theory can be found during the Middle Ages.

The main purpose of Fiction theory was to solve the important legal issues related to the treatment of social groups within the legal system. For example, how could social groups like religious orders, trade guilds and towns, hold property, contract with individuals, have perpetual existence, sue and be sued etc. The solution was to treat the group as if it were a 'fictitious' person and to provide it with the bundle of rights that persons normally enjoyed – or, in other words, provide it with 'corporate personality'.

The earliest formulation of Fiction theory was made by Pope Innocent IV in 1243 when he pronounced that certain social groups that were treated by law as persons (universitas and collegium) could not be excommunicated because they were only fictitious persons and not real persons. Fiction theory became well developed

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191. There is a serious academic debate between Savigny (and his followers) who believed that Roman lawyers were always strict adherents to the Fiction theory school and Raymond Saleilles (and others) who argued that Fiction theory was “an invention of modern times and so far as it does appear implied in texts of Roman law, it was merely rather scanty theoretical clothing given to certain facts of which the Roman lawyer had a realistic appreciation.” See Hallis supra note 90 at 3. In fact, Planiol argued that the concept of fictitious persons could be found only in the work of Florentinus, one of the later jurisconsults of the Digest see Planiol supra note 106 at 777. In a more recent Duff concludes that Fiction theory cannot be traced to Rome: “Lastly, and most important, it is unlikely that the Romans should have worked out a theory so elaborate, so sophisticated, so remote from ordinary ideas, and left us only a few ambiguous hints that they ever thought about the matter at all.” Duff supra note 113 at 232.

192. This term is the term that was used before 1930 to refer to theories of the corporation because all of the theories assumed that the corporation was to be treated as a person – the only question was whether the corporation was a real person or a fictitious one. This technique solved all of the issues outlined above. Looking back, it is surprising that the jurists of the Middle Ages created the ‘fictitious’ person to provide rights to social groups because a real person had many more rights than the rights they wanted the groups to have. Why then, did they not just identify the legal rights that they wanted groups to have and then grant those rights to them? While it is almost impossible to tell, the answer probably lies in ‘Organism’ theory. During the Middle Ages it was the dominant theory of society and it conceived of society as organism with the king as the head. Therefore, to treat the group as if it were a person was a natural extension of organism theory. In any event, social groups did not end up acquiring all of the rights of a real person through their fictitious status as is evidenced in the concept of ultra vires – the group could only act for the purposes for which it was created.

in the Medieval church. It was used to order the otherwise unordered life of the Church and to establish the supreme authority of the Papacy.\textsuperscript{194}

\textit{Concession Theory – Historical Context}

Concession theory (together with Fiction theory) was received into the United Kingdom, from the Church, during the 15\textsuperscript{th} century.\textsuperscript{195} It is evident in Lord Coke’s decision in \textit{Sutton’s Hospital} where he wrote that corporations are: “invisible, immortal and resting only in intendment and consideration of law.”\textsuperscript{196} The theory is also evident in Blackstone’s Commentaries. In 1783, Blackstone wrote about the convenience of Concession theory:

\begin{quote}
We have hitherto considered persons in their natural capacities, and have treated of their rights and duties. But, as all personal rights die with the person; and, as the necessary forms of investing a series of individuals, one after another, with the same identical rights, would be very inconvenient, if not impracticable; it has been found necessary, when it is for the advantage of the public to have any particular rights kept on foot and continued, to constitute artificial persons, who may maintain a perpetual succession and enjoy a kind of legal immorality. \textit{These artificial persons are called bodies politic, bodies corporate, (corpora corporata) or corporations. . . [I]n England, the king’s consent is absolutely necessary to the erection of any corporation . . .via see, Leicester C. Webb, \textit{Legal Personality and Political Pluralism} (Melbourne: Melbourne University Press, 1958) at v where the author stated: “It was in the Church, however, and not the State, that the device of legal personality was first used as an instrument of political policy. The considerable development in the theory of legal personality that took place among the canon lawyers of the twelth century was primarily a response to the medieval Church’s need to introduce order into its profuse and sometimes undisciplined group life and to establish the supreme authority of the Papacy.”
\end{quote}

\textsuperscript{194} See, Leicester C. Webb, \textit{Legal Personality and Political Pluralism} (Melbourne: Melbourne University Press, 1958) at v where the author stated: “It was in the Church, however, and not the State, that the device of legal personality was first used as an instrument of political policy. The considerable development in the theory of legal personality that took place among the canon lawyers of the twelth century was primarily a response to the medieval Church’s need to introduce order into its profuse and sometimes undisciplined group life and to establish the supreme authority of the Papacy.”

\textsuperscript{195} C.T Carr, \textit{The General Principles of the Law of Corporations: Being the Yorke Prize Essay Winner for the year 1902} (Cambridge, Cambridge University Press: 1905) at 161 “Before [fiction theory] spread over England, conducted through the channels of Canonism.” \textit{See also} Pound \textit{supra} note 90 at 215 (fiction theory) and also at 223 (concession theory) where Pound states: “At any rate, the Digest clearly taught the later medieval and modern law that legal personality could only come from the state.”

\textsuperscript{196} Sutton’s Hospital Case, 10 Co. Rep. 1 (a) 32.

\textsuperscript{197} See Blackstone \textit{supra} note 126 at 467-470.
Concession theory rose to prominence in England because of the historical circumstances in the 17th and 18th centuries. England and France had been at war with each other for decades. The Monarch of each country was effectively bankrupt and decided to use Concession theory to sell trade monopolies under corporate charters to raise money for the government coffers. The most well known examples of these chartered trading companies were: the East India Company, the Hudson’s Bay Company and the Mississippi Company, but there were many others.

The combination of these charters and the invention of freely tradable joint stock, led to a speculative bubble in the trading of stock in both countries. This speculative bubble was fueled by the activities of two companies: The South Seas Trading Company in England and the Mississippi Company in France. While both of these companies originally started as chartered trading companies, they effectively

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198 John Dewey has argued that the rise of concession theory was the product of the rise of the nation state. See Dewey supra note 95 at 666 where he states: “It is essentially a product of the rise of the nation state, with its centralizing tendencies and its objection to imperia in imperio at a time when religious congregations and organizations of feudal origin (communes and guilds) were rivals of the claim of the national state to complete sovereignty. The shortest cut to making good its claims was to treat all minor organizations as “conjunctions” and conspiracies, except as they derived all of the powers from an express grant of a supreme power”.

199 For example, see Malcolm Balen, A Very English Deceit: The Secret History of the South Sea Bubble and the First Great Financial Scandal (London: Fourth Estate, 2002) at 82.


201 For a great historical account of these events see Balen supra note 199. John Blunt was the individual behind the South Seas Company. John Law was the individual behind the Mississippi Company. For a legal description of the events of the South Sea Bubble see Cooke supra note 109 at 80-109. Balen wrote at 36: “Encouraged by their success, Blunt and Harley now set to work on their most ambitious scheme of all: to try and find a way to reduce the national debt. The government owed money everywhere, in a confusing tangle of loans. There were the goldsmiths and moneymen who had lent money; there were the holders of lottery tickets, and the holders of the Treasury’s notched hazel tallies; then there was money raised by the Army, the Navy, the customs, the Commissioners of Victualling – the government’s obligations seemed endless.”
became banks that the Monarchs of England and France used to retire their respective national debts. The process was essentially the same in both countries. Holders of national debt (mostly loans) could exchange them for shares of stock in the one of the companies. As a result of speculation, the value of the shares was always going up, and so the incentive was for everyone to exchange their shares. Through this exchange process the national debt of each country was quickly exchanged into shares in the two companies.

However, neither company made any actual profits from their trading activities and, eventually, they both failed. The result was that all the shares that were issued in exchange for the debt became worthless. However, in the process the national debts of England and France had largely been extinguished. The activities of these two companies created a general speculative bubble in the trading of shares of companies, many of which did not have real businesses, and, most of which collapsed along with the South Seas Company and the Mississippi Company.

In England, this collapse is referred to as the “South Seas Bubble.” The reaction to it was the passing of the Bubble Act that prohibited the formation of joint stock companies in England for over 100 years.

202 See Balen Ibid at 36-37: “The company would ask the government’s creditors to exchange he money they were owed, directly, for shares in the new trading venture. To help service the interest on the debt the compay itself would be paid more than a half a million pounds a year by the government.”

203 For an example of the speculative rise of the shares in the companies see Balen ibid at 71 describing the rise of the shares of the Mississippi Company during just one summer period: “All the while, the Mississippi shares went on rising. From the early heights of 1,000 livres in the summer of 1719, they rose to two, then three, then four thousand livres, until, in August, they reached the unheard of heights of five thousand livres a share! . . . Up and up soared the shares, so that by the end of 1719, 500-livre shares were selling for thirty times their original value, at 15,000 livres. In one month alone they rose 1,000 per cent. The term millionaire was coined during these heady times.” [Emphasis in original].

204 For example, of the 190 companies launched in England in 1720 only 4 survived the bubble. See Balen ibid at 107.

205 The Bubble Act was in effect from 1720 to 1850.
From the United Kingdom concession theory was then exported to the North American Colonies. Professor Maitland argued that:

Nowhere has the concession theory been proclaimed more loudly, more frequently, more absolutely than in America.

S. E. Baldwin, an historian of the Early American colonies wrote:

Long before the days of the Revolution, any of the enterprises in which the colonists became engaged were so extensive that they could hardly have been undertaken without the aid of aggregated capital, contributed by many, but managed by a few.

The best example of concession theory in the United States is the famous 1819 decision in *Dartmouth College v. Woodward*:

A corporation is an artificial being, invisible, intangible, 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 existence.

The end of Concession theory was brought about by the South Seas Bubble, the passing of the Bubble Act and the American Revolution. Each of these events highlighted the fact that corporations could form naturally, they did not owe their existence to the state and that the corporate charter process was open to abuse. During the nineteenth century chartered corporations created by concession were linked to privilege, political favoritism and political inequality. Thomas Hobbes summed up

206 See Hurst supra note 110 at 14 where he states: “Paralleling businessmen’s desire for the corporation in the late eighteenth century was a steady implicit adherence to the idea that only a positive act of the sovereign might create corporate status. We were familiar with this idea from our colonial beginnings. Trading companies with founded colonies existed under royal charters.” See also S.E. Baldwin, *Select Essays in Anglo-American Legal History* (Boston: Little, Brown and Company 1907-1909) at 243, where the author argued that Concession theory bridged over to the United States from England when the Bubble Act was expanded to include the Colonies.

207 Maitland (1951) supra note 79 at xxxi.

208 Baldwin supra note 206.


210 See Webb supra note 194 at v.
to the views of time when he wrote that corporations were the: “worms in the entrails of natural man.”

During the years of the Bubble Act, when no new charters were being issued, business continued to organize themselves into large groups and to raise large amounts of capital. Armand Dubois did an amazing study in 1938 that showed that more joint-stock companies were formed during the years of the Bubble Act, than in all the years prior to it. This showed that business organizations were not dependent on the grant of a charter from the state. In a reaction against corruption and special privilege corporations moved from being specific grants of special charters to being freely available under general incorporation statutes. The best example of this occurred in the United States after the American revolution. In reaction against the imperialistic behaviour of the English chartered companies that had founded and operated the colonies, the United States eliminated concession theory and introduced the first general incorporation statutes in the early 1800’s. General incorporation arrived in England in 1862 with the passing of the Companies Act.

Fiction/Concession Theory

Concession theory was developed into its fullest form by the German jurist F.C. von Savigny. There were three main contentions in Savigny’s Concession theory. First, only individuals could hold rights. Second, regardless of the fact that

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211 Hobbes supra note 155.
212 See Dubois supra note 83
213 See Millon supra note 90.
214 For a brief discussion of the general incorporation statutes see Bratton supra note 90 at 1485.
216 Savigny supra note 190.
individuals have always formed groups, those groups do not exist until they are recognized by the state.\textsuperscript{217} Third, because the corporation is not a real person it does not have any personality of its own and it has no mind, no will and no ability to act.\textsuperscript{218} As soon as it acts to a purpose for which it is not created it is \textit{ultra vires} and as such it ceases to exist in the eyes of the law.\textsuperscript{219}

The most prominent supporter for Savigny’s Concession theory in England was John W. Salmond.\textsuperscript{220} The most vocal critic of Concession theory was Sir Frederick Pollock who argued that Fiction theory had never been adopted into the law of England and that English courts still could adopt the more progressive Entity theory.\textsuperscript{221}

In 1938, Wolff made an interesting argument in support of Fiction theory by removing Concession theory from it. Wolff felt that Fiction theory was useful as exactly that: a fiction that allowed a lawyer to deal with an organization in simple way (as a person) without having to determine what the exact sociological nature of a corporation was.\textsuperscript{222} His work was not seen as influential at the time, but his argument has some intellectual appeal. The events of the \textit{Bubble Act} and the American

\begin{footnotesize}
\begin{enumerate}
\item This point was recognized by Hallis \textit{supra} note 90 at 9.
\item See Derham \textit{supra} note 15 at 9.
\item Stokes \textit{supra} note 90 at 162 where she argued that Stokes has argued that the concept of \textit{ultra vires} was used to legitimize the power of corporations by keeping them within very narrow bands of activity.
\item See John W. Salmond, \textit{Jurisprudence} (London: Stevens and Haynes, 1916) at 281; John W. Salmond, \textit{Summary of the Law of Torts} (London: Steven and Hyanes, 1912) at 43: “To say that a corporation is a fiction devoid of real existence does at any rate stress what actually happens in situations involving corporations . . . But to state that the company is a real but mysterious entity explains nothing at all.”. See also, Duff \textit{supra} note 113 at 209 where he states: “The best known English accounts of the Fiction Theory are those of Maitland [referring to the quote provided in the text], a Realist, and Salmond, a staunch adherent of Savigny” and Hager \textit{supra} note 90 at 591 where he states: “Salmond was the most prominent spokesman for the fiction paradigm, and he defended it staunchly against advocates of Gierke’s theory.”
\item Sir Frederick Pollock, “Has the Common Law received the Fiction Theory of Corporations’ (1911), 37 L.Q.R 219.
\item See Wolff \textit{supra} note 181 at 505-521. For a discussion of this argument see Pound \textit{supra} note 90 at 222 - 244.
\end{enumerate}
\end{footnotesize}
revolution only called into question the Concession portion of the theory i.e. that only
the state could create corporations. The Fiction component could still be used as a
‘short-cut’ to provide rights to groups. However, it is the contention of this book that
the use of such legal ‘short-cuts’ leads to unintended results and that our modern
understanding of the corporation does not require us to use such short-hands
anymore.

Modern Forms of Concessionism

Concession theory has survived into modern times. It is used mostly by
activist groups to argue that the state should revoke the charters of corporations that
are damaging society. One example of such an organization is POCLAD (the
Program on Corporations, Law and Democracy). 223 Gil Yaron has written in favour
of the adoption of a new Neo-concessionist corporate theory that he describes as a
blend of Concession theory and Contractual theory:

Whereas concessionism argues that the corporation is an artificial entity
created by statute, neo-concessionism incorporates elements of contractualism
acknowledging the dual nature of the corporation as both a creature of statute
and an institution controlled by shareholders. However, while shareholders are
responsible for the creation and management of the corporation, the state
retains the ability to determine whether the corporation is operating in the
interests of society. With regards to the second element of concessionist
theory, neo-concessionism argues that the ability of the corporation to exist
and carry on business is still dependent on the permission of the state. 224

Given the historical development of corporate theory, it is highly unlikely that
these modern efforts to re-establish Concession theory will ever result in anything

223 POCLAD’s website is: www.poclad.org.
224 Yaron supra note 186. For another example of modern concessionism see Bakan supra note 39 at 153-
155. For example, Bakan writes on 153: “The state is the only institution in the world that can bring a
corporation to life.”
more than raising the awareness of the abuse of power that large corporations are capable of. The availability of general incorporation all but eliminates any idea that corporations can only be granted by privilege of the state. Similarly, the pervasiveness of the corporate form in modern society would make any attempt to justify corporate theory based on concession from the state extremely difficult. Furthermore, because of the intellectual deficiencies in Concession theory (which are outlined below) it is unlikely that there will ever be widespread intellectual support for such a theory again.

Normative Assumptions of Fiction/Concession Theory

Concession theory does not make any apparent judgment on the conception of human nature. Concession theory does, however, have a very strong underlying assumption that the only unit of analysis in society is the individual. For example, Savigny wrote that only individuals could hold rights. Similarly, under Concession theory, groups do not exist in the legal system until, and only if, it is recognized by the state and granted the status of an 'individual'.

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225 Morton Horwitz described it in the following way: "Gradually, by making the corporate form universally available, free incorporation undermined the [Concession] theory, incorporation eventually became regarded not as a special state-conferred privilege but as a normal and regular mode of doing business." Horwitz supra note 90. For another example of this argument see Patfield supra note 68 at 8.

226 See Maitland (1951) supra note 79 at xxxviii "It has become difficult to maintain that the States makes corporations in any other sense than that in which the State makes marriages when it declares that people who want to marry can do so by going, and cannot do so without going, to church or registry. The age of corporations created by way of 'privilege' is passing away . . . What is more, many foreign lawyers are coming to the conclusion that in these days of free association, if a group behaves as a corporation, the courts are well nigh compelled to treat it as such, at least in retrospect."

227 Many commentators have recognized that concession theory and fiction theory are very individualistic theories. For an example, see Hallis supra note 90 at 5.
Concession theory also has an underlying assumption that the corporation is a public institution.228 In fact, many of the earliest chartered companies were created for the purpose of developing and administering public works.229 Those companies had few rights and their activities were severely constrained compared to modern standards for corporate activities. They had limited objects and purposes, shareholders had unlimited liability, they could exist only for a prescribed period, their capital was fixed and they could not merge or consolidate assets. The public perception of the corporation at the time was as a “socially useful instrument of economic growth.”230 Because corporations owed their existence to grant from the state there was (theoretically) an ability on the part of the state to regulate the behaviour of the companies.

Therefore, Concession theory had the underlying assumptions that the individual is the correct unit of analysis in society and that the corporation is a public institution. This locates the Fiction and Concession theories in the upper-right hand quadrant of the Assumptions Chart.

Advantage of the Fiction/Concession Theory

The major advantage of Fiction/Concession theory was its simplicity. It allowed for a type of short-hand in assigning rights to the corporation. Instead of

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228 For example, see Cooke supra note 109 at 51 where the author states: “The first essential of a corporation’s existence in the seventeenth and eighteenth centuries was that it must serve a public purpose, ‘the advantage of the public’ or the ‘advancement of religion, of learning, and of commerce’. The grant of the privileges of incorporation was not a grant for private gain; it was, in theory at least, a grant for the public benefit.”

229 See Hurst supra note 110 at 17 where he states: “From the 1780’s well into mid-nineteenth century the most frequent and conspicuous use of the business corporation – especially under special charters – was for one particular type of enterprise, that which we later called public utility and put under particular regulation because of its special impact in the community.”

230 Ibid at 47.
actually determining which rights the corporation was to have, jurists simply deemed
the corporation to be a person in law with the result that it gained all of the rights of a
real person. 231

Criticisms of Fiction/Concession Theory

The first criticism of Fiction/Concession theory was that, even though from a
theoretical perspective concession theory allowed for state regulation of corporations,
in practice the state did not regulate private enterprise. 232 Since corporations were not
subject to regulation and since they were not liable for criminal acts or torts because
they were not real persons, they effectively did not have to account for corporate
responsibility. Hallis explains this situation:

It follows that the Fiction Theory must necessarily fail to produce a
satisfactory account of corporate responsibility. It permits the members of the
association to take safe cover behind the persona ficta for which the law
creates rights but to which it cannot attribute obligations. 233

The second criticism of Fiction/Concession theory was that it ignored social
reality and, in particular, the natural processes by which people have always formed
themselves into groups. Fiction/Concession theory denied individuals the right of
free association unless it was recognized by the state. 234 Hallis describes this:

231 Planiol supra note 106 at 800 makes this point: “It is this simplicity of the mechanism that has made the
success of the traditional fiction. Everything works out most easily. Juridical acts of all kinds, sales,
purchases, loans, payments, placing of mortgages and making of investments etc. are carried out for
account of the collectives in the same for as for individuals.”

232 Laski and Dieser in particular were proponents of this criticism. For a discussion of this criticism see
Hager supra note 90 at 625-626.

233 This criticism is also raised by Ernst Freund. See Ernst Freund, The Legal Nature of Corporations
(Chicago: Chicago University Press, 1987) at 67, where Freund states: “if corporate acting capacity is
purely a gift of the law, it is as difficult to understand a corporate tort as a corporate ultra vires act.”; see
also Paul Vinogradoff, “Juridical Persons”, 24 Colum. L. Rev. 594 (1924) at 602-603; and Hager supra
note 90 at 586-587.

234 See also Wolff (1938) at 508 where he states: “The fiction theory has also been reproached with being
incompatible with an important tenet of liberalism, the principle of ‘free association’: it’s backbone is – so
But before the individual can at law constitute in conjunction with others an association capable of acting in corporate capacity, it is above all necessary to obtain a concession from the state.\textsuperscript{235}

This power was used by government officials to perpetuate privilege, favoritism and political inequality. The more subtle version of this criticism argues that Fiction/Concession theory did not explain \textit{de facto} corporations or prescriptive corporations which are corporations that form on their own without legislative approval and are later granted status.\textsuperscript{236}

The final and more modern criticism of Fiction/Concession theory (aimed mostly at the Fiction theory component) is that people forgot that the grant of legal personality to corporations was a convenient short-hand and began to treat these fictitious persons as if they were real and to attribute to them the rights of real persons.\textsuperscript{237} Best example, is in the U.S. where corporations have successfully argued for the right to free speech.\textsuperscript{238}

\textit{Insights Offered by Concession Theory}

The most striking insight offered by this analysis of concession theory is that simple theories that use short-hands can lead to unintended results. Using the legal shortcut of equating the corporation with a real person and attributing to it legal personality in order to give a corporation rights, ignored the complexity of the

\textit{it has been asseted} – the Concession theory, according to which the juristic person is a concession or creation of the State.

\textsuperscript{235} Hallis \textit{supra} note 90 at 10.

\textsuperscript{236} Pound \textit{supra} note 90 at 224: “Not only does the Concession theory fail to meet the very common case of \textit{de facto} corporations, but it is seriously strained by difficult questions whether there is creation of a legal entity when statutes give “corporate advantages without incorporation”.

\textsuperscript{237} See Planiol \textit{supra} note 106 at 781. \textit{See also} Dewey \textit{supra} note 95 at 656 where he states: “In saying that “person” might legally mean whatever the law makes it mean, I am trying to say that “person” might be used simply as a synonym for a right-and-duty-bearing unit.”

\textsuperscript{238} See footnote 133.
corporation as a human organization and may have created more problems than it solved.

3.4.3 Entity Theory (Or Early Sociological Theory)\textsuperscript{239}

Entity theory is the most overlooked historical corporate theory. This is probably because of Entity theory's metaphysical peculiarities. However, it should not be overlooked because it offered a number of important insights into corporate theory, including: the recognition that groups (including corporations) exist in reality as social facts that can be studied; the recognition that the group is a legitimate unit of analysis in society that can hold and exercise legal rights; and the recognition that the corporation is an entity that can be regulated by the state. In other words, Entity theory was the first corporate theory that viewed the corporation as a social institution. Entity theory was created by the German legal theorist Otto Gierke in his 1881 work \textit{Das Deutsche Genossenschaftsrecht – The German Law of Fellowship}.\textsuperscript{240} Gierke's work was brought to the attention of Anglo-American scholars by Professor Ernest Freund in 1897 with the publishing of his \textit{The Legal Nature of Corporations} and F.W. Maitland in 1900 with the publishing of his translation of Gierke's \textit{Political Theories of the Middle Ages}.\textsuperscript{241} Entity theory had a significant influence on the

\textsuperscript{239} In France this was called "moral personality" see, Horwitz \textit{supra} note 90. It has also been called "realist" theory because it asserts a real personality for the group or sociological theory because it builds on the work of Gierke, Ehrlich and Hauriou see Pound \textit{supra} note 90 at 244, natural entity theory or group person theory see Stokes \textit{supra} note 90 at 163; and "corporate realist theory" see Patfield \textit{supra} note 68 at 8 and also "Pluralism" see Webb \textit{supra} note 194 at vii and Yalden \textit{supra} note 90 at 11..

\textsuperscript{240} Planiol \textit{supra} note 106 at 779 has argued that Gierke's theory was based on the work of Beseler. Horwitz has argued that there were "natural entity" writers that pre-dated Gierke including D. Jones see Horwitz \textit{supra} note 90 at 218.

\textsuperscript{241} See Otto Gierke trans. by F. W. Maitland, \textit{Political Theories of the Middle Ages}, (Cambridge, Cambridge University Press: 1951). Maitland's translation was the first portion of Gierke's great work to be translated into English. Since then three more parts that have been translated into English: (1) Otto
development of a number of other theories and movements in Anglo-American countries including stakeholder theory, the corporate social responsibility and the organized labour movement.\textsuperscript{242} Entity theory was also widely adopted in Germany, France, Italy and England. In particular, it was very popular in Germany and France where it had a longer lasting influence on corporate theory than it did in Anglo-American jurisdictions.\textsuperscript{243}

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Gierke, trans. by George Heiman, \textit{Associations and the Law: The Classical and Early Christian Stages} (Toronto, University of Toronto Press: 1977). The author's introduction provides the first complete analysis in English of the natural law philosophy of Otto Gierke including a description of Gierke's concept of group person, the fellowship (\textit{Genossenschaft}) and the position of the association in a 'modern state of laws' (\textit{Rechtsstaat}). In essence, Gierke's theory was that: (1) Man is a social and political animal and that it is natural for him to live in association with his fellow men (despite Hobbes), (2) that organized human groups actually have an independent personality of their own and their inner unity is not derived from the law as was believed in Roman law with the concept of the fictitious person (\textit{persona ficta}); and (3) that the law is the result of social associations as they develop over history and that the law merely confirms what was spontaneously and perhaps unconsciously created by historical forces. In essence, Gierke's philosophy was a challenge to the Roman system of law that was being imported into Germany at the time and it contained the demand for the free right to associate without help or hindrance from the state. It also contained in it an argument against concession theory according to which associations or groups are brought into being and exist at the sufferance of the state. The portion of Gierke's work that is translated in this text is his work that focuses on the importance of social associations to historical legal analysis and traces the concept of association from ancient philosophy in Greece (the \textit{polis}) to Roman jurisprudence (the \textit{universitas, collegia etc.}) to early Christianity (the \textit{republic, church, modern state and ecclesiastical corporations}); (2) Otto Gierke, trans. by Ernest Barker, \textit{Natural Law and the Theory of Society}, (Cambridge, Cambridge University Press: 1934). The portion of Gierke's work that is translated in this text is his theory of Natural law. It is of less significance to corporate research than the other portions of his work that have been translated into English but it does contain a whole chapter on Gierke's application of natural law theory to the theory of corporations which in effect is an argument against concession theory; and (3) Otto Gierke, \textit{Community in Historical Perspective: A Translation of Selections from Das Deutsche Genossenschaftsrecht (The German Law of Fellowship)}, trans. by Mary Fischer, ed. By Anthony Black (Cambridge: Cambridge University Press: 1990). This portion of Gierke's work begins with a historical account of German fellowship in the feudal system before 800 and tracks through the historical developments of gilds, medieval cities, political unions, city leagues, the German empire, rural communes in Switzerland and North Germany to corporations and the sovereign state. It finishes with a detailed account of the German concept of corporation (\textit{Körperschaft}).

\textsuperscript{242} Morton Horwitz has gone so far as to declare that "by 1900, the "entity" theory had largely triumphed and corporation and partnership law had moved in radically different directions. See Horwitz \textit{supra} note 90 at 182. However, this interpretation does not seem to be accurate. Given the content of American corporate law at the turn of the century it makes more sense to conclude that corporate law was a blend of Fiction/Concession theory and Contractual theory. However, there is evidence to suggest that Entity theory was adopted in at least a few U.S. court decisions see J.T. Carter, \textit{The Nature of the Corporation as a Legal Entity} (Baltimore: M. Curlander, 1919) at 73-76. For a description of the link between Entity theory and trade unionism see Hager \textit{supra} note 90 at 617-625.

\textsuperscript{243} For a list of early German and French sources see Pound \textit{supra} note 90 at 201-202 (in the footnotes). For the effect that Entity theory had on modern German corporate law see Kay (1996) \textit{supra} note 3.
Historical Context

Gierke created Entity theory in reaction to the particular historical circumstances that surrounded the formation of the German State. In the 15th and 16th centuries, German princes were consolidating their power and Roman law was being received widely across Germany from the Holy Roman Empire. The ‘reception’ of Roman law in Germany occurred in three different phases. In the first phase, Roman law was accepted and adapted to German customs. In the second phase, Savigny and the supporters of the Historical School, successfully argued for the adoption of true Roman Law, without adaptation to local customs. This in turn, led to the third phase, which was a counter-reaction to the Historical School.244 The third phase was characterized by a total rejection of Roman law and the search for law that was truly Germanic in origin. Otto Gierke was the champion of this movement. His political goal was a German law for the forming German state.245 This German law was to be based largely on natural law theory, Gierke’s theory of the Germanic fellowship, the metaphysical ideas of the Hegelian School and organic conception of society that was dominant at that time in philosophy and science.246

244 For a discussion of these three phases see Maitland (1951) supra note 79 at xv-xvii.
245 See Maitland ibid at xvi where it is described as follows: “A common legislature there might not be, but a Common Law there was, and a hope that the law of Germany might someday be natively German was awakened. Then in historical retrospect the Reception [of Roman Law] began to look like disgrace and disaster, bound up as cause and effect with the forces that tore a nation into shreds.”
246 Hallis supra note 90 at 139. Organism theory came out of the Middle Ages (see Maitland (1951) supra note 79 at 24 and 131) and has taken on ludicrous forms at times. For example, John of Salisbury, the 12th century scholastic who compared the prince as head, senate as heart and princes assistants as flanks. see Wolff supra note 181 at 498. Also, the work of Nicholas of Cues (Concordantia Catholica) who called the land the skeleton of the state, the people the flesh and the law the nerves (see Wolff supra note 181 at 499). Another interesting historical fact was that at the time of Maitland’s translation of Gierke there was a rising interest in sociological jurisprudence – the result was a coupling between Entity theory and sociological jurisprudence for the English Pluralists. For a discussion of this see Hager supra note 90 at 582.
The new German law was to have a collectivist approach to combat the individualistic approach of the Roman law.\textsuperscript{247} Roman law saw society as consisting of only the state and the individual with a number of legally created fictitious persons in between. Gierke filled in that conception of society by adding real associative groups between the individual and the state. Gierke’s goals were described by Frederick Hallis:

The old Roman individualistic conception of society is, thus, cast aside. In its place Gierke has put an organic conception. Individuals are no longer exclusive units. They are capable of sinking their own peculiar idiosyncrasies in the interest of a common life. And what is more, these individuals are no longer indivisible units. They are capable of sharing, of being absorbed in the corporate life of more than one corporate body, and at the same time remaining in other respects private persons.\textsuperscript{248}

\textit{Entity Theory}

For Gierke, the history of corporate theory was the history of human society.\textsuperscript{249} He saw the corporation as a social institution similar in kind to the church and the state. The essence of Entity theory is that the corporation is conceived of as a real or natural entity that has a social reality that exists prior to, and independent of, any State or law.\textsuperscript{250} It has its origin in the natural activities of private individuals who

\textsuperscript{247} For a discussion of the individualistic nature of Roman Law as presented by Savigny see Hallis supra note 90 at xx to xxix. Gierke also noted the individualistic nature of Roman law see Heimann supra note 241 at 117.

\textsuperscript{248} Hallis supra note 90 at 150.

\textsuperscript{249} Maitland (1951) supra note 79 at 1, where Maitland wrote: “The development by Legists and Canonists of a Theory of Corporations came into contact at many points with the efforts of the Medieval Spirit rationally to comprehend Church and State in their entirety, and therefore scientifically to conceive the nature of all Human Society.”

\textsuperscript{250} See Tollefson supra note 90. See also Horwitz supra note 90 at 218.
have always formed into groups for common purposes.\textsuperscript{251} Hallis describes this part of Gierke’s theory:

The crucial point in Gierke’s theory is that corporate organizations come to be as the result not of a creative act of the legislator but of a living force, of ‘historical or social action.’\textsuperscript{252}

Entity theory views the corporation as an organic body with an independent mind and will that is separate from its human participants.\textsuperscript{253} All rights and duties emanate from the corporation itself and not the shareholders.\textsuperscript{254} It conceives of the corporation as a ‘real person’ and not a fictitious legal person.\textsuperscript{255}

At the heart of Entity theory, is the belief that the group and not the individual was the basic unit of society and thus the unit with which legal analysis should be interested. Maitland describes this aspect of the theory:

Our German fellowship is no fiction, no symbol, no piece of the State’s machinery, no collective name for individuals, but a living organism and a real person, with body and members and a will of its own. Itself can will, itself can act, it wills and acts by the men who are its organs and as a man wills and acts by brain, mouth and hand. It is not is not a fictitious person; it is a Gesamtperson, and its will is a Gesammtwille; it is a group-person, and its will is a group-will.\textsuperscript{256}

Wolff makes a similar explanation:

\ldots this theory assumes that the subject of rights need not be human beings, that every being that which possesses a will and a life of its own may be the subject of rights and that States, corporations, foundations are being just as alive and just as capable of having a will as are human beings. They are – so it says – social organisms just as human are physical organisms. Their will

\textsuperscript{251} Millon \textit{supra} note 90 at 219.
\textsuperscript{252} Hallis \textit{supra} note 90 at 140.
\textsuperscript{253} This metaphysical aspect of the theory is important to note because it is one of the hardest portions of the theory to reconcile with modern thought.
\textsuperscript{254} See A.V. Dicey, \textit{Law and Public Opinion} (London: MacMillan, 1976) at 165, where the author states: “whenever men act in concert for a common purpose they tend to create a body, which from no fiction of law but from the very nature of things, differs from the individuals of whom it is constituted.”
\textsuperscript{255} This allowed Entity theory to get over many of the problems associated with Fiction/Concession theory including \textit{ultra vires} acts, liability for criminal acts and liability for torts.
\textsuperscript{256} Maitland (1951) \textit{supra} note 79 at xxvi.
('common will') is different from the will of the members of the corporation or from the will of the founder. Their actions are their own, not carried out by agents or representatives like those of incapables (infants, lunatics), but in the same way as those of normal adults. Man uses his bodily organs for the purpose. Corporations use men.257

This conception of the group is essentially sociological. It recognizes that the corporation is both a group of individuals and a social fact that can be studied in and of itself.

In Entity theory, the purpose of corporate law is to recognize associations - not create them.258 Entity theory also recognizes that corporate law is not solely a legal domain. Because corporations are social units, corporate problems are social problems and corporate theories are theories about the nature of social organization.

The most famous supporter of Entity theory in England was F. W. Maitland.259 Maitland translated the first portions of Gierke’s work into English. Gierke’s influence on their thought can be seen in the following description of a corporation offered by F.W. Maitland:

A company or any group of individuals acting together for a common purpose creates a living organism, or a real person, capable of willing and acting through the people who are its organs just as a natural person wills and acts through their brain, mouth and hands.260

257 Wolff supra note 181 at 498.
258 This interpretation was also adopted by Chicago law professor Arthur W. Machen, Jr. see Machen supra note 90 at 261-262, where he states the law just recognizes something that already exists: “All that the law can do is recognize, or refuse to recognize, the existence of this entity. The law can no more create such an entity than it can create a house out of a collection of loose bricks.”
259 Other influential English Pluralists included Sir Frederick Pollock and Cecil Carr. These supporters of Entity Theory in England became known as the English Pluralists. For an example of their work see Carr supra note 195. Carr’s book contains an amazingly detailed analysis of the development of the theory of corporateness that is organized by corporate characteristic as opposed to the traditional organization that traces corporate developments by geographic area. The author describes the development of the following corporate characteristics: Corporate personality, perpetuity, the corporation sole, the corporation’s ability to hold land, the corporation’s ability to sue and be sued, limited liability, concession theory etc. The strength of this book is its description of the development of the early forms of corporateness in Europe and its discussion of the Italian theory of corporateness.
260 Maitland (1951) supra note 79 at xxvi.
Entity theory had a profound impact on corporate law scholars from around the world and it sparked two distinct sets of work. The first was research into native forms of associations in each country to try and understand how each society had chosen to organize themselves prior to the importation of the concept of the corporation. Examples of this work are: In England, F.W. Maitland, Sir Frederick Pollock, Cecil Carr; and in the United States, J.P. Davis and Harold J. Laski. And in a similar scholarly pursuit Arthur Kuhn wrote a particularly interesting book comparing the international development of institutions and the characteristics of corporations.

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261 See Hager *supra* note 90 at 611-614. Where he describes that Gierke’s theory has a link to the destruction of the medieval social organizations: e.g. guilds, towns etc. and sees the creation of a situation where the individual is left alone to protect itself from the state. Taking away the power of the individual to have any political power or effect. This aspect of Gierke led to a huge revival in the study of the medieval forms of Group life especially by Maitland, Pollock, Laski and John P. Davis.

262 See F.W. Maitland, *Selected Essays* (Cambridge: University Press, 1936); Cecil Carr, “Onn English Boouroughs” in *Select Essays in Anglo-American Legal History* (Boston: Little, Brown and Company 1907-1909) at 167, where Carr states: “The appearance of corpoateness which grew up in the English Burroughs was a native English product. However Italian may have been the principles which came to govern the corporation at the end of the Middle Ages, it is doubtful whether there was anything Roman about the earliest English municipalities, except perhaps, here and there, the forticfcations.” (pg 167 of the 1909 article); and F. Pollock and F. Maitland, *History of English Law before the time of Edward I* (Cambridge: University Press, 1895); Harold J. Laski, “The Early History of the Corporation in England” in Laski, *The Foundations of Sovereignty* (New York: Harcourt Brace, 1921).

263 John P. Davis, *Corporations: A Study of the Origin and Development of Great Business Combinations and of their Relation to Authority of the State*, 2 Volumes (New York, Lenox Hill: 1905). Reprinted (New York, Burt Franklin: 1971). Next to the English translations of Otto Gierke’s work on German fellowships, these two volumes are the most extensive description of the development of the idea of the corporation when the corporation is considered to be a social group instead of a purely economic organization. In the two volumes the author traces the development of the idea of the corporation from Roman times through the following developmental stages: Ecclesiastical corporations, feudalism and corporations, municipalities, gilds, educational and eleemosynary corporations, the nation state, regulated companies, joint- stock companies, colonial companies and modern corporations.

264 Arthur K. Kuhn, *A Comparative Study of the Law of Corporations: With Particular Reference to the Protection of Creditors and Shareholders* (New York, AMC Press: 1912). This book contains an early Western comparative analysis of corporations. Kuhn shares the belief of early corporate law theorists that the corporation was nothing more than a recognition of a social group and that social groups naturally developed the family in ancient times to the church in the middle ages to the nation state and then in more modern times into guilds, societies, trading companies and then corporations. He argues that since social groups developed differently in different countries the application of the term “corporation” to any particular group organization in a particular country was nothing more than an application of “medieval nomenclature” to a modern institution. He also argues that the development of the idea of the corporation was not continuous and that early corporations were the result of “many antecedent trade devices developing concurrently in accordance with the particular group-form which each occupation or trade tended to assume” (pg. 34). The strength of this book is its detailed sections on the development of the idea.
The second set of work that was sparked by Entity theory was a proliferation of other sociologically based theories of the corporation including: Representation theory, Early Sociological theory, Left-Gierkianism and Early Stakeholder theory.

*Representation Theory*\textsuperscript{265}

In 1897, Ernst Freund translated Gierke for America. In the translation process, Freund removed the metaphysical aspect of Gierke’s arguments for the more practical American audience.\textsuperscript{266} Freund believed that the German version of Entity theory had lost itself in “metaphysical speculations and refined distinctions of little substantial value.”\textsuperscript{267} In presenting Gierke’s theory, Freund presented it as a theory of representation that portrayed the corporation as a representative democracy

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\textsuperscript{265} Hager classifies Freund as a contactualist, see Hager *supra* note 90.

\textsuperscript{266} For a great description of Freund’s work, see Horwitz *supra* note 90 at 202.

\textsuperscript{267} Freund *supra* note 233 at 5. It is very interesting that Freund had to prune Gierke’s version of entity theory of its metaphysical characteristics because Gierke’s theory was an already pruned version of an earlier theory called organism theory – which had its roots in Medieval times and reached its peak during the biological sociology period following Darwin’s theory of evolution. According to Organism theory, the subject of a right secured by law need not be a human being because every being which has a will and life of its own may be a subject of rights. Associations were deemed to be social organisms in the same way that human beings were deemed to be physical organisms and so municipalities, foundations etc. were deemed to be real beings (actual organisms) alive with wills and could hold rights. Gierke did away with the association as an actual physical organism metaphor but did maintain that associations were real entities. For a description of organism theory see Pound *supra* note 90 at 240-244.
governed by majority rule, where the ‘will’ of the corporate entity was, for policy reasons, the vote of the majority of the shareholders.\textsuperscript{268} Freund described it this way:

\begin{quote}
[W]e speak of an act or an attribute as corporate, it is not corporate in the psychologically collective sense, but merely representative and imputed to the corporation for reasons of policy and convenience.\textsuperscript{269}
\end{quote}

This version of the real entity theory has been called the theory of corporate representation.\textsuperscript{270}

The major issue with Freund’s theory was the importance that it placed on the majority rule of the shareholders as the will of the corporation. As a result of this focus, it was unable to explain the then emerging fact that the control of corporations in U.S. society was switching from shareholders to managers.\textsuperscript{271}

Freund’s work is important because it attempted to use Entity theory in an Anglo-American context by removing its metaphysical components. It was not widely accepted because of it tried to equate the will of the majority of shareholders as the will of the corporation.\textsuperscript{272}

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\textsuperscript{268} See Freund \textit{supra} note 233 at 10 where he explains the substitution of the majority will for the will of the corporation: “The true corporate will would be expressed by unanimous action resulting from common deliberation and mutual compromise and submission; but for purposes of convenience the law stops the process of reaching the conclusion halfway, and is satisfied with the concurrence of the greater portion of those acting. The justification of this legal expedient lies in the fact that the will of the majority may be presumed to express correctly what would be the result of forced unanimity; a presumption not always agreeable to fact, but convenient and more practicable than any other”
\end{flushleft}

\begin{flushleft}
\textsuperscript{269} \textit{Ibid.}
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\begin{flushleft}
\textsuperscript{270} Hager \textit{supra} note 90 at 590.
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\textsuperscript{271} For a description of theis process see Chapter 3 — “Managerialism”.
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\textsuperscript{272} This begs one question: How influential would his work might have been if he had chosen “managers” or “stakeholders” as his representative group for the will of the corporation?
\end{flushleft}
Early Sociological Theory

In 1930, Frederick Hallis wrote an important book entitled *Corporate Personality: A Study in Jurisprudence.* In it, Hallis sketched out the first complete argument in favour of an Anglo-American social theory of the corporation. The book made a surprisingly broad survey of corporate theories and included chapters on most of the important jurists from the European continent. Corporate theory was more important in Europe because the civil system relies more on theory to provide interpretation for the civil codes. The European approach also accepts the fact that the law is part of a wider social system and must rely on insights from the social sciences.

Hallis' sociological theory of the corporation offers three main insights into corporate theory: First, corporate theory is of limited use unless the theory is descriptive of reality. Second, corporate theory is political (or normative) in nature. Third, the real issue in corporate theory is in balancing the interest of individuals and groups.

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273 Hallis would never have referred to his own theory as “Sociological” because he believed that the term referred to a body of work where too much emphasis was placed on the group at the expense of the individual – so much so, that they make the mistake of ascribing personality to a group.

274 Hallis *supra* note 90


276 See footnote 91. Hallis *supra* note 90 at xv-xvi where he provides: “[C]ontinental lawyers are in the habit of taking juristic theories more seriously and literally than are English lawyers. The Law of Germany and the Law of France are codified, and accordingly abstract theory plays a more important role in their operation than it does in our Common Law.”
In order for corporate theory to resemble reality it has to incorporate insights from other disciplines, especially philosophy, politics and sociology. In making this point Hallis wrote the following:

If we recognize that legal problems are social problems, and that law is itself a social phenomenon, we must admit that the various social sciences have a claim upon the respect and attention of the jurist. Particularly is this the case where the jurist is concerned with so fundamental an issue as the conception of corporate personality. On this question he does not hold the field alone. Other sciences, such as political science, psychology and sociology, have also an interest in it, and although they cannot solve the problem with which he is par excellence concerned, whatever they may have to say must receive his attention. This is but a corollary of the fact that the problems of law are social problems.

The corporate law should be based on the social facts about corporations that are observed in the other disciplines – in particular the insight that groups do exist in society and therefore the law should recognize their right to exist. However, Hallis argued that any corporate theory that provided those rights to the corporation by imbuing it with personality was not useful because it would not:

interpret the actual life of society, and which will therefore have disastrous consequences if applied to the practical problems of society.

This aspect of the early sociological theory of the corporation is consistent with Karl Polanyi’s view that the economy is embedded in society. In order for corporate theory and the corporate law to have meaning it needs to be interpreted within the framework of our larger understanding about politics, sociology and psychology.

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277 Hallis’ choice of these three disciplines is interesting because it anticipates the levels of analysis approach adopted in modern organizational theory. The levels of analysis approach argues that we need to analyze social phenomenon from at least three different levels: the societal level, the organizational or structural level and the individual level. See Chapter 7 – “Levels of Analysis” for a discussion of this concept. Hallis’ choices are interesting because they correspond roughly to the levels: politics (our understanding of society), sociology (our understanding of organizations and social structures) and psychology (our understanding of individuals).

278 Hallis supra note 90 at xii.

279 Ibid at xxvii.
Hallis also recognized that the law is political and social in nature. For Hallis, the problem of corporate personality (corporate theory) embraced “the entire fact of human life in all its aspects” because it essentially was the structure of how individuals and groups are accommodated in society.\textsuperscript{280} This is a key insight. Individuals and groups exist as observed social facts. However, Anglo-American legal systems are based solely on the rights and duties of individuals. There is no room in the Anglo-American legal system for a right and duty bearing unit that is not an individual. Therefore, the early jurists solved the problem in the only way they knew how: they made the group into a person. Hallis highlighted the reflexive relationship between political ideas that the law:

Now it is inevitable that political ideas should influence law. Both are concerned with social problems; both derive their contents from the same world of social fact. It is therefore to be expected that where the development of new facts has prompted new political ideas, legal thought should also find itself in need of new constructions.\textsuperscript{281}

Finally, Hallis recognized that the real issue in corporate theory was in recognizing the difference between and then balancing the interests of individuals and groups. Hallis proposed to solve the issue of ‘corporate personality’ by recognizing groups as right and duty bearing units in society.\textsuperscript{282} These right and duty bearing units are separate from the individuals (who are also right and duty bearing units) which compose them. The rights and duties assigned to the groups are to be based on the observed differences between individuals and groups offered by the other social

\textsuperscript{280} Ibid at xxii.

\textsuperscript{281} Ibid at xiv.

\textsuperscript{282} This is an interesting insight and it illustrates a level of complexity in the individual vs. group assumption. There are two levels to the assumption: the structure of society and the structure of the legal system. The first question to ask is: Is the group an recognized part of the social structure of society distinct from its members? The second question is: If yes, is the group going to be assigned rights and duties separate from its members? See Hallis supra note 90 at xxviii-xxix.
sciences. In offering his corporate theory, Hallis relied heavily on the work of the French sociologist Maurice Hauriou and his *Theory of the Foundation* because it was a great example of a contemporary attempt to incorporate the observed social facts from sociology into a juristic treatment of groups.\(^{283}\)

The insights offered by Hallis are crucial to understanding the updated social theory of the corporation that is discussed in more detail in Chapter 6 of this book.

*Left-Gierkianism*\(^{284}\)

Left-Gierkianism is the term applied to the work of Harold J. Laski and George Deiser. Laski and Deiser were very concerned with the negative impact corporations were having on society. They both believed that the trade union movement in the United States, in the early 1900’s, could provide the template for an alternate social institution that would eventually replace the state and the corporation.\(^{285}\)

Laski believed that the major problem in modern society was the inability to make corporations liable for their actions. He argued that despite Fiction/Concession theory’s assumption favouring regulation by the state, it had failed to control corporations because of two major stumbling blocks: the concept of *ultra vires* acts

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\(^{283}\) Hallis proposed that in order to have a personality at law a corporation (a legal right-and-duty nearing unit”) was required to have three elements: 1) It must be an organized collectivity capable of acting as a whole in furtherance of an interest that the law will protect – this can be translated to mean that it must be a group with an internally organized governance structure where the members really participate in its government, 2) It must have a directing idea, a definite aim which gives it ‘a local habitation and a name.’ . . . for the law can recognize as persons only responsible beings. Through the internal governance system this idea becomes subjectivized into the the consciousness of its members, and 3) The fact must have a social value which calls for legal protection because it has a meaning for human life and can be realized See Hallis *supra* note 90 at 224 and 241-242.

\(^{284}\) For a more complete description of Left-Gierkianism see Hager *supra* note 90 at 604-611.

\(^{285}\) See Hager *supra* note 90.
and the inability to make corporations liable for criminal or tortuous actions that resulted from the concept of the corporation as a fictitious person. Laski believed that these shortcomings could be overcome with Entity theory’s attribution of a real personality to the group. In fact, he believed that: “less than the admission of real personality results in illogic and injustice.” Laski’s work explores the implications of using Entity theory for to make corporations liable for their actions.

George Deiser held similar views. In 1909, he wrote a series of three articles. In those articles he explored the concept of corporate personality and argued for the adoption of Gierke’s Entity theory because it could protect society from the ‘abusive power of corporate capital.’ Deiser believed that for practical everyday corporate transactions, any of the corporate theories was adequate, and the only meaningful difference between the theories emerged when considering the immense social consequences of corporate enterprise.

Early Stakeholder Theory

Edwin Merrick Dodd made one of the more famous uses of Entity theory in his 1930’s debate in the Harvard Law Review with Adolph Berle. The debate was about the issue of corporate social responsibility and the fiduciary duties of the

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286 For his complete argument in this regard please see Harold J. Laski, “The Personality of Associations,” (1916) 29 Harv. L. Rev. 404.
287 Ibid at 416.
290 For a more thorough description of Deiser’s articles see Hager supra note 90 at 605.
291 Deiser supra note 289 at 141.
292 For a detailed description of this debate see Chapter 4 – “The Last Great Debate”.

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managers of a corporation. Dodd used a modified version of Entity theory to provide a theoretical basis for corporate social responsibility and to attempt to justify a fiduciary duty owed to stakeholders as opposed to just shareholders. Dodd based this argument on the fact he:

saw an evolution in public opinion in the direction of viewing the business corporation as an economic institution that has a social service as well as profit making function.

This debate will be discussed in more detail in Chapter 4 - “The Rise of Economics in Corporate Law”.

**Modern Versions of Entity Theory**

There was a flood of articles on Entity theory in Anglo-American law reviews from the early 1900’s until the 1930’s. The main unifying theme of the articles was the view that the corporation was a real or organic entity that could not be analyzed as a mere sum of its parts. Then, in the 1930’s, probably as a result of John Dewey’s legal realist critique about the uselessness of corporate theory, Entity fell out of favour. There are only a few notable modern examples.

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293 Edwin Dodd, “For Whom are Corporate Managers Trustees?” (1932) 45 Harv. L. Rev 1145. See also Adolph Berle, “Corporate Powers as Powers in Trust” (1931) 44 Harv. L. Rev. 1049. This debate will be covered in more detail in the next Chapter: Why did the economic conception of the corporation become so dominant?

294 Dodd *ibid* at 1145.


296 Dewey *supra* note 95. For a discussion of the rise and fall of Corporate Theory see Bratton *supra* note 90. For a modern argument in favour of Entity theory see Hager *supra* note 90. Horwitz, in particular, believes that John Dewey’s article was the event that ended the corporate personality debate. See Horwitz *supra* note 90 at 175.
One example of a modern work based on Entity theory, is the 1950 book by C.A. Cooke: *Corporation, Trust and Company.* In the book, Cooke offers a modern interpretation of the idea of the corporation as a social grouping as opposed to a purely economic entity. He traces the development of the idea of the corporation from the boroughs and guilds in England to the beginnings of the English trading companies to the advent of joint-stock companies through the Bubble Act to the general incorporation statues in England (1860's). His main argument is that corporations have come to control large amounts of capital that should be used for the benefit of society and not for the benefit of a few individuals. The following quote is an example of the Entity theory roots of his ideas:

> In less than three hundred years the social institution connotated by the words 'company' and 'corporation' has undergone mutations in form and application that have placed in amongst the most influential of social groupings.

In his conclusion, Cooke also makes the familiar Entity argument that the purpose of corporate law is not to create organizations but to recognize organizations that already exist:

> This essay began with some reflections on the relations of law and society; it is perhaps fitting that it should end on the same theme. We have, within our field of observation, seen how, through several centuries, there has been continuous change in the legal view of the way in which certain groups may work. The two sets of purposes within the rule of law, - the individual purposes of living and the collective purposes of social control – have been seen at work, continuously changing the content of the law. And though it is customary to think and to write of the legal form of an institution which has come into being to perform certain social functions, the history of corporate groups suggests that it might be better to write of the social form and the legal function in society. For in the point of evolution the corporation, the trust and the joint-stock company are social forms clothed by the law with dress suitable to their times and occasions. Although they appear in society through legal recognition, they are not institutions created by the law. A child

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297 See Cooke *supra* note 109
298 *Ibid* at 7.
is not created by the law. But when it appears in the world it is clothed with a personality which the law recognizes. So with social groups; they appear first and are recognized by the law after their creation.  

Mark Hager has also argued for the revival of Entity theory. Other than Cooke and Hager, there are few modern references to Entity theory.

**Underlying Assumptions of Entity Theory**

Entity theory conceives of humans as social beings that have always naturally formed into groups. This is evidenced in Gierke’s idea of the German Fellowship. Entity theory also assumes that groups are valid units of analysis in society. In fact, Gierke specifically designed the theory to recognize this and contrast the German legal system with the individualistic Roman legal system. Finally, while some have argued that real entity theory was essentially private in nature, Entity theory was clearly conceived of the corporation as a public entity capable of being regulated.

M. Hager has correctly written that:

Gierke’s own work has established the basis for connecting real entity theory with notions of the “public” character of corporations. His discussions had imagined private and public law not as binary opposites, but as poles on a graded continuum. Far from imagining the real corporate entity as a private institution, Gierke conceived it as in many ways a public one.

Gierke himself wrote about the dual nature of the corporation as both a private and public entity:

In so far as a corporation is considered generally or for certain purposes as only a special entity as opposed to the state, its public-law position in the state

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299 C.A. Cooke *supra* note 109 at 187.
300 See Hager *supra* note 90.
301 See Horwitz *supra* note 90 who argued that real entity theory had a private anti-regulatory stance and that it was one of the main factors that contributed to the rise of big business in America.
302 Hager *supra* note 90 at 630-631. See also Laski (1916) *supra* note 288.
will be equal or analogous to that of single citizens. But special legal relations enter in so far as a corporation is considered as a more restricted community for the state- as an intermediate organism between the state-whole and single citizens. For here it becomes necessary to draw a line between the two capacities of the narrower association reaches, the state will possess a more or less extended right over not only the external, but also the internal life of the organism attached to it. The rise and modification, composition, business, content and compass of membership, its organization and activity in general, will not be determined for the narrower community by its will alone, but to some degree or other by the will of the state.  

Thus, Entity theory conceives of humans as social beings, groups as legitimate units of analysis in society and corporations as public entities. This locates Entity theory in the upper-left quadrant of the Assumptions Chart. All of the theories presented in this section are also plotted on the Assumptions Chart and are similarly located in the upper left quadrant.

**Impact of Entity Theory**

Morton Horwitz has argued that Entity theory had two impacts on society: that it legitimized large scale enterprises in the United States and that it destroyed any special basis for state regulation of the corporation that derived from Concession theory. Communitarian scholar David Millon also argued that Entity theory was pro big-business and commentator Joel Bakan has argued that Entity theory led to the personification of the corporation.

However, if these results did occur, they were unintended and peculiar to Anglo-American countries. The strongest advocates of Entity theory would never

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304 See Horwitz *supra* note 90 at 174 and 221. Horowitz's argument in this regard was also discussed in M. Hager *supra* note 90 at 581.

305 See Millon *supra* note 90 at 203 and 220 and Bakan *supra* note 39 at 16.
have imagined that these results could be justified by Entity theory. In 1989, M. Hager wrote of the unintended results of Entity theory:

Nothing could have been further from the minds of Gierke’s advocates than that his paradigm might actually reinforce the hegemony of corporate capital.306

If real entity theory did indeed provide pro-capital shifts in certain doctrines, it certainly was not meant by its most articulate advocates to do so. On the contrary, articulate opinion tended to view the real entity theory as one which would help to curb and check the antidemocratic effects of large scale corporate organization. Moreover, real entity theory was deployed by certain thinkers as a crucial building block in an attempt to articulate new visions of democratic social life, visions responding to the sweeping changes wrought by large-scale corporate industrialism.307

The misinterpretation of Entity theory arises because of confusion between the two underlying assumptions of the structure of society and the ability to regulate the corporation that are explored in this Chapter. Entity theory was in favour of the group as a valid unit of analysis in society. It argued that human beings naturally formed into groups and that those groups did not need to be recognized by the state in order to exist. This was an argument against the then dominant Concession theory. However, Entity theory never took the next step and argued that those groups were private in nature and should be free from regulation from the state. That argument is part of Contractual theory (which is presented next). This is the interpretation of Entity theory that makes people believe that it was pro big business. Entity theory clearly recognized that while the state does not create or sanction groups – it can still regulate them.

In support of this interpretation, it should be noted that Entity theory was never thought to be pro big business in Germany where, “the perspective continues to

306 Hager supra note 90 at 585.
307 See Hager supra note 90 at 581.
underpin the German view of the corporation,” and has led to the creation of a corporate structure more accountable to society with the supervisory board and the concept of co-determination.\textsuperscript{308}

\textit{Advantages of Entity Theory}

The biggest advantage of Entity theory is that it is very descriptive of real life. It is a social fact that people naturally associate in groups. This natural tendency highlights the fact that corporations are not created by the State. It also highlights the fact that we do not need abstract legal concepts to describe the corporation because it is real and observable.

Entity theory also overcame the issue associated with the doctrine of \textit{ultra vires} acts because the powers of the corporation were seen as natural attributes of its own internal life and not grants from the state.\textsuperscript{309} Therefore, corporations could be held liable for \textit{ultra vires} acts and torts and crimes because the corporation was seen to have independent will.\textsuperscript{310}

\textit{Criticisms of Entity Theory}

The metaphysical aspects of Entity theory are extremely hard to accommodate in modern thought. Not only is the idea that a corporation is a living being hard to

\textsuperscript{308} Kay (1996) supra note 3. Kay also gives examples of the effect this different view has had in Japan.

\textsuperscript{309} Hager \textit{supra} note 90 at 593. In fact, Hager points out that J.T. Carter has argued that real entity theory has been used in two Maryland cases to impose corporate tort liability.

\textsuperscript{310} See \textit{ibid} at 585.
understand, it can lead to some ridiculous results. For example, if a corporation owns another subsidiary corporation – is that slavery?\textsuperscript{311}

There is also an internal inconsistency in Entity theory. Treating the corporation as a real person is not consistent with social fact. A group of people are not a person – they are a group of people. D.P. Derham points out that confusing the group with a legal person is not helpful:

Similarly, arguments which spring from an assertion that groups have real personalities and real wills are also broken-backed, though not so dangerously perhaps, for they confuse the human being with the legal person and seek to impose the same confusion up in the group seen as a legal person.\textsuperscript{312}

\textit{Insights Offered by Entity Theory}

The first insight offered by Entity theory is that there have been corporate theories in the past that treated the corporation as a social institution. In fact, Entity theory was tremendously influential before 1930 and had an impact on a number of other influential theories and movements including Stakeholder theory and the labour union movement. If Entity theory was so influential before 1930, it raises the question of why it no longer has any significant influence. Part of the reason is probably due to its metaphysical characteristics. But there are other reasons. Those are outlined in more detail in Chapter 4.

The second insight offered by Entity theory, is that it is possible to overcome H.L.A. Hart's criticism of abstract concepts, if a theory of the corporation is based on

\textsuperscript{311} For examples of the types of logic problems that arise from treating the corporation as a real person see Wolff \textit{supra} note 181 at 501, where he states: "The assumption that juristic persons enjoy a real life leads to fallacious legal arguments." For example, the creation of a subsidiary company can be equated to the "creation of a 'living being' to live the life of a slave or of a criminal eternally chained up in a dungeon or similarly, a merger agreement between two companies would be characterized as a contract by which one of the companies promised to commit suicide."

\textsuperscript{312} Derham \textit{supra} note 15 at 6.
social fact. Entity theory offered this advance and showed that the corporation is a social institution much like previous social institutions including the church and the state. This insight was possible because supporters of Entity theory looked to the latest insights offered by sociology about the way corporations actually worked. This insight will be used in Chapters 5 and 6 to update the social theory of the corporation with the latest insights from organizational theory and economic sociology.

3.4.4 Contractual Theory (Or Early Economic Theory)313

Historical Context

At the same time that Entity theory was developing in Europe to justify the move away from concession theory, Contractual theory was being developed in the United States to explain the existence of the new general incorporation statues. Since most U.S. states had previously been British or French colonies founded and run by chartered trading companies, U.S. citizens (as colonists) had already had a long history of dealing with the political abuses of the chartered company system.314 As a result, after the American revolution, the United States quickly moved away from the idea that a corporate charter could only be granted by the state. The United States was the first country to adopt general incorporation statutes under which anyone could obtain a corporate charter provided that they met the requirements in the legislation. The first general incorporation statute was passed in the United States in

313 Also called Aggregate theory see Patfield supra note 68 at 7. Also been called property based theory or the contract based model see Yalden supra note 90 at 2.
314 Williston supra note 78.
The result of this movement toward general incorporation statutes was that a new theory of the corporation was required to replace Concession theory. In contrast to Entity theory, Contractual theory conceptualized the corporation as a private entity that came into being upon the free agreement of its shareholders. The corporation did not owe its existence to the state. Furthermore, because of its private nature, it should not be subject to regulation from the state.

Contractual theory (and its successors) has been the dominant corporate theory in Anglo-American jurisdictions since the 1880's. It has gone through three distinct phases: (1) Early Contractual theory, (2) Managerialism or property based theory, and (3) the Nexus of Contracts theory of the corporation. The first two stages are discussed below. The Nexus of Contracts theory will be discussed in the section on "Modern Theories".

Stage 1: Early Contractual Theory – 1880’s to 1932

The first work on Contractual theory was Victor Morawetz’s: A Treatise on the Law of Private Corporations. It was published in 1882. In it, Morawetz proposed a novel conception of the corporation as a private association formed by the free will of its shareholders. Morawetz provided the following definition of corporation:

It is evident, however, that a corporation is not in reality a person or a thing distinct from the corporators who compose it. The word 'corporation' is a collective name for the corporators or members who compose an incorporated

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315 Connecticut was the first but most other states followed by the early 1900’s. See Berle and Means (1968) at 126-127.
316 This theory has also been referred to as Managerialism see Bratton (1989) supra note 90.
association; and when it is said that a corporation is itself a person, or being, or creature, this must be understood in a figurative sense only.\textsuperscript{318}

He also claimed that the rights of the corporation were nothing more than the rights of its individual members:

Although a corporation is frequently spoken of as a person or unit, it is essential to a clear understanding of many important branches of the law of corporations to bear in mind distinctly, that the existence of a corporation independently of its shareholders is a fiction; and that the rights and duties of an incorporated association are in reality the rights and duties of the persons who compose it, and not of an imaginary being.\textsuperscript{319}

In effect, Morawetz de-aggregated the corporation and conceptualized it as being no different than a partnership.

The theory was an attempt by Morawetz to update corporate theory to make it consistent with the move in the United States towards general incorporation statues. He wrote:

There is no reason of immediate justice to others, why a number of individuals should not be permitted to form a corporation of their own free will, and without first obtaining permission of the legislature, just as they may form a partnership or enter into ordinary contracts with each other.\textsuperscript{320}

In Contractual theory, the purpose of corporate law is to allow the corporation to form by free will of the shareholders. Because he viewed the corporate charter as a contract among shareholders, the source of corporate power for Morawetz was the shareholders and therefore they were the correct body to regulate corporate activity (through unanimous shareholder agreement) and not the government.\textsuperscript{321} This was the

\textsuperscript{318} Ibid at 1.
\textsuperscript{319} Ibid at 2.
\textsuperscript{320} Morawetz (1st edition 1882) at 24.
\textsuperscript{321} Morawetz (1st edition 1882) at 420-22, explaining that since the corporate charter was a contract among the shareholders, no state can regulate the activities of the corporation. He wrote: "A State cannot in any manner alter the purposes of a corporation as set forth in its charter, because that would impair the contract existing between the members of the association. A law imperatively altering the charter of a private corporation would impair the obligation of written agreement upon which the shareholders have joined in
beginning of the anti-regulatory position of all future contractual theories of the corporation.

Contractual theory was adopted by other prominent American jurists including Henry O. Taylor and Charles Fisk Beach.\textsuperscript{322} It was also adopted in 1919 in the famous U.S. case of \textit{Dodge vs. Ford Motor Company} where in resolving a dispute between shareholders the court stated that, "A business corporation is organized and carried on primarily for the profit of stockholders."\textsuperscript{323} Contractual theory was the basis for the shareholder primacy model of corporate governance that dominates Anglo-American corporate law and it eventually evolved into the dominant "nexus-of-contracts" theory of the corporation.\textsuperscript{324}

This theory competed with Entity theory throughout the late 1800's and the early 1900's right up until the.

\textsuperscript{322} See, Henry O. Taylor, \textit{A Treatise on the Law of Private Corporations} (New York: The Banks Law Publishing Co., 1902) at 30 where he states the following about the nature of the corporation: "On the whole, it is more in accordance with the ordinary use of terms, and a clearer and more serviceable conception, to regard to the corporation as consisting of the shareholders, who may with propriety be said to constitute the body corporate, as it is through their acts, or the acts of their predecessors, that incorporation is caused. . . The shareholders, then, vested with the corporate powers, are the body corporate, corporation, or company". In fact, Taylor spends some time discussing the similarities between the corporation and partnerships. See Taylor (1902) at 33-45. See also Charles Fisk Beach, \textit{Law of Private Corporation: whether with or without capital stock, also of joint-stock companies and of all the various voluntary unincorporated associations organized for pecuniary profit or mutual benefits} (Chicago: T.H. Flood, 1891).

\textsuperscript{323} \textit{Dodge v. Ford Motor Company}, 204 Mich. 459, 170 N.W. 668. (Mich. 1919). In this case, the court decided that Henry Ford could not use corporate assets for the benefit of employees or customers if there was no benefit to shareholders. For a more detailed description of this case see Millon \textit{supra} note 90 at 223. See also Ashford (2002) \textit{infra} note 459, where the author uses binary economics to argue that the case should have been decided differently.

\textsuperscript{324} Patfield \textit{supra} note 68 at 8.
Underlying Assumptions of Contractual Theory

Contractual theory had the underlying assumptions that human beings are self-interested individuals, that the individual is the correct unit of analysis in society, and that the corporation is a private institution that should be not be regulated by the government. In fact, the corporation as an entity does not exist in Contractual theory. It is merely an aggregation of individuals that forms without assistance from the state. This locates Contractual theory in the bottom right quadrant of the Assumptions Chart.

Advantages of Contractual Theory

Contractual theory has a number of advantages. Contractual theory is a better theory than Concession theory, because it is more descriptive of what actually occurs in the real world. For example, individuals can and do freely choose to form groups that exist without recognition from the state. Contractual theory is also easier to assimilate than Entity theory because it is based completely on the individual and does not require acceptance of the metaphysical notion that a group of people has a will of its own.

Criticism of Contractual Theory

The biggest criticism of contractual theory is that it ignores the social fact that groups are different than individuals. Groups are capable of acting as a collective entity and for this reason alone they justify being treated differently than as a simple aggregation of all of their members.
Insight from Contractual Theory

The most important insight from Contractual theory is that groups do not need approval from the state in order to form.

Stage 2: ‘Managerialism’ – 1932 to 1980’s

After 1930, the focus of the corporate theory debate shifted from corporate personality to social policy. The emphasis of the social policy was controlling the conduct of corporate managers. This shift in the focus of corporate theory was caused by a book that was published in 1932 by Adolph Berle, a law professor at Harvard, and Gardiner Means, an economist. The book was called *The Modern Corporation and Private Property*. This book is arguably the most important book in the history of the development of corporate law. In it, Berle and Means conducted an economic analysis of a number of large U.S. corporations and argued that, as a result of the structure of the large widely held corporation, there was for the first time in history, a separation between the ownership and the control of business organizations. The thesis of the book is best summed up in the following quote:

By the use of the open market for securities, each of these corporations assumes obligations toward the investing public which transforms it from a legal method clothing the rule of a few individuals into an institution at least nominally serving investors, who have embarked their funds in its enterprise. New responsibilities towards the owners, the workers, the consumers, and the State thus rest upon the shoulders of those in control. In creating these new relationships, the quasi-public corporation may fairly be said to work

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325 Both Bratton and Millon refer to this movement as “Managerialism”. See Bratton and Millon supra note 90.
326 See Bratton (1989) supra note 90.
327 Berle and Means supra note 35.
revolution. It has destroyed the unity that we commonly call property – has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of profit seeking enterprise.\textsuperscript{328} [emphasis added]

This meant that owners were no longer involved in the day-to-day management of the business.\textsuperscript{329} Berle and Means described the situation as follows:

[I]t is therefore evident that we are dealing not only with distinct but often opposing groups, ownership on the one side, control on the other – a control which tends to move further and further away from ownership and ultimately to lie in the hands of management itself, a management capable of perpetuating its own position. The concentration of economic powers separate from ownership has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating “owners” to the position of those who supply the means whereby the new princes may exercise their power.\textsuperscript{330}

With the elimination of the classic economic assumption that the owner of capital will always put it to its most productive use, it followed that the greatest:

challenge for the corporation, was to sort out how to hold management accountable, given the inability of owners to exert the influence they once had.\textsuperscript{331}

Berle and Means describe the elimination of the assumption in the following way:

The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use. It consequently challenges the fundamental economic principle of individual initiative in industrial enterprise. It raises for reexamination the question of the motive force back of industry, and the ends for which the modern corporation can be or will be run.\textsuperscript{332}

\textsuperscript{328} Berle and Means \textit{ibid} at 7.
\textsuperscript{329} See Millon \textit{supra} note 90 at 214.
\textsuperscript{330} Berle and Means \textit{supra} note 35 at 124.
\textsuperscript{331} Yalden \textit{supra} note 90 at 3. It is a very curious fact that this problem does not seem to be isolated to capitalist societies. In fact, in the Chinese socialist system of State-Owned Enterprises they encountered the same agency problem. For a discussion of this see Robert Art & Minkang Gu, “China Incorporated: The First Corporation Law of the People’s Republic of China” 20 Yale J. Int’l. L. 273 (1995) at 285: “Without the discipline of the stock exchanges and the oversight of government officials, some managers have treated state assets like their own private property. Some, for instance, have purchased expensive foreign automobiles and other luxuries nominally for the enterprise. In the words of one local government official, ‘[m]any state factories have become an empire, with the general manager as the emperor who is accountable to nobody.’”
\textsuperscript{332} Berle and Means \textit{supra} note 35 at 9.
Building on contractual theory's conclusion that shareholders were the correct stakeholder group to regulate corporate activity, corporate theory began to explore the “agency” concept or how to get managers (who were acting as agents for shareholders) to act in the best interests of shareholders.

The influence of this theory cannot be understated. It became widely accepted because its observation that managers controlled corporations was far more descriptive of reality than the arguments of either Contractual theory, that assumed that shareholders controlled the corporation, or Entity theory, that assumed that the corporation controlled itself.

Under Managerialism the primary purpose of corporate law became solving the agency problem that was presented by the separation of ownership from control. The underlying assumption in this theory is that property owners (shareholders) have the primary interest in the corporation that needs to be protected. In this way, Managerialism indoctrinated shareholder primacy into North American corporate law.

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333 Yalden supra note 90 at 4. William Bratton has pointed out that the book remains one of the most cited corporate law sources see William Bratton, “Berle and Means Reconsidered at the Century’s Turn” (2001) 26 Journal of Corporation Law 737. In that article Bratton concludes: “Berle and Means and the separation of ownership and control therefore remain relevant and fiduciary standards remain a primary concern in corporate governance.”

334 For an example of this type of argument see Horwitz supra note 90 at 206. This observation has caused Horwitz to include Ernst Freund’s Representation Theory as part of Contractual theory because it assumes that control of the corporation lies in the hands of the majority of shareholders.

335 For an example of this view see Millon supra note 90 at 222 where he states: “In any event, the immediate challenge was to design a corporate governance scheme that would subject management’s stewardship of other people’s property to some kind of meaningful constraint. The problem of managerial discretion and accountability to shareholders thus emerged as the central problem of corporate law, a position it has occupied ever since.”
Underlying Assumptions of Managerialism

Managerialism shares Contractual theory’s conception of human nature as self-interested. Implicit in Managerialism is the assumption that managers will act in their own self-interests unless they are policed.

Managerialism is more moderate than Contractual theory in its views about the individual and the group as units of analysis in society. Managerialism acknowledged that the corporation was an entity separate from its shareholders that could be controlled by management.\(^{336}\)

Managerialism also assumed that the corporation is both public and private in nature. It is a public institution to the extent that it is an aggregation of capital. Berle and Means refer to it as a “social institution”. It is a private institution to the extent that ownership in it is based on property rights. This locates Managerialism in the bottom right quadrant of the Assumptions Chart.

Advantages of Managerialism

Managerialism’s greatest advantage was that it was a simple theory that made accountability in corporations clear: managers were to always run corporations in the best interests of the shareholders.

\(^{336}\) This is evidenced by the many references to the corporation as an institution or social institution throughout the book. Examples of these references were provided in Chapter 2.
Criticisms of Managerialism

The largest critique of Managerialism is that it is not really a theory of the firm but more of a narrow movement advocating that corporations should be managed in a particular way. The fascination with solving the separation of ownership from control, while important, was misguided. The separation of ownership from control has always existed in every public institution, for example, the church, the state, the guild the town etc. The separation of ownership from control is simply the issue of the exercise of public power. For corporate law to spend 70 years trying to resolve this problem is unfortunate. That was 70 years that we could have been using to better understand exactly what a corporation is.

Managerialism was also severely criticized on the grounds of corporate social responsibility because it allowed managers to externalize costs on society in the pursuit of returns for shareholders. By the 1970’s, Managerialism had found a set of ardent supporters in the Chicago school economists, who believed that externalities were justified, the most notable of whom was Milton Friedman. In 1972, Friedman wrote an article in the NY Times Magazine entitled “The Social Responsibility of Business is to Increase its Profits” in support of Managerialism:

The businessmen believe that they are defending free enterprise when they declare that business is not concerned “merely: with profit but also with promoting desirable “social” ends; that business has a “social conscience” and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers. In fact they are – or would be if they

337 For an example of this criticism see Ralph Nader, Mark Green and Joel Seligman, *Taming the Giant Corporation* (New York: Norton, 1976).
or anyone else took them seriously – preaching pure unadulterated socialism. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades. . . That is why in my book ‘Capitalism and Freedom’ I have called it a ‘fundamentally subversive doctrine’ in a free society, and have said that in such a society, ‘there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.\textsuperscript{340}

A similar argument was made by Daniel Fischel who became one of the founders of the Nexus of Contracts theory of the corporation. In 1982 he wrote:

Those who argued that corporations have a social responsibility and, therefore, that managers have the right, and perhaps the duty, to consider the impact of their decisions on the public interest assume that corporations are capable of having social or moral obligations. This is a fundamental error. A corporation . . . is nothing more than a legal fiction that serves as a nexus for a mass of contracts which various individuals have voluntarily entered into for their mutual benefit. Since it is a legal fiction, a corporation is incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having these obligations. Only people can have moral obligations or social responsibilities, and only people bear the costs of non wealth-maximizing behaviour.\textsuperscript{341}

In this quote you can see the connection between the early contractual theory, managerialism and the new nexus of contracts theory that was to develop. And from there the economists influenced by Morawetz’s early contractual theory and Managerialism began to construct the Nexus of Contracts theory of the corporation. It is interesting to note that by the end of his career Adolph Berle had also begun to criticize the shareholder primacy paradigm.\textsuperscript{342}

\textsuperscript{340} Ibid.
Insights from Managerialism

The first important insight from Managerialism is the recognition of the corporation as an important social institution. An institution whose power and influence continues to grow in modern society. The second important insight from Managerialism is that there definitely is an issue in corporations with the exercise of public power or, in other words, there is an issue with making sure that the managers of corporations make decisions that are consistent with the best interests of the stakeholders. Whether the group of stakeholders considered includes all of society or just shareholders will depend on the normative position adopted.

The Modern Corporate Theories

The modern corporate theory debate has become a competition between two competing models: 1) the economic Nexus of Contracts theory (otherwise known as the ‘contractarian’ theory of the corporation), and 2) progressive law theories.\(^{343}\) The Nexus of Contracts theory of the corporation is by far the dominant model in Anglo-American countries. The progressive law theories arose largely as critiques of the Nexus of Contracts theory.

\(^{343}\) I prefer the classic label for these theories that was presented by Lawrence Mitchell, see Mitchell supra note 58. These theories have also been referred to as “corporatist” theories, see Stokes supra note 90; “communitarian” theories, see Millon supra note 90; and “socioeconomic” theories, see Dallas supra note 55.
3.4.5 The “Nexus of Contracts” Theory Of The Corporation

Historical Context

The intellectual roots of the modern Nexus of Contracts theory lay in the Contractual theory of the corporation, Managerialism and the work of economist Ronald Coase. A complete description of the historical context surrounding the rise of this theory in Anglo-American corporate law is included in Chapter 4 – “The Rise of Economics in Corporate Law.”

The Nexus of Contracts Theory

The Nexus of Contracts theory was developed by economists during the 1970’s. It began to be adopted into corporate law in the 1980’s. In 1991, Fischel and Easterbrook wrote the key book that linked economic theory with corporate law: The Economic Structure of Corporate Law.

The theory views the corporation not as an entity but as an aggregate of inputs that together produce goods and services. Contractarian scholar Stephen Bainbridge has summarized the theory in the following way:

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344 There are two forms of modern contractarian theory: 1) the ‘weak’ or institutional economics form that is based on the work of Ronald Coase and Oliver Williamson that acknowledges that actors have ‘bounded rationality’, and 2) the strong form or Nexus of Contracts theory advocated by Fischel and Easterbrook; This classification was identified by William Bratton see Bratton supra note 90. For the purposes of this chapter the Nexus of Contracts theory is presented because it is now the dominant theory.
345 See Ronald Coase “Nature of the Firm” (1937) 4 Economica 386. For a complete discussion of this article see Chapter 4 – “Ronald Coase – The Nature of the Firm”.
346 For a description of the historical development of the theory see Chapter 4 – “The 1980’s to the Present: The Rise of the Economic Conception of the Corporation”
Contractarians model the firm not as an entity, but as an aggregate of various inputs acting together to produce goods or services. Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of the management. Management monitors the performance of employees and coordinates the activities of the firm's inputs. The firm is simply a legal fiction representing the complex set of contractual relationships between these inputs. In other words, the firm is not a thing, but rather a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm.\textsuperscript{349}

In law, this theory views the corporation as simply a legal fiction, a “nexus” that represents all of the contracts between the participants in the corporation including employees, creditors, shareholders and managers.\textsuperscript{350}

The theory is best characterized by its commitments to:

1. ‘shareholder primacy’, which requires that managers should run the corporation only for the benefit of shareholders;\textsuperscript{351} and

2. private regulation, which provides that markets and private contracts should govern corporations and not public regulations.\textsuperscript{352}

In this regard, the theory is very similar to Managerialism. In the contractarian model, shareholders are given the job of policing the actions of management because the shareholders are the residual claimants in the corporation. The traditional form of this argument sees shareholders as the residual claimants because all of the value of the equity

\textsuperscript{349} Bainbridge \textit{supra} note 16 at 4.
\textsuperscript{350} Fischel and Easterbrooke \textit{supra} note 348 at 15.
\textsuperscript{351} From a theoretical perspective this arises not because shareholders enjoy a right of private property ownership – like they did under “Managerialism” – but because from a contractual point of view they are the parties that is most efficiently capable of monitoring managers. Property rights have very little to do with the Nexus of Contracts theory because the theory itself treats shareholders as only one of a number of inputs into the corporation – someone owns each input – but no-one owns the whole corporation. See Bainbridge \textit{supra} note 16 at 8.
\textsuperscript{352} See Fischel and Easterbrook \textit{supra} note 348 at 34. These two primary characteristics of Nexus of Contracts theory were also identified by Lynn Dallas see Dallas \textit{supra} note 55 at 480.
of the shareholder depends on the success of the firm. Fischel and Easterbrook explain this concept in the following way:

Voting exists in corporations because someone must have the residual power to act (or delegate) when contracts are not complete. Votes could be held by shareholders, bondholders, managers, or other employees in any combination. Yet voting rights are universally held by shareholders, to the exclusion of creditors, managers, and other employees. The reason is that shareholders are the residual claimants to the firm's income. Creditors have fixed claims, and employees generally negotiate compensation schedules in advance of good performance. The gains and losses from abnormally good or bad performance are the lot of shareholders, whose claims stand last in line. As the residual claimants, the shareholders have the appropriate incentives (collective choice problems notwithstanding) to make discretionary decisions.

Another way to put it is that shareholders implicitly bargained for the right to control the corporation in exchange for a higher degree of risk that the other groups with an interest in the corporation. Shareholders are also given the policing job because it makes accountability in the firm clear. Macey & Miller supported this view of shareholder primacy:

"It is desirable to maintain a system of corporate governance in which fiduciary duties are owed exclusively to shareholders because no suitable alternative means of protecting shareholders' claims exist other than by way of a judicially enforced regime of fiduciary duties. By contrast, the obligations owed to other claimants

\[353\] For a defense of the contractarian view of shareholders as the residual claimant see Stephen M. Bainbridge, “Private Ordered Participatory Management: An Organizational Failure Analysis” (1998) 23 Del. J. Corp L. 979 where he argues that shareholders and other stakeholders in the corporation would bargain for shareholder primacy terms: “As a result, if the parties could bargain over the distribution of control rights, shareholders would bargain for control rights, so as to ensure a corporate decision-making system emphasizing monitoring mechanisms designed to prevent shirking by employees, and employees would be willing to concede such rights to shareholders.” (pg. 1068). See also Jonathon R. Macey, “An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties” (1991) 21 Stetson L. Rev. 23 where it is argued that the more acute contracting problems faced by shareholders justify their primacy position with regard to control rights: "shareholders face more daunting contracting problems than other constituencies. These acute contracting problems vindicate the traditional common law rule that managers and directors owe their primary fiduciary responsibilities to shareholders.” (pg. 36). For a critique of both of these arguments see Kent Greenfield, “The Place of Workers in Corporate Law” (1998) 39 B.C.L. Rev. 283 where he argues that workers too have residual claims in the firm and that workers are not capable of contracting to protect their interests as is assumed by contractarians.

\[354\] Fischel and Easterbrook supra note 348 at 68.
can be enforced by contract because they are more precisely defined than the obligations to shareholders.\textsuperscript{355}

For contractarians, the purpose of corporate law is to establish the rights among the participants in the corporation.

The role of corporate law at any instant is to establish rights among participants in the venture. Who governs? For whose benefit? Without answering difficult questions about the effectiveness of different devices for controlling agency costs, one cannot determine the appropriate allocation of rights.\textsuperscript{356}

In effect, the corporate law allows efficiency gains, by acting as a standardized contract among the participants saving them time and cost of having to negotiate:

We treat corporate law as a standard-form contract, supplying terms most venturers would have chosen but yielding explicit terms in all but a few instances. The normative thesis of the book is that corporate law should contain the terms that people would have negotiated, were the costs of negotiating at arm’s length for every contingency sufficiently low. The positive thesis is that the corporate law always conforms to this model. It is enabling rather than directive.\textsuperscript{357}

Later on in the book Fischel and Easterbrook also refer to corporate law as an ‘off-the-rack’ solution:

The short but not entirely satisfactory answer is that corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting.\textsuperscript{358}

Contractarians also believe that people should be able to make their own bargains free from the influence of regulators. Fischel and Easterbrook explain it this way:

The standby terms [of the corporate law] grant great discretion to managers and facilitate actual contracts. They leave correction to the interplay of self-interested actors rather than to regulators.\textsuperscript{359}

\textsuperscript{355} J.R. Macey and G.P. Miller. "Corporate Stakeholders: A Contractual Perspective" (1993) 43 U. of T. L. J. 401 at 423. This is similar to Adolph Berle’s argument – See Chapter 4 – “The Last Great Debate”.
\textsuperscript{356} Fischel and Easterbrook \textit{supra} note 348 at 14.
\textsuperscript{357} Fischel and Easterbrook \textit{ibid} at 15.
\textsuperscript{358} \textit{Ibid} at 34.
\textsuperscript{359} \textit{Ibid}.
This theory views the relationship between managers and shareholders is an agency relationship where the managers are the agents and the shareholders are the principal.\textsuperscript{360}

You can see here the close relationship between this theory of the firm and the Managerialism theory proposed by Berle and Means. Berle and Means referred to this issue as the "separation of ownership from control."\textsuperscript{361} Contractarians refer to it as the "agency conflict".\textsuperscript{362} The agency conflict gives rise to increased costs where the managers do not act in the best interest of shareholders. Therefore, shareholders are given the right to monitor managers.

Underlying Normative Assumptions of Nexus of Contracts Theory

Modern contractarian theory is just a modern form of traditional Contractual theory. Because contractarian theory was developed by economists, it relies upon the traditional assumptions of neo-classical economics. These assumptions are similar to Contractual theory’s assumption. Neo-classical economics and the Nexus of Contracts theory of the corporation assume that human beings are rational self-interested profit maximizers. For instance, Fischel and Easterbrook described the role of self-interest in the functioning of corporations in the following way:

To sum up: self-interested entrepreneurs and managers, just like other investors, are driven to find the devices most likely to maximize net profits. If they do not, they pay for their mistakes because they receive lower prices for corporate paper. Any one firm may deviate from the optimal measures. Over ten of years and thousands of firms, though, tendencies emerge. The firms and managers that make the choices investors prefer will prosper relative to others.\textsuperscript{363}

\textsuperscript{360} Yalden \textit{supra} note 90 at 3.
\textsuperscript{361} For a contractarian discussion of the 'separation of ownership' from control see Fama and Jensen (1983) "The Separation of Ownership From Control" 26 J.L. & Econ 301 (1983).
\textsuperscript{362} See Jensen & Meckling \textit{infra} note 577.
\textsuperscript{363} Fischel and Easterbrook \textit{supra} note 348 at 6.
In the scale of the theories surveyed thus far contractarian theory is the theory that most strongly adheres to this conception of human nature.

Similarly, contractarian theory is the strongest in support of the individual as the unit of society to be measured as opposed to groups. In essence, the theory does away with the group essence of the corporation altogether and conceptualizes it solely as a collection of contractual relationships. Contractual theory at least acknowledged that the corporation was made up of humans (its members). The Nexus of Contracts theory does away with the human beings altogether.

This theme is again represented when it comes to the regulatory assumption. Contractarians believe that the corporation is purely a private entity that it should regulate itself and it should be free (at least within the corporate law) from regulation by the state.\(^{364}\)

Each of these assumptions of neo-classical economics has come under severe criticism for being unrealistic.\(^{365}\) Some contractarian theorists have attempted to adjust the theory take these criticisms into account. One of these theories, Team Production Theory, is discussed in the “Progressive Contractarian Theory” section below; another, Socioeconomics, is discussed in the “Progressive Law” section. These attempts to moderate contractarian theory does not diminish the fact that the contractarian theory of the firm is an extreme corporate theory when its normative assumptions are analyzed. The extreme viewpoint of contractarian theory is illustrated by its position in the bottom right corner of the Assumptions Chart.

\(^{364}\) Ibid at 38-39.

Advantages of the “Nexus of Contracts” Theory

Contractarianism has prevailed as the dominant corporate theory in Anglo-American jurisdictions because it had many advantages over previous theories.

First, the model leads to a very simple framework for making corporate decision. Since the only obligation of managers is to act in the best interests of shareholders, there is only ever one stakeholder whose interests needs to be taken into account. In this regard, it is just a modern version of Managerialism. The simplicity of the theory also makes it useful in making policy decisions about corporate law.

Second, the model presents universal rules that should apply in all situations. Because the model is driven by efficiency and the reduction of transaction costs it should be applicable to any society and any business organization in the world.366

Third, because the model was built on economic theories it is very good at explaining how economic markets work, although this is accomplished by the simplifying assumptions imported from economics.

Finally, economists and law and economic scholars are almost unanimous in their support for it. As a result, there is one model that everyone adheres to which simplifies the discussion and solution of corporate law issues.

Each of these advantages of contractarian theory has been called into question.367

366 In fact, this belief reached such an a state of acceptance that in early 2001, two of the most prominent corporate law scholars in the U.S. wrote and article entitled “The End of History for Corporate Law.” That article argued that since the U.S. contractarian model of the corporation had proven itself to be the most efficient - the debate over which corporate law model was the best was over - ending the history of the corporate law debate. It would just be a matter of time before all other jurisdictions in the world adopted the U.S. model. See Hansmann and Kraakman supra note 11. It was ironic that the Internet Bubble ensued shortly after the article was written.

367 Each of these advantages and the critiques of them is discussed in more detail in Chapter 4 - “Critiques of Economics, Law and Economics and the Economic Conception of the Corporation”.

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Criticisms of Contractual Theory

The Nexus of Contracts theory has come under severe criticism from many sources. In fact, the criticism of the theory is so widespread that it gave rise to a whole new movement in corporate law called “progressive corporate law”. This movement will be described in more detail in the next section.

Nonetheless, in general, the main criticisms leveled against the theory are: First, that it is not a new theory at all but the old Contractual theory in a new form. Second, that it is not, in any way, descriptive of reality and that it is merely a construction of abstract theory. Third, and a related criticism, is that it does a very poor job of taking into account the “human” portion of behaviour (i.e. social norms, informal rules, culture, non-rational behaviour etc.); Finally, that it is too simplistic and ignores the complexity of real life and that its simplicity causes antisocial behaviour such as driving all business activities toward the maximization of profit and creating a fascination with short-term horizons.

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368 This argument was made by Bratton supra note 90 and Millon supra note 90 at 229-231: “The legal theory’s reliance on economic analysis and vocabulary are novel developments, but the theory’s aggregate, shareholder-centred foundation is not. . . The new economic theory of the corporation is thus a novel and sophisticated version of [Contractual theory] that has dominated corporate law discourse since the 1930’s and has been interpreted to mean that corporate law should focus on the welfare of shareholders.” See also Kay (1996) where he states: “The widespread perception that the purpose of British corporations is to maximize shareholder value is the product of a particular economic theory of the modern corporation rather than the structure of British Company Law. Although the description of the corporation as a nexus of contracts is an illuminating analogy, it is not a historical account of how such organizations came into being. It occupies the same status in relation to business life as Hobbes’ Social Contract enjoys in political theory.”

369 Patfield supra note 68 at 8.

370 See Bakan supra note 39.
Progressive Contractarianism

A number of progressive contractarian scholars have begun the process of adapting the Nexus of Contracts theory to overcome some of its critiques. The most widely known of these initiatives is: Team Production theory. This theory attempts to overcome the criticisms that shareholders are not the only residual claimants in the firm and that shareholder primacy is not justified by the Nexus of Contracts theory. 371

Team Production Theory

Margaret Blair and Lynne Stout developed the Team Production Theory of the corporation. 372 This theory views the corporation not as a “nexus of contracts” but as a team of members who pool their resources to produce goods or services. Possible team members include managers, shareholders, employees, creditors and local communities.

Blair & Stout describe their conception of the corporation in the following two quotes:

371 For an example of this critique see Lynn Stout, “Bad and Not-So-Bad Arguments for Shareholder Primacy” (2002) 75 Southern California Law Review 1189. See also, Eugene Fama, “Agency Problems and the Theory of the Firm” (1980) 88 Journal of Political Economy 288. Fama rejects the language of property in favour of the language of contract. Fama argues that it is not shareholders but stakeholders who are most at risk. The concept of ownership should be done away with altogether. Ownership of capital should not be confused with ownership of the firm. See also Yalden supra note 90 at 57: “[t]he firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this Nexus of Contracts perspective, ownership of the firm is an irrelevant concept. Dispelling the tenacious concept notion that a firm is owned by its security holders is important because it is the first step toward understanding that control over a firm’s decisions is not necessarily the province of security holders.”.

372 See Margaret Blair & Lynn Stout, “A Team Production Theory of Corporate Law” (1999) 85 Va. L. Rev. 247; and Margaret Blair & Lynn Stout, “Director Accountability and the Mediating Role of the Corporate Board” (2001) 79 Wash. U. L. Quarterly 403. The concept of the firm as a team production unit was also used by Alchian and Demetz in their 1972 article on the theory of the firm. See Armen Alchian and Harold Demetz, “Production, Information Costs, and Economic Organization” (1972) 62 American Economic Review 777. To illustrate this consider the following quote: the firm is “the centralized contractual agent in a team production process – not some superior authoritarian directive or disciplinary power . . . . Team production will be used if it yields an output enough larger than the sum of separable production . . . to cover the costs of organizing and disciplining team members.” Ibid at 778-779. In their view the firm arose to solve the problem of shirking by team members.
Our argument suggests that it is misleading to view a public corporation as merely a bundle of assets under common ownership. Rather, a public corporation is a team of people who enter into a complex agreement to work together for mutual gain.\(^{373}\)

The mediating hierarchy model consequently suggests that the public corporation can be viewed most usefully not as a nexus of implicit and explicit contracts, but as a nexus of firm-specific investments made by many and varied individuals who give up control over those resources to a decision-making process in hopes of sharing in the benefits that can be had from team production.\(^{374}\)

The theory is based on two ideas from labour economics: First, stakeholders make firm specific investments. Second, the results of those investments into team production are better than they would if members were acting on their own. However, stakeholders would not agree to make those firm specific investments, if shareholders had complete control of a corporation. Blair & Stout argue that stakeholders agree to make those investments because the board of directors has agreed to take on a “mediating role”.\(^{375}\)

The mediating role of the board was described as follows:

Thus, the primary job of the board of directors of a public corporation is not to act as agents who ruthlessly pursue shareholders’ interests at the expense of employees, creditors, or other team members. Rather, the directors are trustees for the corporation itself – mediating hierarchs whose job is to balance team members competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.\(^ {376}\)

In order for this theory to work, the board needs to be independent from any of the stakeholders including the shareholders. As such, the board is not seen to be an agent of shareholders in this model. Instead, the Board takes on the role of independent third party mediator and decides how to allocate the surplus of the corporation among the team members. This aspect of Team Production theory allows managers to take into account

\(^{373}\) Blair & Stout (1999) \textit{ibid} at 278.
\(^{374}\) \textit{Ibid} at 285.
\(^{375}\) See Blair & Stout (1999) \textit{ibid} at 277-278.
\(^{376}\) \textit{Ibid} at 281.

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the interests of stakeholders other than shareholders. In this regard, Team Production theory appears to be similar to other progressive corporate law theories. However, Blair & Stout are quick to point out that Team Production theory is just a modification of the Nexus of Contracts theory.

Because this view challenges the shareholder primacy norm that has come to dominate the theoretical literature, our analysis appears to parallel many of the arguments raised in recent years by the 'communitarian' or 'progressive' school of corporate scholars who believe that corporate law ought to require directors to serve not only the shareholders' interests, but also those of employees, consumers, creditors, and other corporate 'stakeholders'. We believe, however, that our mediating hierarchy approach, which views public corporation law as a mechanism for filling in the gaps where team members have found explicit contracting difficult or impossible, is consistent with the "nexus of contracts" approach to understanding corporate law.377

Other than the insights offered from labour economics, Team Production theory is in all respects substantially similar to the Nexus of Contracts theory. It sees the purpose of corporate law as a standard form contract. It is based on the assumptions of self-interested human nature, the individual over the group and the private nature of the corporation.378

The two most important insights offered by Team Production Theory are: First, corporations are not just bundles of contracts and the most important components of

377 ibid at 254.
378 For example, Blair & Stout's theory is based on the assumption that individuals unless monitored will shirk and free-ride within the corporation. This is consistent with a self-interested view of human nature. They have written: "Because shirking and rent-seeking can erode or even destroy the gains that can be had from team production, it is also in the collective interest of team members to minimize such behavior if the terms of the relationship among the team members call for them to share in any rents. How can team members save themselves from their own opportunistic instincts? . . ." Blair & Stout (1999) ibid at 271. Although in a later article they did write the following moderating words: "[A]t least some of the people, to some extent, some of the time, are capable of looking out for the interests of others – even when they reap no direct economic benefit form doing so. Indeed, this assumption underlies most fiduciary relationships." Blair & Stout (2001) supra note 372 at 444.
corporations are the human beings who form the contractual relationships. Second, shareholders do not own the corporation or control management.\textsuperscript{379}

Team production theory has been criticized by Progressive Law scholars\textsuperscript{380} and Feminist scholars.\textsuperscript{381} While these critiques are diverse, they can be summarized in the following points: First, Team Production Theory just maintains the status quo. The allocation of the surplus in this model becomes a matter of power and not principle because participants compete to strike the best bargain with the board of directors. The participants with the best ability to exit should be able to strike the best deal. Therefore, shareholders will probably still acquire the largest allocation. Second, Team Production theory allows the Nexus of Contracts theory of the firm to remain in place.\textsuperscript{382} Blair & Stout are unable to break from the model they are criticizing.\textsuperscript{383} Team Production theory with its emphasis on economic analysis is still not able to overcome other critiques of the Nexus of Contracts theory of the corporation.\textsuperscript{384}

\textit{Insights Offered by “Nexus of Contracts” Theory}

The Nexus of Contracts theory was important because it returned the focus of corporate theory to questions about the nature of the corporation and away from

\textsuperscript{379} In this regard, Team Production Theory looks remarkably similar to the social theory of the corporation offered in this book. See Chapter 6 – “The Social Theory of the Corporation”.
\textsuperscript{380} See David Millon, “New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law” (2002) 86 Va. L. Rev. 1001; See also Dallas supra note 55 at 519-520.
\textsuperscript{381} Kellye Testye (2004) infra note 396 at 100; and Kellye Testye (2002) infra note 396 at 1232-1235.
\textsuperscript{382} Kellye Testy is quite adamant about this. In her 2002 article she wrote the following about the use of economic analysis by progressive law scholars: “On the other hand, as Audre Lorde once said ‘the master’s tools will never dismantle the master’s house.” See Testye (2002) ibid at 1229.
\textsuperscript{383} Yalden supra note 90 at 19 and Testy (2004) ibid.
\textsuperscript{384} For a description of these critiques, see Dallas supra note 55 at 520. For an outline of the critiques of economic analysis in general see Chapter 4 – “Critiques of Economics, Law and Economics and the Economic Conception of Corporation”.

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Managerialism's focus on solving the issue of the separation of ownership from control. It was also important because it held the possibility of breaking free from property ownership theories of the corporation. The nexus of contracts theory acknowledged that there were various inputs into the corporation and that the owner of each input had some kind of claim on the corporation. However, in practice the theory did not meet its potential and it ended up maintaining the status quo of shareholder primacy. Finally, nexus of contract theory highlighted the dehumanizing effects of economic theories in general. The effect of economics simplifying assumptions could not have been made clearer than with the wave of mergers and acquisitions that accompanied the rise of the nexus of contracts theory of the corporation during the 1980's.

3.4.6 Progressive Corporate Law Critiques and Theories

Historical Context

Progressive corporate law theories arose during the 1980's in response to the wave of hostile takeover bids that swept across North America. The theories were almost exclusively offered as critiques of the Nexus of Contracts theory. The number

385 This insight is an example open system organizational theory. For a more complete discussion of this see Chapter 5 – “Open Systems Theory”.

386 These critiques and theories have also been called “Communitarian” see Mitchell supra note 58; “Pluralist” see Yalden supra note 90 at 11; “Corporatist” see Patfield supra note 68; and “Law and Socioeconomic” theories see Dallas supra note 55 at 480. Progressive law was chosen for the purposes of this book because it is the label that the scholars in this movement first applied to themselves, see Mitchell supra note 58.

387 Millon supra note 90 at 203.

388 See Testy (2002) infra note 396, where she argues that progressive law is more of a critique than a prescription. See also Bainbridge supra note 16, where he argues that the progressive law scholars have more in common with what they oppose than what they stand for: “In a very real sense, those scholars are far more firmly united by what they oppose – Chicago-style law & economics – than by what they support.
of critiques of the Nexus of Contracts theory is evidence of the strong reaction against the theory. This progressive corporate law movement created renewed interest in corporate theory. Progressive corporate law scholar David Millon described the renewed interest in corporate theory in 1990:

With the public controversy generated by the explosion of hostile takeover activity during the 1980's, we again are witnessing debate about theories of the corporation. Responding to the widespread concerns about the harsh impact of hostile takeovers on target company employees and others, state legislatures, courts, and commentators have focused on the notion of the corporation as an aggregation, defined broadly to include not just shareholders and management but also other participants in the corporate enterprise.389

Progressive Corporate Law Critiques

The progressive corporate law critiques of the Nexus of Contracts theory are numerous and include critiques based on economic analysis, moral and ethical analysis, feminist analysis, communitarian analysis, historical analysis and corporate social responsibility claims.

The economic critiques of the Nexus of Contracts theory can be categorized into three general themes: First, the Nexus of Contracts theory is based on unrealistic normative assumptions.390 Second, shareholder primacy is not justifiable on the claim that shareholders are the residual claimants in the corporation because other stakeholders including employees also have residual claims in the corporation.391 Third, the Nexus of

389 Millon supra note 90 at 203-204.
390 For an example of this criticism see Dallas supra note 55 - Chapter 1.
Contracts theory is not really a theory of the corporation at all, because it treats the corporation as a mini-market within the larger market.\textsuperscript{392}

The moral and ethical critique of the Nexus of Contracts theory is focused on the fact that economic analysis, by virtue of its simplifying assumptions, purposefully removes morals and ethics from business. This critique argues that we need to restore these human aspects to business.\textsuperscript{393}

The communitarian critique of the Nexus of Contracts theory challenges shareholder primacy on the grounds that the corporation is not a private entity but a public entity.\textsuperscript{394}

The historical critique of the Nexus of Contracts theory argues that by looking at the history of corporate theory it can be shown that the Nexus of Contracts theory is not a new theory at all. Rather, it is just the latest in a long line of corporate theories that try to justify “collective production in individualistic terms.”\textsuperscript{395}

The feminist critique of the Nexus of Contracts theory focuses on how the theory perpetuates existing hierarchical structures. Kellye Testy provided the following summary of the feminist critique of corporate law:

\textsuperscript{392} For an example of this critique see Melvin Eisenberg, “The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm,” (1988/1989) 24 J. Corp. L. 819.


\textsuperscript{394} For an example of this critique see David Millon \textit{supra} note 90.


\textsuperscript{396} For examples of this critique see Janis Sarra, “The Gender Impotence of Corporate Governance Change”, 1 Seattle J. Soc. Just. 457 (Fall/Winter 2002); Kellye Testy, “Linking Progressive Corporate Law with Progressive Social Movements”, 76 Tulane L. Rev. 1227 (2002); Kellye Testy, “Capitalism and
These scholars' feminist insights into corporate law divide into three key points. The first is a challenge to shareholder primacy and an argument that corporate decision making should consider a wider array of constituents without the hierarchy of the shareholder primacy model. The second is a critique of the shortcomings of existing fiduciary duty law, and an argument that feminist insights into concepts of care and connection can and should give increased substantive context to director and officer duties. The third argument is more wide ranging but through different tacks is at its core a critique of concentrations of undemocratic corporate power together with an argument that to the extent that power works hardships on individuals in society, those hardships fall disproportionately on women (especially third-world women). These critiques bear a remarkable similarity to the progressive critique of corporate law.  

The corporate social responsibility movement argues against the anti-regulatory and shareholder primacy components of the Nexus of Contracts theory on the basis that corporations need to be run consistent with “good governance” practices that take stakeholders and the environment into account.  


enforcing certain duties which are owed, as an ethical matter, to members of the community other than stakeholders.\textsuperscript{399}

\textit{Assumptions of the Progressive Law Critiques}

It is difficult to make any generalizations about the assumptions that underlie the progressive law critiques because they are so varied. Nonetheless, the two common ideas outlined above place the progressive law critiques at the public and group ends of the continua in the Assumptions Chart. This locates the progressive law critiques in the upper left quadrant of the Chart, in the same quadrant as Entity theory, Stakeholder theory and Early Sociological theory.

\textit{Strengths of the Progressive Corporate Law Critiques}

The progressive corporate law critiques were extremely successful at highlighting the weaknesses in the Nexus of Contracts theory of the corporation. They were also

\textsuperscript{399} Patfield \textit{supra} note 68 at 9. \textit{See also} Testy (2002) \textit{supra} note 396. Lynne Dallas has summarized the similarities between progressive corporate law theories in a slightly different way: “Progressive corporate-law scholars generally advocate the adoption of one-or more of the conditions Bowie recommends as necessary for a firm to constitute a "moral community": 1. The firm should consider the interests of all stakeholders in any decision it makes. 2. That consideration should involve getting input from all of the affected stakeholders. 3. It should not be the case that for all decisions, the interests of one stakeholder take priority 4. Each business firm must establish procedures designed to ensure that relations among the stakeholders are governed by principles of justice. These principles of justice are to be developed in accordance with conditions 1 through 3 and must receive the endorsement of representatives of all stakeholders.” Dallas \textit{supra} note 55 at 481. \textit{See also} Testy (2004) where she provides that while the ‘contours’ of progressive corporate law are still emerging there are some unifying characteristics including: the view of corporation as at least a quasi-public entity; the view that corporate law has a substantive job to do—rather than enable private bargaining; support for stakeholders over shareholders; boards of directors as trustees for society; concentration on anti-democratic uses of corporate power; focus on corporate illegality and immorality; interest in increasing wealth disparities; and interest in environmental and worker externalities.
extremely important in highlighting the normative basis of both the Nexus of Contracts theory and other corporate theories. The feminist critique was especially useful in this regard.

Criticisms of Progressive Corporate Law Critiques

The development of the progressive law movement as a critique of the Nexus of Contracts theory resulted in two main issues for the movement: First, because most of the theories are critiques, very few of them offer a fully developed alternate theory of the corporation that can be used instead of the Nexus of Contracts theory to build practical solutions to problems. This criticism speaks to the realization that you cannot replace a dominant corporate theory until you offer another theory that is better or as good. Feminist legal scholar, Kellye Testy has criticized the movement for offering only critiques:

It is not enough to seek to counter shareholder primacy, for instance, without being clear about exactly what it is about shareholder primacy that is troubling and what its reform will accomplish...Put simply, then, I am encouraging a more explicit account of what it is that progressive corporate law seeks to accomplish.

Second, there is no single accepted theory of the corporation within the progressive law movement. Instead, there is a multitude of different progressive law theories each using its own methodology. Some, progressive law scholars have responded to these criticisms

400 See Bainbridge supra note 16 at 21, where he states: “Although Progressive Corporate Law’s scholars are united in their rejection of the contractarian model and of Economic Man, they have achieved less unity in offering an alternative theory of the firm.”

401 See Chapter 3 – “Politics and Normative Assumptions”.

402 Kellye Testy (2002) supra note 396 at 1241. Kellye Testy has argued that there are 4 main discourses against the Nexus of Contracts theory of the corporation: (1) Team Production Theory (which is included in the Nexus of Contracts section of this chapter), (2) corporate social accountability (which is not really a full theory), (3) Stakeholder theory (which is described in this section), and (4) the corporate social responsibility movement (or progressive corporate law theories).
by advocating a movement towards one or a few progressive law corporate theories. This idea can be taken further, to argue that the theories need to be simplified to make them suitable for making policy decisions.

Another criticism of the progressive law critiques is that none of the theories offers an alternative model where accountability in the corporation is as clear as the shareholder primacy model. Fiona Patfield stated this criticism in the following way:

[M]aking management accountable to too many different interest groups will either give management too many interests to take into account in any rational way or suggest – with arguably more merit – that it will make management accountable to no one, because of the refusal of the courts to reconsider the business judgments of management.

**Insights Offered by Progressive Law Critiques**

The first major insight of the progressive corporate law critiques is that corporate theory is normative. This came about as a result of the critiques that showed that there was nothing about the Nexus of Contracts theory of the corporation that made it intellectually superior to any other theory.

The second major insight is that critiques can only go so far. If the intent of the progressive corporate law movement is to make significant changes to the corporate law system an updated version of the social theory of the corporation either needs to be developed or one of the current social theories of the corporation needs to become the widely accepted theory of the movement. The current progressive corporate law theories are summarized below.

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403 Both Kellye Testy and Rob Yalden have called for this to occur. See Testy (2002) *supra* note 396 and Yalden *supra* note 90.
405 Patfield *supra* note 68 at 10.
Progressive Law Theories

A number of progressive corporate theories have been offered that are not just simply critiques of the Nexus of Contracts theory. These theories include: Stakeholder theory, Power Coalition Theory, and Socioeconomics.⁴⁰⁶

Stakeholder Theory

Stakeholder theory traces its intellectual roots back to the work of Edwin Merrick Dodd in the 1930’s.⁴⁰⁷ Its modern form was developed in the 1960’s and it started to receive more widespread acceptance in the 1980’s.⁴⁰⁸ The theory was developed largely in business schools, as an exercise in business ethics, and its strongest supporters were business school professors R. Edward Freeman (Virginia), Max Clarkson (U. of Toronto), Thomas Donaldson (Georgetown) and Lee Preston (Maryland).⁴⁰⁹ The key book that sparked interest in stakeholder theory was R. Edward Freeman’s 1984 book Strategic Management: A Stakeholder Approach.⁴¹⁰

Stakeholder theory was a direct response to the inadequacy of the Nexus of Contracts theory to deal with ethical and moral issues like the impact of corporate activity

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⁴⁰⁶ Kellye Testy has argued that there are 4 main discourses against the Nexus of Contracts theory of the corporation: (1) Team Production Theory (which is included in the Nexus of Contracts section of this chapter), (2) corporate social accountability (which is not really a full theory), (3) Stakeholder theory (which is described in this section), and (4) the corporate social responsibility movement (or progressive corporate law theories).

⁴⁰⁷ For a description of Dodd’s work see Chapter 4 – “Early Stakeholder Theory” and Chapter 4 – “The Last Great Debate”.


⁴⁰⁹ In 1995, the Alfred P. Sloan Foundation sponsored the “Redefining the Corporation” Project under the supervision of Donaldson, Preston and Clarkson.

The fact that economic analysis separates ethics and morals from business has been recognized for a long time. Freeman refers to this process as the "separation thesis":

"The discourse of business and the discourse of ethics can be separated so that sentences like, "x is a business decision" have no moral content, and "x is a moral decision" have no business content."

He argued that the goal of stakeholder theory is to bring ethics and morals back into business:

Now the whole point of the stakeholder approach is to deny the Separation Thesis... There is always a context to business theory, and that context is moral in nature. It is only by recognizing the moral presuppositions of business theory, refining them, testing them by living differently, and revising them that we can invent and reinvent better ways to live.

The theory arose as a direct critique of the "nexus of contracts theory". Freeman describes it in the following way:

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411 See R. Edward Freeman and John McVea, "A Stakeholder Approach to Strategic Management" (2001) Darden Business School Working Paper No. 01-02. Available at SSRN: http://ssrn.com/abstract:263511 at 1 where it is stated: "The impetus behind stakeholder management was to try and build a framework that was responsive to the concerns of managers who were being buffeted by unprecedented levels of environmental turbulence and change."


414 Ibid. For a critique of this argument see Kenneth Goodpaster, "Business Ethics and Stakeholder Analysis" in Max Clarkson, ed., The Corporation and its Stakeholders: Classic and Contemporary Readings (Toronto: University of Toronto Press, 1988) 103-120, where the author argues that there is a 'stakeholder paradox' because stakeholder analysis is incompatible with widely-held views about the fiduciary duty owed to shareholders by management. Goodpaster wrote the following on page 113: "It can be argued that multi-fiduciary stakeholder analysis is simply incompatible with widely-held moral convictions about the special fiduciary obligations owed by management to stockholders. ... It seems essential, yet in some ways illegitimate, to orient corporate decisions by ethical values that go beyond strategic stakeholder considerations to multi-fiduciary ones. I call this a paradox because it says there is an ethical problem whichever approach management takes. Ethics seems both to forbid and to demand a strategic, profit-maximizing mind-set." Goodpaster concludes the paper by summarizing his argument: "This does not mean, however, that 'stakeholders' lack a morally significant relationship to management, as the strategic approach implies. It means only that the relationship in question is different from a fiduciary one. Management may never have promised customers, employees, suppliers etc. a 'return on investment', but management is nevertheless obliged to take seriously its extra-legal obligations not to injure, lie or cheat these stakeholders quite apart from whether it is in the stockholders' interests."
The temptation has been for a long time to depict the stakeholder concept as a kind of rallying cry against the stockholder theory [Nexus of Contracts theory]. Armed with stakeholder maps on our shields and banners, we have marched forth to browbeat the infidels, mostly economists and finance theorists, and others who want to be like them, such as marketing theorists and accountants, and show them that the stakeholder theory is “better” than the stockholder theory.\(^{415}\)

The stakeholder approach views the corporation as an entity that has relationships with many stakeholders.\(^{416}\) The classic definition of a stakeholder was provided by Freeman in 1984:

A stakeholder in an organization is (by definition) any group or individual who can affect or is affected by the achievement of the organization’s objectives.\(^{417}\)

Kenneth Goodpaster has pointed out that the definition was a deliberate attempt to oppose the definition of ‘stockholder’:

The term ‘stakeholder’ appears to have been invented in the early 60s as a deliberate play on the word ‘stockholder’ to signify that there are other parties having a ‘stake’ in the decision-making of the modern, publicly-held corporation in addition to those holding equity positions.\(^{418}\)

Examples of stakeholders include shareholders, employees, suppliers, customers, creditors, competitors, governments, communities and managers.

Stakeholder theory never directly addressed the question: What is the purpose of corporate law? However, stakeholder arguments have been made to expand the fiduciary

\(^{415}\) Ibid at 413.

\(^{416}\) For instance, Donaldson and Freeman have described the stakeholder view of the corporation in the following way: “it views the corporation as an organizational entity through which numerous and diverse participants accomplish multiple, and not always entirely congruent purposes.” [emphasis added] Donaldson and Preston supra note 142 at 179.

\(^{417}\) Freeman supra note 410 at 46. This was based on the Stanford Research Institute’s definition of stakeholder.

\(^{418}\) Kenneth Goodpaster, “Business Ethics and Stakeholder Analysis” in Max Clarkson, ed., The Corporation and its Stakeholders: Classic and Contemporary Readings (Toronto: University of Toronto Press, 1988) 103-120 at 104. This view is shared by Freeman see R. Edward Freeman, “A Stakeholder Theory of the Modern Corporation” in Max Clarkson, ed., The Corporation and its Stakeholders: Classic and Contemporary Readings (Toronto: University of Toronto Press, 1998) 125-137 at 129 where the author states: “The concept of stakeholders is a generalization of the notion of stockholders, who themselves have some special claim on the firm. Just as stockholders have a right to demand certain actions by management, so do other stakeholders have a right to make claims. The exact nature of these claims is a difficult question . . . but the logic is identical to that of stockholder theory.”
duties of managers to include all stakeholders. These arguments were successful to a limited extent during the 1980’s as many U.S. states adopted statutes that allowed managers to consider the interests of non-shareholders in takeover situations.\footnote{This is referred to as the “multi-fiduciary” duty model. Lawrence Mitchell has argued that the board of directors should be under a duty “to act reasonably to avoid injury to non-shareholder stakeholders in the process of corporate decision making.” See Lawrence Mitchell, “A Theoretical Framework for Enforcing Corporate Constituency Statutes,” (1992) 70 Tex. L. Rev. 579 at 276. See also Kathleen Hale, Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes 45 Ariz. L. Rev. 823 (Fall 2003).}

In 1995, Donaldson and Preston wrote an article that pointed out that stakeholder theory had three different uses: descriptive, instrumental and normative.\footnote{This article was described in more detail above in Chapter 3 – “Politics and Normative Assumptions”} The key insight was that stakeholder theory was fundamentally normative and that at the heart of each version of stakeholder theory was a set of normative assumptions about the way the world ‘ought’ to be.\footnote{See Donaldson and Preston \textit{supra} note 142 at 196 where it is stated: “This last point is absolutely critical for our argument, and recognition of it confirms our most important proposition: that the stakeholder theory is fundamentally normative.”} Their conclusion was that the Nexus of Contracts theory of the firm was not justifiable on a normative basis. They wrote:

But the management serving the shareowners model (i.e. the principal-agent model in its standard financial economics form) is not only descriptively inaccurate; careful analysis has shown that it is normatively unacceptable as well.\footnote{Donaldson and Preston \textit{supra} note 142 at 191.}

\textit{Normative Assumptions of Stakeholder Theory}

Stakeholder theory, with its emphasis on ethics and morals, clearly conceives of humans as social beings capable of altruistic or unselfish behaviour. It also acknowledges the existence of the corporation as a group that is a valid unit of analysis in society and it recognizes the public nature of the corporation. These assumptions locate Stakeholder theory in the upper left quadrant of the Assumptions Chart.
Strengths of Stakeholder Theory

The key strength of Stakeholder theory is its ability to reintroduce morality and ethics into business. It is also far more descriptive of what a corporation actually looks like in the real world than the abstract Nexus of Contracts theory.

Critiques of Stakeholder Theory

The first critique of Stakeholder theory is that, it is not a complete theory of the corporation. Mitchell, Agle and Wood identified this deficiency in Stakeholder theory:

Stakeholder theory has been a popular heuristic for describing the management environment for years, but it has not attained full theoretical status.\(^{423}\)

Stakeholder theory is merely a critique of the Nexus of Contracts theory of the firm. To use the terminology of Donaldson and Preston, Stakeholder theory is nothing more than a normative statement about the way corporations “ought” to be run.\(^{424}\) For example, Margaret Blair wrote the following critique of the incompleteness of the early corporate social responsibility versions of stakeholder theory:

The idea never had much theoretical rigor to it, failed to give clear guidance to help managers and directors set priorities and decide among competing socially beneficial uses of corporate resources, and provided no obvious enforcement mechanism to ensure that corporations live up to their social obligations.\(^{425}\)


\(^{424}\) It is acceptable to have normative assumptions within theories. In fact, normative assumptions are in almost all theories. All that needs to occur is for the theorist to clearly state the normative assumptions from which he or she is proceeding.

The second critique of stakeholder theory, and perhaps its biggest weakness, is that it is very difficult to identify who stakeholders are. Mitchell, Agle and Wood observed that:

Stakeholder theory . . . offers a maddening variety of signals on how questions of stakeholder identification might be answered. . . . Throughout the various ways of identifying stakeholders, as well as in the agency, behavioral, ecological, institutional, resource dependence, and transaction cost theories of the firm, we have found no single attribute within a given theory that can reliably guide us on these issues.426

This is compounded by the fact that two different definitions of stakeholder have been offered in the stakeholder literature. The narrow definition includes only those groups who are vital to the survival and success of the corporation. The wide definition includes any group or individual who is affected by the corporation.427 The wide definition would include groups like competitors.

The third critique of Stakeholder theory is that even once the stakeholders are identified, it is not clear how management is to take their interests into account. As managers are obligated to take more and more interests into account, it becomes increasingly difficult to keep accountability clear and to discipline self-serving managers.428 The stakeholder response to this criticism is that the dramatic rise in

426 Mitchell et al supra note 423 at 270-276. Mitchell, Agle and Wood have proposed a definition that relies on three components: power, legitimacy and urgency. At page 276 they offer: “We then propose that classes of stakeholders can be identified by their possession or attributed possession of one, two, or all three of the following attributes: the stakeholder’s power to influence the firm, the legitimacy of the stakeholder’s relationship with the firm, and the urgency of the stakeholder’s claim on the firm.”


428 For example see Erik Orts, “Beyond Shareholders: Interpreting Corporate Constituency Statutes” (1992) 61 George Wash. L. Rev. 14-135 where Orts argues that biggest issue with the new corporate constituency statutes is disciplining self-serving managers. This is of course the fear that Adolph Berle voiced in 1932 see Chapter 4 – “The Last Great Debate”.

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executive pay since the 1980's is evidence that the Nexus of Contracts theory has also not been able to discipline self-serving managers either.\textsuperscript{429}

The final critique of stakeholder theory is that it will only compound the agency problem. Each stakeholder group will need to be represented somehow either by agents or by expanding the fiduciary duties of managers to become multi-fiduciaries which makes accountability unclear.

\textit{Insights Offered by Stakeholder Theory}

The most important insight offered by stakeholder theory is that corporate theory can be interdisciplinary. With its focus on business ethics, stakeholder theory was able to incorporate stakeholder concepts from diverse theoretical fields including corporate planning, systems theory, corporate social responsibility and organizational theory.\textsuperscript{430} Of particular interest for the arguments made in this book are the contributions of systems theory and organizational analysis to stakeholder theory. Both of these theories emphasized the relationship between the corporation and its environment, including stakeholders.\textsuperscript{431} The influence of these theories led to some distinct characteristics of stakeholder theory. First, it acknowledges that the corporation is affected by its environment (including its stakeholders) and that it can also affect its environment. Second, it acknowledges that the central concerns of the corporation are survival, a focus

\textsuperscript{429} See Donaldson and Preston \textit{supra} note 142 at 197 where they argue that: "[T]he conventional model of the corporation, in both legal and managerial forms, has failed to discipline self-serving managerial behavior. In this era of multimillion dollar CEO compensation packages that continue to increase even when profits and wages decline it is difficult to conceive of managers having greater scope for self-serving behavior than they already have." For a statistical analysis of the rise in executive packages see Chapter 4 -- "The Effect of the Economic Conception of the Corporation".


\textsuperscript{431} For example, the insight offered by systems theory see Freeman and McVea \textit{ibid} at 5: "Systems theory emphasizes the external links that are part of every organization. Thus, organizations described as 'open systems' are part of a much larger network rather than as independent self-standing entities."
on long term success, an integration of economic, political and moral analysis, and a focus on the "names and faces" of stakeholders or understanding who they really are and not just their roles. These types of characteristics are a direct result of using systems theory and organizational theory to understand the corporation and they will be explored in more detail in Chapter 5.

Power Coalition Theory

Power Coalition theory was introduced by Lynn Dallas in 1988. Drawing on a number of sources from management science and sociology she proposed a theory of the corporation, that viewed the corporation as:

not a 'nexus' or marketplace, but an organic institution with its own internal structure and processes that impact on control of the firm.

The primary influence for this theory was resource dependency theory from organizational theory. Resource dependency postulates that the structure of organizations is determined by the resources that are available to them and that the primary goal of an organization is to survive in its environment. Power Coalition theory builds on this to argue that the primary goal of the corporation is to:

decrease the uncertainty of its environment by increasing its power over, and autonomy from, its environment.

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432 These characteristics are taken from a list presented by Freeman and McVea ibid. The list also includes: a focus on long-term success.
433 These characteristics results when one adopts a "natural" and "open" theoretical framework from organizational theory see Chapter 6 - "The Social Theory of the Corporation."
435 Ibid at 25. For a description of resource dependency see Chapter 5 - "Resource Dependence".
436 Resource dependency is one of the natural and open theoretical frameworks from organizational theory see Chapter 6 - "The Social Theory of the Corporation".
Power, in power coalition theory, is the inverse of dependency.\textsuperscript{439}

Dallas describes the theory's conception of the corporation as follows:

The power model depicts the firm as an institution with its own internal structure that seeks to decrease its uncertainty by increasing its own autonomy and discretion over its environment. Unlike a wheat market, it utilizes various strategies to decrease its dependence on its environment, thus muting the effects of market constraints. According to the power model, not only are organizations [perceived as] constrained by the political, legal and economic environment, but, in fact, law, legitimacy, political outcomes, and economic climate [are understood to] reflect, in part, actions taken by organizations to modify these environmental components for their interests of survival and growth. Thus the firm is not merely reactive with respect to its environment but proactive.\textsuperscript{440}

Under this model, firm behaviour results from the power struggle among the different constituency groups within the firm. The objective of any actor within the firm is to become part of the dominant power coalition.\textsuperscript{441} In order to understand what a corporation is, one must understand who the dominant coalition is because the dominant coalition determines the corporation's goals. Power-Coalition theory maintains that:

existing governance structures are not necessarily efficient but are explained by the interrelationships among historical, cultural, political and economic factors.\textsuperscript{442}

In Power Coalition theory, corporate governance structures persist for four reasons:

(1) because they are demanded by those in positions of power, (2) because they have become the traditional or accepted ways of doing things, (3) because changing structures would require the adoption of values not reinforced by existing structures that tend to generate their own value system; or (4) because they are buffered from the effects of competition.\textsuperscript{443}

\textsuperscript{439} This is a concept taken straight from resource dependency theory in organizational analysis. For a description of resource dependency theory in see Chapter 5 - “Resource Dependency”.

\textsuperscript{440} Dallas (1988) supra note 87 at 31.

\textsuperscript{441} A similar idea was presented by James March in 1962 when he proposed that the business firm was a political coalition and that actors interest within a firm is to try and put together a political coalition to attain their goals. See James March “The Business as a Political Coalition” (1962) 24 Journal of Politics 662.

\textsuperscript{442} Dallas supra note 55 at 520.

The purpose of corporate law under Power Coalition theory is to strengthen the bargaining power of some stakeholders to protect their interests in the corporation. Dallas argues that:

political and legal action may be appropriate in 'situations' characterized by significant power disparities, unequal bargaining power, or pending power changes.\(^{444}\)

Normative Assumptions of Power Coalition Theory

The theory contains conflicting ideas on human nature. On the one hand, it recognizes that humans interact in groups and so are capable of social behaviour. On the other hand, the theory conceives of social behaviour as a political struggle centered around power that is indicative of a self-interested view of human nature. Dallas acknowledges this criticism of the theory.\(^{445}\) However, she argued strongly that the theory conceives of human as social beings capable of altruistic behaviour:

The relational, social character of economic behavior is central to the power coalition theory. Group behavior is expressed in terms of the formation of effective coalitions and governance of the corporation through shifting coalitions. Groups are embedded in a political and social context and may pursue both altruistic and self-interested goals.\(^{446}\)

With regard to the structure of society, the theory conceives of the corporation as a separate 'institution' or group trying to survive in its environment. It definitely adopts an assumption that groups are a valid unit of analysis in society. This assumption is best illustrated in the theory's concept of coalitions:

Every person is a part of a coalition at one point or another: as consumers, employees, and, often, shareholders. When a person is a member of one of these

\(^{444}\) Dallas supra note 55 at 522.
\(^{446}\) Ibid at 56.
groups. That group identity is more material to an understanding of his behaviour and choices than his distinct identity. Sometimes a person internalizes the roles, norms or cultural beliefs attached to his membership. At other times, he is bound by rules that he cannot change. An understanding of coalitions in economic life recognizes that a person often operates as a member of coordinated groups rather than as an individual or autonomous actor. Moreover, in group, as in individual, activity a person’s behaviour need not be dictated by his material self-interest, but may be influenced by his sense of morality or by a desire to be accepted by the group.\textsuperscript{447}

It also conceives of the corporation as a public entity because it conceives of the role of corporate law as leveling the playing fields for participants within the corporation. This locates Power Coalition theory in the upper left quadrant of the Assumptions Chart.

\textit{Strengths of Power Coalition Theory}

Power coalition theory had many strengths. First, it was the first corporate theory that tried to incorporate the progress that was being made in organizational theory into corporate theory. By the 1980’s organizational theory had progressed away from the theories that the Nexus of Contracts theory was founded on.\textsuperscript{448} These new theories were referred to as “natural open systems” theories. Power Coalition theory was an attempt to generate a new corporate theory based on the insights of the natural open systems theories.

The second, strength of the theory is that by adopting an organizational analysis approach it automatically adopted organizational theory’s preference for multidisciplinary analysis. Organizational theory has long known that organizations are

\textsuperscript{447} \textit{Ibid} at 51.
\textsuperscript{448} For a description of this process and the new theories see Chapter 5.

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complex social phenomena that can be analyzed from a number of different perspectives. This is in stark contrast to the 'nexus of contracts' theory which is based solely on economic analysis. Dallas acknowledged this particular strength of power coalition theory:

The power coalition theory serves to open up a number of avenues of inquiry virtually foreclosed by market models. It demonstrates the importance of factors other than markets to explain corporate behavior and corporate governance structures. By drawing on psychology, sociology, and organizational behavior literature, as well as economics, it also provides a more realistic starting point for understanding these subjects.\(^{449}\)

The groundwork for a new paradigm of corporate governance is being dug by writers drawing on sociology, psychology, history and ethics, as well as economics, to understand corporate behavior and governance structures. The power coalition model discussed in this essay is an effort to draw on this literature to deepen our understanding of these subjects. What new paradigm of corporate governance will emerge is difficult to predict.\(^{450}\)

The final strength of the theory is the realization that corporation's are not just affected by their environment but that they can affect their environment. In the modern world of large multinational corporations this is much more descriptive of reality than the Nexus of Contracts theory which sees the corporation simply as a nexus of contractual relationships.

For all of these reasons, power coalition theory is probably the most important corporate theory to be developed since the 1970's. Unfortunately, the theory was not widely accepted. Probably because of the weaknesses in the theory outlined below. Lynn Dallas has since abandoned the theory and has now turned her attention to using socioeconomics to analyze the corporation. Socioeconomics is described in the next section.

\(^{450}\) Ibid at 59.
Weaknesses of Power Coalition Theory

The greatest weakness of power coalition theory is the over-reliance of political power and authority to describe the internal power structure of the corporation. This is a direct result of the link between Power Coalition theory and resource dependency theory in organizational theory. In organizational theory, resource dependency theory is referred to as ‘conflict theory’ because of its emphasis on power and coercion. Conflict theories find their roots in the work of Karl Marx and they have generally not been accepted in North America. There is a preference in North America for theories based on consensus, as opposed to conflict. While the conflict portions of the theory are descriptive of the internal relationships within the corporation, the inclusion of these ideas is not consistent with the normative views of Anglo-American societies concerning corporations and it probably affected the acceptance of its other insights.

A related weakness of the theory is that Dallas limited the acceptance of the theory through her choice of language. The importance of language was discussed in the introduction to this book. Language can generate emotional responses and affect the acceptance of ideas. The language in power coalition theory generates the wrong type of emotions for Anglo-American societies. The language is focused on power, coercion and conflict. For example, Dallas refers to the internal groupings in the corporation as “coalitions” instead of “groups”. She refers to the process of getting support from a

451 Although they have are more readily accepted in Europe.
452 For a complete discussion of the link between organizational theory and corporate theory and the conflict vs. consensus paradigms see Chapter 5 – “Natural Systems Perspective”.
453 These insights were extremely important and they are discussed more in Chapter 5. In short, power coalition theory was the first natural open systems corporate theory and it was a major advance over the Nexus of Contracts theory that was a rational open systems corporate theory.
stakeholder group by including them in the governance of the organization as “cooptation” as opposed to “participatory governance”. The language that she used was true to the language that was used to describe those concepts in the organizational literature, but it did not help the theory’s acceptance.

**Insights Offered by Power Coalition Theory**

Power Coalition theory was a great attempt to use the latest insights from sociology and organizational analysis to build a social theory of the corporation. However, there were a few issues with power coalition theory: First, it used only a single theory from the organizational theory literature, resource dependency, to base its theory on. There are a multitude of theories in organizational theory – all with different insights to offer to corporate theory.

Second, power coalition theory’s focus on power and authority makes it hard to accept as an overall theory. There are, however, many other schools of thought in organizational theory that are not so focused on power and authority that can also offer insights into a new theory of the corporation including institutional theory. In fact, Dallas herself admitted that institutional factors play a part in understanding the corporation. A theory of the corporation developed on insights from sociology should

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454 For an example of the theory’s focus on power and authority consider the following quote: “Second, the efficiency model’s treatment of the board as a device permitting shareholders to monitor managers and thereby enhance the efficiency of the firm is replaced with an understanding of the board as a tool of management, which serves to legitimate the substantial amount of power in the hands of management.” Dallas (1988) *supra* note 87 at 80.

455 Using these other natural open systems theories it is possible to construct a theory of the corporation that is “better” than the nexus of contracts theory and that is based on consensus instead of conflict. *See* Chapter 6.

456 *See* Dallas (1988) *supra* note 87 at 80 where she states: “Resource dependence and institutional factors are important to understanding power and the relationship between the firm and various constituencies.”
attempt as much as possible to integrate insights from as many areas of sociology and organizational theory as possible.

Finally, the choice of language used in a theory can affect its overall acceptability. In developing a new corporate theory for Anglo-American societies care should be taken not to rely too heavily on conflict theories or language from conflict theories. Words like: power, coercion, cooptation, control etc. are generally associated with a paradigm that is not consistent with dominant norms in Anglo-American societies.

Socioeconomics and the Socioeconomic Conception of the Corporation

Socioeconomics is a discipline that uses insights from other disciplines to inform the traditional neoclassical economic model to better reflect the way that markets and markets participants actually act.\textsuperscript{457} Lynne Dallas offers the following definition of law and socioeconomics:

Law and socioeconomics (LSOC) studies the interrelationship between law and economic/social processes. It is interdisciplinary, drawing on a number of disciplines, such as psychology, sociology, anthropology, political science and economics. It encompasses diverse perspectives, which include a number of schools of economic thought, such as behavioral, neo-institutional, feminist, binary, traditional institutional and post-Keynesian economics. These heterodox economic approaches are united in that they reject one or more significant aspects of neoclassical economics. LSOC constitutes a 'new realism' in that disagreements with neoclassical economics stem from efforts to better understand the functioning of real economies.\textsuperscript{458}

\textsuperscript{457} This theory could just as easily have been classified as a progressive contractarian theory and included in the “Progressive Contractarian” section of this Chapter.

\textsuperscript{458} Dallas (2005) supra note 55 at 3.
Notwithstanding its multidisciplinary character, it still recognizes the primacy of economic analysis. This commitment to economic analysis is evidenced in the following quote from Robert Ashford, another leading socioeconomic scholar:

Drawing upon economics, sociology, political science, psychology, anthropology, [biology and other social and natural sciences,] philosophy, history, law and management, [and other disciplines,] socio-economics regards competitive behaviour as a subset of human behaviour within a societal context that both enables and constrains competition and cooperation. Rather than assume that people act optimally, rationally, or that they pursue only self-interest, socioeconomics seeks to advance a more encompassing interdisciplinary understanding of economic behaviour open to the assumption that individual choices are shaped not only by notions of rationality but also by . . . social bonds, beliefs and expectations. . . . Unique among interdisciplinary approaches, however, socioeconomics recognizes the pervasive and powerful influence of the neoclassical paradigm on twentieth-century thought . . .

Socioeconomics is different then from neoclassical economics because it views:

[E]conomic behavior as a subset of human behavior that includes both competition and cooperation shaped not only by self-interested rationality, but also by institutions, social bonds, expectations, beliefs and other aspects of human nature and society. By recognizing this, socioeconomics is capable of emphasizing that the market is not a harmonious place where equilibrium is reached by the forces of supply and demand but that it is a social construction complete with conflict and power struggles between social actors and groups.

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460 Ibid at 1188.
461 For a complete discussion of 'Embeddedness' see Chapter 6 – "A Note on Embeddedness".
462 See Dallas (2005) supra note 55 at 5. This idea is reminiscent of Dallas' earlier corporate theory – Power Coalition theory.

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Socio-economics is especially important to an understanding of the law because it:

1. Recognizes the importance of institutions (e.g. law) in shaping economic behavior,
2. Draws upon many disciplines to understand economic behavior, and
3. Approaches economics with the scientific method and in a way that is conscious of assumptions and values.\textsuperscript{463}

\textit{The Socioeconomic Theory of the Corporation}

Unfortunately, because socioeconomics is an emerging field, there has not been a lot of work done on socioeconomics and corporate theory.\textsuperscript{464} The two main exceptions to this are Robert Ashford’s work relating to binary economics and capital ownership and Lynn Dallas’ work on the structure of boards of directors.

Robert Ashford has adopted a socioeconomic approach and used binary economics to argue for wider ownership of share capital in society.\textsuperscript{465} Binary economics is based on the assumption that \textit{capital} and not just \textit{labor} is productive. Ashford argues that socioeconomics should be taken into account by corporate fiduciaries when considering issues related to capital acquisition, wealth maximization and corporate social responsibility. His argument is that there is a vast, persistent, and growing underutilized productive capacity despite widely accepted claims that markets are

\textsuperscript{463}This list is summarized from Ashford (2002) \textit{supra} note 459 at 1196-1197.
\textsuperscript{464}For a collection of essays on socioeconomics and the corporation see (2002) 76 Tulane L. Rev.
becoming more competitive. The binary economics approach sees the process of capital acquisition as the main cause of underutilized productive capacity. He argues for a broadening of the process of capital acquisition to allow poor and working class people to participate. This would allow them to accumulate more wealth which would feed growth throughout the whole market system. Ashford has offered a binary economic model of the U.S. economy but not a model of the corporation.\textsuperscript{466}

Lynn Dallas' works starts from the premise that while corporate law favours shareholders, legal rules, informal social, political and economic factors have contributed to a corporate governance system dominated by managers called "managerialism."\textsuperscript{467} Her work explores how the hostile takeover bids of the 1980's interrupted managerialism by focusing corporate governance on stock values. She argues that, in this setting, a new 'managerialism' arose that consisted of a focus on short term decision making and window dressing for increased stock values. Her argument is that diversity on corporate boards of directors has the potential to counter this new 'managerialism'. Her work has a socio-economic focus and uses socio-psychological literature to show the advantages and disadvantages of heterogeneous/homogenous groups and show that diverse perspectives on corporate boards is likely to improve the quality of decision making.\textsuperscript{468}

From these two examples of the application of socio-economics to corporate theory, we can see that it is too early to determine exactly what the socioeconomic theory of the corporation is. To date, socioeconomics has not provided clear answers to the two questions of corporate theory: What is a corporation and what is the purpose of corporate

\textsuperscript{466} See Ashford (2006) \textit{supra} note 465.
\textsuperscript{467} Dallas' conception of Managerialism is similar to the conception of managerialism adopted in this Chapter see Lynne Dallas, "The New Managerialism and Diversity on Corporate Boards of Directors" (2002) 76 Tulane L. Rev. 1363.
\textsuperscript{468} See Dallas (2002) \textit{Ibid.} For Dallas' other work on Socioeconomics see Dallas \textit{supra} note 55.
law? Is the socioeconomic conception of the corporation simply a modification of the ‘nexus of contracts’ theory? Or is it a new theory altogether? It is hard to tell. However, with the examples outlined above we can begin to see how socioeconomics can use insights from other disciplines to inform the contractual analysis of the corporation.

Normative Assumptions of Socioeconomics

Socioeconomics is based on the normative assumptions that: human beings are social animals, the individual and the group are valid units of analysis in society, and the corporation as a public institution. This would normally place socioeconomics in the upper-left quadrant of the Assumptions Chart. However, because of its commitment to neoclassical economics it has been kept just inside the lower right quadrant of the Assumptions Chart.

Strength of Socioeconomics

The real potential of the socioeconomic theory of the corporation is its ability to blend the social theory of the corporation with the economic theory of the corporation. Lynn Dallas has helped tremendously in this task by highlighting the differences in the assumptions behind traditional economic analysis and socioeconomic analysis. A

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469 Dallas talks about the “bounded rationality” of human behaviour, the existence of altruism, morality, belief systems and ideology see Chart 3 and Dallas (2005) supra note 55.
470 Ibid.
471 Ibid. Dallas refers to this as an “emphasis on regulation as the foundation of a market economy”.
472 This justifies its inclusion in the Progressive law section of this Chapter and not the Progressive Contractarian section of this chapter.
473 This view is shared by Lynne Dallas and Diana Strassman. See Dallas (2005) supra note 55 at 26 where she quotes Strassman.
portion of her chart outlining the assumptions is reproduced as Table 3-3. In short, she has identified the major assumptions on which 'neoclassical economics and socioeconomic' differ. This chart is equally applicable to the differences in assumptions between the 'nexus of contracts' theory and the socioeconomic conception of the corporation. Examples include: human behaviour as 'bounded rationality' instead of rationally self-interested; the individual, the group and society as legitimate units of analysis in society as opposed to simply individuals; the market as a social construction as opposed to being 'natural' and 'private'; and an emphasis on regulation as the foundation of a market economy as opposed to an emphasis on self-regulation by markets.

**Criticism of Socioeconomics**

The strongest criticism of socioeconomics is that its commitment to the primacy of neoclassical economics is completely inconsistent with its professed interdisciplinary approach.

**Insights Offered by Socioeconomics**

The interesting thing about the 'changed assumptions' of socioeconomics is that they do not simply 'inform' economic theory, as socioeconomic scholars contend, but, in fact, they actually create a new corporate theory. Since corporate theories are normative, changing the assumptions of a theory invalidates the theory. When you change the assumptions of a corporate theory you are, in effect, creating a new theory. Why not
then, just take the new assumptions of socioeconomics, which are consistent with the assumptions of other social theories of the corporation, and develop a new social theory of the corporation based on those assumptions, and ignore, at least initially, neoclassical economics and the nexus of contracts theory of the firm altogether? This may sound like a novel idea, but, as has been shown in this chapter, social theories of the corporation and markets based on those assumptions have been around for a while. By using the latest insights from sociology and organizational theory an updated version of the social theory of the corporation could be developed and it would have the potential of being an alternate theory of the corporation that could be used by progressive law scholars to oppose the Nexus of Contracts theory. Only when the progressive corporate law movement has its own fully developed and accepted theory of the corporation will real progress actually be made in blending the progressive corporate law with the Nexus of Contracts model. If socioeconomics maintains its commitment to neoclassical economics then it will never be that new theory and it will just inform Nexus of Contracts theory with isolated critiques from other disciplines.

3.5 Corporate Theories Are Normative

The analysis provided in this chapter has shown that corporate theories are normative. At the core of every corporate theory are a set of assumptions about the way the world “ought” to be. The normative core of each of the corporate theories discussed in this chapter is plotted on the Assumptions Chart. The Assumptions Chart is useful to allow a comparison of the normative positions of the different corporate theories.

475 This approach would be consistent with the idea that economic actions are embedded in social actions and so there is no reason that requires economic analysis of economic behaviour.
The Assumptions Chart also provides a number of other important insights. Firstly, the normative assumptions are almost always found together in two groupings. All of the corporate theories in the upper left quadrant of the Assumptions Chart share the following three normative assumptions: humans are social beings, the group is a valid unit of analysis in society and the corporation is a public institution capable of being regulated. All of the corporate theories in the bottom left quadrant share the following assumptions: humans are self-interested, the individual is the only unit of analysis in society and the corporation is a private entity. There are almost no corporate theories in any of the other quadrants. From these facts it can be argued that the conclusions of any given corporate theory can be determined by simply looking at its most basic assumption: how does the theory conceive of human nature? If it conceives of human nature as self-interested, then the theory will be individualistic and private. If it conceives of human beings as social beings then the theory will be group oriented and public.

Secondly, the Assumptions Chart shows that the Nexus of Contracts theory of the corporation is a normatively extreme theory when compared to all other corporate theories.

Finally, the Assumptions Chart shows that there has been a normative shift in corporate theory during the course of the 20th century away from the upper-left quadrant (call them “social theories” - based on their assumptions) and toward the lower right quadrant (call them “economic theories” – based on their assumptions). Before the 1930’s, there was a healthy balance of both social and economic corporate theories, but, that is no longer the case. Figure 3-4 is a modified version of the Assumptions Chart where all of the theories that are no longer seriously considered have been removed. It
shows that all of the complete corporate theories that are left are located in the bottom right quadrant. There are no complete social theories of the corporation left. That represents a major loss in the normative balance of corporate theories. How did this happen? Are the economic theories of the firm widely supported because they are intellectually superior or because they are consistent with Anglo-American societies’ norms concerning corporations? Were they really an advance in our understanding of corporations or were they just the theories that said all of the right things at the right time? The next chapter provides answers to these questions and explains how economic theories of the corporation rose to dominate Anglo-American corporate law.

3.6 Conclusion

This chapter has shown that the idea that the corporation is a social institution is not new. Before the 1930’s, there were many corporate theories that conceived of the corporation as a social institution. Entity theory and Early Sociological theory were highlighted as the two best examples. This chapter also showed that corporate theories are normative theories. The normative positions of each of the theories were plotted on the Assumptions Chart. From this chart it was illustrated that the Nexus of Contracts theory of the corporation is extreme in its normative assumptions when compared to all other corporate theories. There is no corporate theory more extreme in its preference for the individual over the group and private action over regulated action. Anglo-American countries are now dealing with the consequences of having such an extreme normative core to the theory of one of their most important social institutions. Mergers and acquisitions are rampant, large scale lay-offs are an everyday event, managers are
fanatically obsessed with short term results and profit is more important than people. One of the key insights from this chapter is that there is nothing inevitable about this state of affairs. The Nexus of Contracts theory is not a positive theory. It is simply a normative theory based on political choices. Corporate theory can be changed by simply developing a new theory based on a different set of desired normative assumptions. This was done in the past as is evidenced by the large number of social theories of the corporation found in the upper-left quadrant of the Assumptions Chart.

The second insight from the Assumptions Chart, is that there is no longer any widely accepted theory to oppose the Nexus of Contracts theory that values the group over the individual and the public nature of the corporation over the private conception of the corporation. While a lot of work has been done by the progressive corporate law movement, most of it is simply a critique of the current Nexus of Contracts theory. Few alternate corporate theories have been offered and the few that have been offered are all still economic theories that are similar in their normative assumptions to the Nexus of Contracts theory. For progressive scholars who are looking to make normative changes to corporate theory, these theories are not acceptable. This may explain why they have not yet received wide support from progressive corporate law scholars.

Attention needs to be given to restoring some balance to corporate theory by re-establishing the persuasive power of social theories of the corporation. Anglo-American societies are in need of moderating theories that are based on the assumptions that: 1) humans are social beings, 2) the group is a valid unit of analysis in society, and 3) the corporation is public in nature. By doing this, it is possible to construct an updated
version of the social theory of the corporation that can act as a meta-theory to support the wide and disparate claims of progressive law scholars.

Exploring that possibility is the purpose of the remainder of this book.
FIGURE 3-1
THE THREE ASPECTS OF CORPORATE THEORY

Note: This page has been removed for copyright restrictions. It was a graphic representation of the three aspects of corporate theory and it was an adaptation of a figure from “Three Aspects of Stakeholder Theory” Figure from Thomas Donaldson and Lee Preston, “The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications” in Max Clarkson, ed., The Corporation and its Stakeholders: Classic and Contemporary Readings (Toronto: University of Toronto Press, 1988) 173-203 at 183.
TABLE 3-1

EUROPEAN AND RUSSIAN CORPORATIONS ON THE EVE OF WORLD WAR I

Note: This page was removed for copyright restrictions. It was a chart from Thomas C. Owen, *Russian Corporate Capitalism from Peter the Great to Perestroika* (New York: Oxford University Press, 1995) at 180. It outlined the number of companies in certain European countries before WWI.
FIGURE 3-2: DEVELOPMENT OF SELECTED CORPORATE THEORIES

- **Fiction Theory** (Middle Ages)
  - Pope Innocent

- **Concession Theory** (1500-1900)
  - F.C. Von Savigny
  - Prof. Salmond

- **Real Entity Theory** (1887)
  - Otto Gierke

  - **Left Gierkianism** (1920-1940)
    - Harold J. Laski
    - George Deiser

  - **English Pluralists** (1900-1920)
    - F.W. Maitland
    - Sir Frederick Pollock

- **Representative Theory** (1897)
  - Ernst Freund

  - **Contractual Theory** (1880)
    - Victor Morawetz
    - Henry Taylor
    - Charles Fisk Beach

  - **Managerialism** (1930-1970)
    - Adolph Berle
    - Gardiner Means

  - **Managerial Critique**
    - J.K. Galbraith
    - R. Nader

  - **"Nexus of Contracts"** (1970-Present)
    - Jensen & Meckling
    - Fischel & Easterbrook

  - **Progressive Law Critiques** (1980 – Present)

- **Modern Stakeholder Theory** (1990-Present)
  - Donaldson, Freeman, Clarkson

- **Power Coalition Theory** (1988)
  - Lynne Dallas

- **Socio-Economic Theory** (2005)
  - Ashford & Dallas

- **Team Production Theory** (1999)
  - Blair & Stout
FIGURE 3-2

GRAPHIC REPRESENTATION OF ASSUMPTIONS OF CORPORATE THEORIES (PUBLIC/PRIVATE AND INDIVIDUAL/GROUP)

- Complete theory of the corporation.
- Critique or partial theory of the corporation that is not yet fully developed.
FIGURE 3-3

GRAPHIC REPRESENTATION OF ASSUMPTIONS OF MODERN CORPORATE THEORIES (PUBLIC/PRIVATE AND INDIVIDUAL/GROUP)

- Stakeholder Theory
- Social Theory
- Socioeconomic Theory
- Team Production Theory
- "Nexus of Contracts"

- Complete theory of the corporation.
- Critique or partial theory of the corporation that is not yet fully developed.
### TABLE 3-2: SUMMARY OF CORPORATE THEORIES

<table>
<thead>
<tr>
<th>Corporate Theory</th>
<th>What is a Corporation?</th>
<th>What is the Purpose of Corporate Law?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concession/Fiction Theory</td>
<td>An artificial entity whose separate legal personality is granted as a privilege by the state</td>
<td>To recognize and create valid groups in society that hold rights.</td>
</tr>
<tr>
<td>Entity Theory</td>
<td>An organic body with an independent mind and will that is separate from its human participants</td>
<td>Simply granting legal rights to corporations that have already formed</td>
</tr>
<tr>
<td>Representation Theory</td>
<td>A representative democracy governed by majority rule, where the ‘will’ of the corporate entity was, for policy reasons, the vote of the majority of the shareholders</td>
<td>Simply granting legal rights to corporations that have already formed</td>
</tr>
<tr>
<td>Contractual Theory</td>
<td>A private association formed by the free will of its shareholders</td>
<td>To allow the corporation to form by free will of the shareholders</td>
</tr>
<tr>
<td>Managerialism</td>
<td>A social institution that is both a method of property tenure and a means to organizing social life.</td>
<td>Solving the agency problem that was presented by the separation of ownership from control</td>
</tr>
<tr>
<td>Nexus of Contracts Theory</td>
<td>A legal “nexus” that represents all of the contracts between inputs that together produce goods and services</td>
<td>Act as a standard form contract among the inputs that offers efficiency gains and establishes their rights</td>
</tr>
<tr>
<td>Team Production Theory</td>
<td>A team of members who pool their resources to produce goods or services</td>
<td>Act as a standard form contract among team members.</td>
</tr>
<tr>
<td>Socioeconomics</td>
<td>Not clear yet</td>
<td>Not clear yet</td>
</tr>
<tr>
<td>Power Coalition Theory</td>
<td>An organic institution with its own internal structure and processes that impact on control of the firm</td>
<td>Strengthen the bargaining power of some stakeholders to protect their interests in the corporation</td>
</tr>
<tr>
<td>Stakeholder Theory</td>
<td>An entity that has relationships with many stakeholders</td>
<td>To protect the interests of the various stakeholders</td>
</tr>
</tbody>
</table>
TABLE 3-3

SELECTION OF CHART FROM DALLAS (2005)

Note: This page was removed for copyright restrictions. It was an adaptation from a chart in Lynn Dallas, Law and Public Policy: A Socioeconomic Approach (Durham: Carolina Academic Press, 2005) at 25-28. It outlined the normative assumptions in neoclassical economics and socioeconomics.
CHAPTER 4: THE RISE OF ECONOMICS IN CORPORATE LAW

4.1 Introduction

The Nexus of Contracts theory is the dominant conception of the corporation in Anglo-American corporate law. It has been dominant since the early 1990’s. It was developed by economists in the late 1970’s and imported into corporate law through the U.S. law and economics movements during the 1980’s and 1990’s. For the purposes of this chapter, it will be referred to as the ‘economic conception of the corporation’ because it is based on economic analysis.

The purpose of this chapter is to answer the question that was posed at the end of the last chapter: How did the economic conception of the corporation rise to dominate Anglo-American corporate law? Are economic theories of the firm widely supported because they are intellectually superior or because they are consistent with Anglo-American societies’ norms concerning corporations? This chapter shows that the economic conception of the corporation rose to dominance because its normative position was consistent with the prevailing normative environment in American society during the Cold War. It also shows that the economic conception of the corporation is not an intellectually superior or positive theory. This chapter also shows that the criticisms

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476 For a complete description of the Nexus of Contracts theory see Chapter 3 – “Nexus of Contracts Theory”.
478 Some of the quotes in this chapter still refer to it as the Nexus of Contracts theory or “contractarianism”.

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leveled against the economic theory of the corporation are the same criticisms that are leveled against economic theories in general. Those criticisms are the result of the simplifying assumptions of economic theory and they cannot be overcome. The result is that if any progress is to be made in moving corporate theory forward it will probably have to come from a discipline or disciplines other than economics.

This chapter is organized into three parts. The first part details the three distinct phases in the rise to dominance of the economic conception of the corporation: 1) The 1930's – Setting the Stage, 2) The 1940's to the 1970's – The Rise of Economics and the Law and Economics Movement, and 3) The 1980's – The Rise of the Economic Conception of the Corporation in corporate law. The second part summarizes the criticisms that have been leveled against economic theory, the law and economics movement and the economic conception of the corporation. Finally, a conclusion is offered that argues that the dominance of the economic conception of the corporation in corporate law may be nearing an end.

4.2 The Rise To Dominance Of The Economic Conception Of The Corporation

The rise to dominance of the economic conception of the corporation will be explained using historical analysis and insights from the institutional analysis of the development of the modern American corporation. This contextual approach is a conscious effort to leave the narrow field of corporate law and to try and understand how the dominant corporate theory developed in the political and social context of American society. The analysis in this chapter, shows that the rise to dominance of the economic
conception of the corporation was part of a wider normative shift in the United States in favour of economic theories during the Cold War, and immediately thereafter.

The rise to dominance of the economic conception of the corporation occurred in three distinct phases. The first phase occurred during the 1930’s. This phase is best characterized as the time period where the stage was set for the rise of the economic conception of the corporation. The second phase began in the 1940’s and continued until the 1970’s. In this phase, economic theory gained general acceptance in American society for a variety of reasons, including the political environment during the Cold War. The third phase started in 1980 and continues to this day. In this phase, the economic conception of the corporation rose to its dominant position in corporate law.

4.2.1 The 1930’s – Setting the Stage

During the 1930’s, two events occurred that set the stage for the ascendance of the economic conception of the corporation. First, Ronald Coase provided the intellectual foundation of the economic conception of the corporation when he published his article *The Nature of the Firm*. Second, corporate theory lost its relevance as a result of the combined effect of the criticisms leveled against it, the development of Managerialism and the outcome of the famous debate between Adolph Berle and Edwin Merrick Dodd. These three events effectively created a vacuum in corporate theory that would not again be filled until the economic conception of the corporation received wide acceptance during the 1980’s.\(^{479}\)

\(^{479}\) It is interesting to note that Economic Sociology or the sociology of how social relations affect the economy also declined in the period between 1920 and 1980 — roughly the same period that corporate theory declined. Richard Swedberg has made this argument about Economic Sociology: “While economic sociology got off to a great start with the classics, it declined after 1920 and would not return to full vigor
The intellectual roots of the economic conception of the corporation are found in Ronald Coase's 1937 article *The Nature of the Firm.*\(^{480}\) In that article, Coase proposed a theory of the firm that conceptualized the firm as a vehicle that internalized market transactions in an effort to create stability and, more importantly, to reduce transaction costs. Coase considered market transactions to be external contractual relationships with third parties that could be coordinated by the firm. Third parties included suppliers, customers and employees. Coase explained that co-ordination of these relationships within the firm replaced the price mechanism of the market:

> Outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur co-ordinator, who directs production.\(^{481}\)

Coase asked, what was, at the time, a novel question: Why do firms exist? His answer was because firms reduce transaction costs. The most significant transaction costs are the cost of contracting with third parties. The firm reduced contracting costs by replacing numerous one time contracts with a single long term contract. Coase described this process in the following way:

> [T]he operation of a market costs something and by forming an organization and allowing some authority (an 'entrepreneur') to direct the resources, certain marketing, costs are saved. The entrepreneur has to carry out his function at less

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\(^{480}\) Ronald Coase, "Nature of the Firm" (1937) 4 Economica 386.

\(^{481}\) Ibid at 388.
cost, taking into account the fact that he may get factors of production at a lower price than the market transactions which he supercedes, because it is always possible to revert to the open market if he fails to do this.  

The main accomplishment of the article was that Coase legitimized the firm as a subject of analysis in economics. The article received little attention when it was first published. At the time, transactions costs were felt to be outside the traditional scope of economic analysis. The article remained largely unnoticed until Oliver Williamson resurrected the study of transaction costs as part of the institutionalist movement in economics in the 1970's. However, once it was rediscovered, it formed the basis of the modern theory of the firm in economics and the economic conception of the corporation in corporate law.

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**Corporate Theory Loses its Relevance**

Corporate theory lost its relevance during the 1930’s, as a result of the combined effect of three events: the criticisms leveled against corporate theory, the development of Managerialism and the outcome of the famous debate between Adolph Berle and Edwin Merrick Dodd in the Harvard Law Review.

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482 *Ibid* at 392. Throughout the article Coase refers to the firm as an “entrepreneur” and transaction costs as “marketing costs”.


484 *Ibid* at 216.


486 For a discussion of the importance of *The Nature of the Firm on* corporate theory see Johnston supra note 483.
Criticisms of Corporate Theory

During the 1930’s, corporate theory came under criticism from a number of sources. These criticisms included the ‘indeterminacy’ criticism of John Dewey and the definitional criticism of H.L.A. Hart. These critiques were summarized in Chapter 3. Each of these criticisms called into question the relevance of corporate theory and were influential in causing a movement away from interest in corporate theory.

Managerialism - The Establishment of Shareholder Primacy in American Corporate Law

At the same time that the relevance of corporate theory was being questioned by the legal realists and H.L.A. Hart, Managerialism was being developed by Berle and Means. Managerialism, offered an entirely new focus for corporate law: A policy focus instead of a theoretical focus. Rather than trying to answer the difficult question of what a corporation was, Managerialism focused on the practical issue of ensuring the managers acted in the best interests of shareholders.

The ‘Last’ Great Debate

Finally, in 1932, Adolph Berle and Edwin Merrick Dodd engaged in a debate in the Harvard Law Review about in whose interests managers should run corporations. This debate was the last debate about shareholder primacy that involved two full

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487 See Chapter 3 – “The Relevance of Corporate Theory”.
488 For a description of this effect see Chapter 3 – “The Relevance of Corporate Theory”.
489 For a complete description of Managerialism see Chapter 3 – “Managerialism”
competing and opposed corporate theories. It involved the two then dominant conceptions of the corporation: the emerging Managerialism on the one hand and Entity theory on the other. Berle supported the managerialist perspective and argued that managers should run corporations solely in the interests of shareholders. Dodd, on the other hand, based his arguments on Entity theory, and argued that managers should run corporations in the interests of a broader range of stakeholders including workers, customers and the community.

The Debate

The debate consisted of three articles. The first article was written by Berle and it was entitled Corporate Powers as Powers in Trust. In this article, Berle argued that corporate statutes were increasingly providing corporate managers with absolute powers including: 1) the power to issue stock, 2) the power to declare dividends, 3) the power to buy stock in other corporations, 4) the power to amend the corporate charter, and 5) the power to merge with other companies. Berle argued that responsibility comes as a result of power. As a result, courts had equitably limited the exercise of the absolute powers of corporate managers in certain circumstances. For example, in the case of

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490 The debate continues to rage in the United States and other Anglo-American countries to this day. The debate has been particularly pronounced in the United States since the beginning of the 1980’s. However, its character has changed. As was shown in Chapter 3, the progressive law side of the debate is largely just a critique of the economic conception of the corporation. There is no widely accepted progressive law theory of the corporation. This debate is referred to in this chapter as The ‘Last’ Great Debate because it was the last time the debate was engaged by two competing theories of the corporation: Managerialism and Entity Theory. In 1932, Dodd and others supported Entity theory. There is no corresponding modern progressive law theory that is widely accepted. For examples of the work of progressive law scholars see Chapter 3 – “Progressive Law Critiques and Theories”.

491 For a complete description of Managerialism see Chapter 3 – “Managerialism”. For a complete description of Entity theory see Chapter 3 – “Entity Theory”.


493 Ibid at 1050-1072.

494 Ibid at 1049.
the issuance of stock by providing existing shareholders with preemptive rights where appropriate.\footnote{Ibid at 1049-1060.} Therefore, managers when exercising those absolute powers were to be treated like trustees in a trust exercising those powers on behalf of their beneficiaries which in his mind were the shareholders.\footnote{Ibid at 1049.} The introduction to the article states his conclusion most clearly:

It is the thesis of this essay that all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.\footnote{Ibid at 1049.}

Dodd responded to Berle in an article entitled \textit{For Whom are Corporate Managers Trustees?}\footnote{Edwin Merrick Dodd, “For Whom Are Corporate Managers Trustees?” (1932) 45 Harvard Law Review 1145.} Dodd agreed with Berle’s analysis that managers were the trustees of an institution. However, he questioned Berle’s assumption that they necessarily had to be trustees for the shareholders. Dodd agreed that Berle’s shareholder primacy argument would have been appropriate for the smaller types of corporations that had existed a few hundred years before.\footnote{Ibid at 1148.} But, he believed that with the growing power, influence and size of modern corporations that there had been a “substantial change in our public opinion with regard to the obligations of business to the community.”\footnote{Ibid at 1153.} As a result, corporations were viewed as having social responsibility to all of the stakeholders of the corporation including shareholders, employees, customers and the community. Dodd stated his opposition to Berle in the following way:

The present writer is thoroughly in sympathy with Mr. Berle’s efforts to establish a legal control which will more effectually prevent corporate managers from diverting profit into their own pockets from those of stockholders . . . He
nevertheless believes that it is undesirable, even with the laudable purpose of
giving stockholders much-needed protection against self-seeking managers, to
give increased emphasis at the present time to the view that business corporations
exist for the sole purpose of making profits for their stockholders. He believes
that public opinion, which ultimately makes law, has made and is today making
substantial strides in the direction of a view of the business corporation as an
economic institution which has a social service as well as a profit-making
function, that this view has already had some effect upon legal theory, and that it
is likely to have a greatly increased effect upon the latter in the near future. 501

Dodd based his argument on Entity theory:

But we are not bound to treat the corporation as a mere aggregate of stockholders
. . . there is another way of regarding it that has distinguished adherents.
According to this concept any organized group, particularly if its organization is
of a permanent character, is a factual unit, ‘a body which from no fiction of law
but from the very nature of things differs from the individuals of whom it is
constituted.’ . . . As previously stated, this entity approach will not substantially
affect our results if we insist that the sole function for the entity is to seek
maximum stockholder profit. But need we so assume? 502

Dodd used this modified version of entity theory to provide a theoretical basis for
corporate social responsibility and to attempt to justify a fiduciary duty owed to
stakeholders as opposed to just shareholders. 503 In effect, Dodd turned the separation of
ownership from control on its head. The separation of ownership from control was not a
problem but a benefit because it freed managers from the demands of owners and allowed
them to take into account the interests of all of society as stakeholders. 504

Berle responded to Dodd in a short article entitled For Whom Corporate
Managers Are Trustees: A Note. 505 The main thrust of his argument was that the only
effective way to police managers was through shareholder primacy because it was the
only system that had clear accountability. When the interests of other stakeholders were

501 Ibid at 1147-1148.
502 Ibid at 1160.
503 This argument is made by David Millon, see Millon supra note 90 at 216-220.
504 This argument was adopted recently by Rob Yalden. See Yalden supra note 90.
505 Adolph Berle, “For Whom Corporate Managers Are Trustees: A Note” (1932) 45 Harvard Law Review
1365.
brought into the equation accountability suffered and managers would be able to take advantage. His position was that until a better system was devised shareholder primacy was the only option:

Now I submit that you can not abandon emphasis on ‘the view that business corporations exist for the sole purpose of making profits for their stockholders’ until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.\textsuperscript{506}

He held firm to this belief because he strongly felt that:

When the fiduciary obligation of the corporate management and “control” to stockholders is weakened or eliminated, the management and “control” become for all practical purposes absolute.\textsuperscript{507}

\textit{The Assumptions Underlying the Arguments}

The different assumptions used by Berle and Dodd can be seen throughout the debate. The assumptions underlying Berle’s argument were: that the individual is the correct unit of analysis in society\textsuperscript{508} and that corporations are private entities that are the property of their owners.\textsuperscript{509} Dodd’s assumptions were: groups are valid units of analysis

\textsuperscript{506} \textit{Ibid} at 1365.
\textsuperscript{507} \textit{Ibid}. Berle believed that if this was allowed to happen we would descend into a state of ‘economic civil war’: “The only thing that can come out of it, in any long view, is the massing of group after group to assert their private claims by force or threat – to take what each can get, just as corporate managements do. The laborer is invited to organize and strike, the security holder is invited either to jettison his corporate securities and demand relief from the state, or to decline to save money at all under a system which grants to someone else power to take his savings at will. The consumer or patron is left nowhere, unless he learns the dubious art of boycott. This is an invitation not to law or orderly government, but to a process of economic civil war.” \textit{Ibid} at 1368-1369.
\textsuperscript{508} For example, Berle made the following statement: “Yet a society based on the individual, whose support and maintenance the state does not assume, can only be carried on by vigorous protection of the property that he has.” Berle \textit{ibid} at 1369.
\textsuperscript{509} This is illustrated in the most surprising and often overlooked portion of Berle’s argument: That in a capitalist system based on private property, corporations have to be run for the benefit of stockholders (who own the corporation through their private property interest). If you want a different result then you need to reorganize society as opposed to reorganizing corporations. The veiled implication is that stakeholder theory is only possible in a socialist society. Consider the following quote: “Either you have a system based on individual ownership of property or you do not. If not – and there are at the moment plenty of reasons why capitalism does not seem ideal – it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income
in society and corporations because of their size, and most importantly, 'power' have become public entities that have a social responsibility.\textsuperscript{510}

One thing that they both agreed on is that with power comes responsibility.\textsuperscript{511} Dodd stated this idea in the following way:

Modern large-scale industry has given to the managers of our principal corporations enormous power over the welfare of wage earners and consumers, particularly the former. Power over the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility.\textsuperscript{512}

The result of the different assumptions is that Berle and Dodd were talking past each other.\textsuperscript{513} In other words, they were unable to find any common ground because they were starting from opposite normative positions about the way society should be structured.

\begin{flushright}
\textsuperscript{510}Dodd's assumptions are more clearly stated because of his references to Entity theory see Dodd supra note 498 at 1163 where he writes: “That lawyers have commonly assumed that the managers must conduct the institution with single-minded devotion to stockholder profit is true; but the assumption is based upon a particular view of the nature of the institution which we call a business corporation, which concept is in turn based upon a particular view of the nature of business as purely a private enterprise. If we recognize that the attitude of law and public opinion toward business is changing, we may then properly modify our ideas as to the nature of such a business institution as the corporation and hence as to the considerations which may properly influence the conduct of those who direct its activities.”

\textsuperscript{511}See Berle supra note 492; see also Dodd supra note 498 at 1162, where he states: “Business – which is the economic organization of society – is private property only in a qualified sense, and society may properly demand that it be carried on in such a way as to safeguard the interests of those who deal with it either as employees or consumers even if the proprietary rights of its owners are thereby curtailed.” Dodd continues at 1163, where he writes: “That lawyers have commonly assumed that the managers must conduct the institution with single-minded devotion to stockholder profit is true; but the assumption is based upon a particular view of the nature of the institution which we call a business corporation, which concept is in turn based upon a particular view of the nature of business as purely a private enterprise. If we recognize that the attitude of law and public opinion toward business is changing, we may then properly modify our ideas as to the nature of such a business institution as the corporation and hence as to the considerations which may properly influence the conduct of those who direct its activities.”

\textsuperscript{512}Dodd \textit{ibid} at 1157.

\textsuperscript{513}For a description of this effect see Chapter 3 – “Politics and Assumptions”.
\end{flushright}
Until they tackle the differences in the broader argument about the structure of society (based on their normative assumptions) and come to some kind of compromise they will never be able to resolve their debate about the correct role for corporations.

Result of the Debate

Dodd lost the debate. Entity theory fell out of favour in Anglo-American countries after the debate and never again figured as prominently in the corporate law as it did before the debate. Although stakeholder theory, its successor, continues on to this day. Berle’s theory became the driving force behind the establishment of shareholder primacy and the fiduciary duties of corporate managers to act in the best interest of shareholders.

The combined effect of the criticism of corporate theory, the development of Managerialism and the result of the Last Great Debate was that corporate theory lost its relevance in the 1930’s and the focus of corporate law became finding doctrinal solutions to the separation of ownership from control problem.

This debate has been referred to as “The Last Great Debate” in this chapter because it remains unresolved to this day. On the one hand, no one has yet managed to answer Adolph Berle’s challenge. No stakeholder system has been designed that is simple enough to be a widely accepted alternative to shareholder primacy. On the other hand, Berle’s shareholder primacy system has failed to accomplish its stated goal of ensuring that managers do not use corporate assets for their own benefit.


515 For empirical data supporting this conclusion see Chapter 4 - “The Policing of Corporate Managers – The Agency Problem".

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4.2.2 The 1940’s to the 1970’s – The Rise of Economics

The period between the 1940’s and the 1970’s witnessed a broad social and political movement in the United States to embrace economics and economic theory. The rise to dominance of the economic conception of the corporation in corporate law is best viewed as a small part of this rise of economic theory in general. The rise of economics occurred in four distinct phases: First, starting in the 1950’s, finance professionals rose to take control of the top executive positions in large American corporations. Second, beginning in the late 1950’s, economics expanded its domain and began to apply economic analysis to areas that had not traditionally associated with economics. Third, as part of this expansion of economic theory, during the 1960’s legal scholars began to apply economic theory to the law. This became known as the ‘law and economics’ movement. Finally, in the 1980’s, the law and economics movement applied economic analysis to corporate law. By the early 1990’s, the economic conception of the firm had been developed and had risen to dominance in corporate law. The first three of these stages is discussed in more detail below. The fourth is described in the next part.

The Finance Conception of Control in U.S. Corporations

Beginning in the 1950’s, finance professionals started to fill the top executive positions of large U.S. industrial enterprises. They brought with them a preference for economic and financial analysis. This was shown in Neil Fli...
history of the large modern corporation in the United States. In his study, he examined the 1000 largest industrial enterprises in the U.S. since 1880. He tracked how the regulatory, social and economic environment in the U.S. at different times over the last hundred years had allowed different groups of professionals to gain control of corporations and to imbue the corporations with their 'conceptions of control'. A 'conceptions of control' is the perspective that managers and entrepreneurs adopt in their efforts to control their internal and external environments of what constitutes appropriate behaviour. Fligstein described conceptions of control in the following way:

Conceptions of control are totalizing world views that cause actors to interpret every situation from a given perspective. They are forms of analysis used by actors to find solutions to the current problems of the organization. At the center of conceptions of control are simplifying assumptions about how the world is to be analyzed.

Between 1880 and 1990 there were only four conceptions of control: First, before 1900, firms tried to control their competitors through direct control by the development of monopolies or cartels (the direct conception of control). Second, in the early part of the 20th century, the manufacturing conception of control became dominant, as manufacturers or engineers gained control of firms. The focus of corporations, at that time, was producing the most products for the least cost. Third, the sales and marketing conception of control became dominant in the 1930's, as sales and marketing professionals became the top executives of firms. The corporation's focus, at that time, was to find markets to

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517 By 'control' he means occupying the senior management positions in the company, for example, CEO, CFO, vice presidents etc.
518 Fligstein's preference for survival and stability as the main goal of economic actors as opposed to efficiency or profit maximization shows his preference for organizational theory over economic theory. For a description of Fligstein's organizational theory methodology see Fligstein supra note 516 at 5-11.
519 Fligstein ibid at 10.
sell all of the goods that they were producing.\textsuperscript{520} Finally, the finance conception of control became dominant beginning in the 1950's, as finance professionals took control of corporations. The focus of corporations, at that time, became a focus on diversified growth to invest the profits they were generating from the sale of products. In effect, as large U.S. corporations evolved from making goods, to selling goods, to investing their profits, they sought professionals who had the primary skills required for that stage of development.

By the 1960's the finance conception of control was firmly in place and "the largest corporations were increasingly controlled by executives whose background or conceptions were finance based."\textsuperscript{521} Fligstein describes the finance conception of control in the following way:

The finance conception of control of the modern corporation, which currently dominates, emphasizes control through the use of financial tools which measure performance according to profit rates. Product lines are evaluated on their short-run profitability and important management decisions are based on the potential profitability of each line. Firms are viewed as collections of assets earning different rates of return, not as producers of given goods. The firm is not seen as being a member of only one industry. Consequently, if the prospect of an industry in which it participates declines, the firm disinvests. The problem for management from this perspective is to maximize short-run rates of return by altering product mix, thereby increasing shareholder equity and keeping the stock price high.

The key strategies are: diversification through mergers and divestments (as opposed to internal expansion); financial ploys to increase the stock price, indebtedness, and the ability to absorb other firms; and the use of financial controls to make decisions about the internal allocation of capital. The product mix of the firms is less important in the finance conception because each of the firms' businesses are no longer product lines, but profit centers.\textsuperscript{522}

He also describes the reasons why the finance conception developed:

\textsuperscript{520} This was the time period that created large U.S. multinationals.
\textsuperscript{521} Fligstein \textit{supra} note 516 at 252.
\textsuperscript{522} \textit{Ibid} at 15.
The new conception of control was invented by and relied on actors with finance backgrounds who were willing to merge firms with disparate product lines into one decentralized administrative structure. Financial criteria alone were used to evaluate the performance of products. The industry of a firm did not matter. Firms had product lines with different rates of return and growth. The executive’s function, therefore, was to invest so that sales, assets and profits would increase. If products or divisions did not meet expectations, they were divested and new ones purchased.

The pioneers of the finance conception and its strategy of diversification through mergers provided a new model of the corporation. Their spectacular growth rates could not be ignored by the managers of other large firms. Many of them evaluated their strategies and opted to follow the finance conception. They reorganized their internal organization and adopted mergers as a growth strategy. Those who resisted the new conception of the firm became merger targets.

The organizational fields [group of comparative firms] of the largest firms were thus restructured. Once a firm adopted the finance conception of control, the industry in which it operated mattered less than its short-run profitability. The stock market, stock prices, and the relative rates of return of firms in other industries became as important as the behavior of a firm’s competitors. The largest firms for the first time formed an organizational field that served as a reference group for other large firms . . . The spread of these tactics has generally increased the power of finance executives. The result is the large-financially driven, multi-product firm that dominates American business today.\textsuperscript{523}

Fligstein contends that this development of this modern corporate form in the United States did not occur as a result of an evolutionary process whereby the most ‘efficient’ form of organization survived.\textsuperscript{524} Instead, he argues that the American corporation developed as a result of managers trying, first and foremost, to ensure that their firms survived in the complex institutional environment (including the legislative, political and

\textsuperscript{523}Ibid at 229-230.

social environment) in the United States during the 20th century. Fligstein stated his thesis in the following way:

My central thesis is that the viability of the large industrial enterprise in the United States is most related to the long-term shifts in the conception of how the largest firms should operate to preserve their growth and profitability. These shifts have occurred in response to a set of interactions between the largest firms, those who has risen to control those firms, and the government. They originated with managers and entrepreneurs who sought more control over their internal and external environments. When one solution was blocked by the actions of the government, new solutions were created and diffused. The result was a shift to a new conception of the large corporation and hence a new set of strategies and structures.

These changes were not the product of profit-maximizing actors in efficient firms working to become more efficient. Managers and entrepreneurs were not optimizers or satisficers. Instead, they constructed new courses of action based on their analyses of the problems of control they faced. The new conceptions and the strategies and structures that resulted were successful to the degree that they allowed firms to survive and grow.525 [emphasis added]

In Fligstein’s view one of the primary causes of the development of the finance conception of control were the U.S. antitrust laws. Because firms were not able to grow within their own businesses, for fear of antitrust action, they developed the strategy of buying firms in completely unrelated fields. He describes it in the following way:

The role of antitrust in this reconstruction was important. The innovators of the finance conception knew that the [antitrust laws] were being enforced by the Justice Department and the FTC in the 1950’s. They tried to avoid antitrust attention by deliberately staying away from mergers in similar product lines. The farther afield mergers were, the less likely antitrust authorities were to intervene.526

In 2001, Fligstein updated his and argued that a new conception of control had emerged in American society: the ‘shareholder value’ conception of control.527 He argued that the change in the conception of control was a result of lower profitability at
U.S. firms because of foreign competition and the state of the U.S. economy throughout the 1970's characterized by high inflation and low growth.\textsuperscript{528} Fligstein described the shareholder value conception of control in the following way:

The shareholder value conception of the firm uses rhetoric that diagnoses the problems of firms in terms of ideas imported from agency theory. The key idea in the shareholder value conception of the firm is that the only legitimate purpose of firms is to maximize shareholder value . . . The main indicator of whether or not management teams are maximizing shareholder value is the share price of the firm on the stock market. Managers who fail to maximize shareholder value fail to raise the stock price of the firm. They deserve to be ousted by boards of directors. From this point of view, if bad managers co-opt boards of directors, then alternate teams of managers can use the market for corporate control to get the most out of a given firm's assets.\textsuperscript{529}

The shift between the finance conception of control and the shareholder value conception of control was a subtle one that just focused the finance conception of control on the sole purpose of raising stock prices.\textsuperscript{530}

The implications of Fligstein's analysis are important to the development of the economic conception of the corporation in corporate law for two reasons: First, given that finance professionals have been in control of corporations since the 1960's, it is not surprising that corporate law and corporate lawyers found a way to communicate with them by developing a conception of the corporation using economic language. As business norms changed to accommodate economic analysis so did legal norms. Second, economic efficiency and economic theory are not the only explanations for the development of the modern business corporation. The modern corporation does not exist because it is the most efficient organizational form. There was a much more complicated process at work in its development. It developed in response to its environment. That

\textsuperscript{528} Ibid.
\textsuperscript{529} Ibid at 148.
\textsuperscript{530} Ibid at 149.
environment included social, political and legislative components in addition to economic considerations. This insight has surprising parallels to the rise of economics, law and economics and the economic conception of the corporation because it shows that the development of organizations and institutions (including the law) in modern societies is a complex process that cannot be fully explained with the simple concept of economic efficiency. Fligstein’s institutional studies of the development of large corporations are also very important to the social theory of the corporation that is outlined in Chapter 6. His studies illustrate two key components of the social theory: First, the usefulness of sociological analysis in understanding the nature of the corporation, and, second, they highlight the fact that the social world is a far more complicated place than economic analysis assumes. Each of these insights is explored more fully throughout the remainder of this chapter and the remainder of this book.

The Expanding Domain of Economics

The next phase in the rise of economics and the economic conception of the corporation was the expansion in the domain of economics.

Economics attempts to answer the question of how scarce resources are allocated in society. Neoclassical postulates that resources are allocated by choice and, in particular, by individual rational choice that maximizes the individual’s own use of resources. The ‘invisible hand of the market’ (market mechanisms) ensure that


532 Heyne writes that economics is: "basically a way of thinking. The theories of economists, with surprisingly few exceptions, are simply extensions of the assumption that individuals choose those options which seem to them most likely to secure their largest net advantage. Everyone, it is assumed, acts in accordance with that rule: miser or spendthrift, saint or sinner, consumer or seller, politician or business
individual choices are driven towards the most mutually beneficial transactions thus ensuring the most efficient use of resources for society when individual choices are aggregated. The neoclassical economic model can be summarized as follows: When individuals compete for scarce resources in a rational way in an effort to maximize their own self-interest the invisible hand of the market will ensure that the scarce resources in society achieve their most efficient use.

Traditionally, this theory was applied only to markets. However, beginning in the 1950’s, economists started to expand the scope of their discipline, on the belief that the model of rational self choice that they had developed, applied in more situations than just market decisions. For example, economist Gary Becker wrote:

The economic approach is not restricted to material goods and wants or markets with monetary transactions, and conceptually does not distinguish between major and minor decisions or between ‘emotional’ or other decisions. Indeed ... the economic approach provides a framework applicable to all human behavior – to all types of decisions and to persons from all walks of life.

Hirshleifer described the belief and the implications that it had for economics becoming the ‘only’ social science:

Rational self-interested choice plays a role in many domains of life other than markets, for example, in politics, warfare, mate selection, engineering design, and statistical decisions.

[I]t is ultimately impossible to carve off a distinct territory for economics, bordering upon but separated from other social disciplines. Economics interpenetrates them all, and is reciprocally penetrated by them. There is only one social science. What gives economics its imperialist invasive power is that our analytical categories – scarcity, cost, preferences, opportunities, etc. – are truly universal in applicability. Even more important is our structured organization of


533 See Stiglitz and Walsh supra note 531.
534 This insight has been around for a long time and has been shared by Jeremy Bentham and Adam Smith.
these concepts into the distinct yet intertwined processes of optimization on the individual decision level and equilibrium on the social level of analysis. Thus economics really does constitute the universal grammar of social science.\(^537\)

One of the strongest proponents of this belief was Milton Friedman.\(^538\) Friedman’s support for this belief was part of his support of a larger movement in economics that has been referred to as the “Big U-Turn”.\(^539\) The movement included the use of economics as a positive science for policy making\(^540\) and changes to economic methodology to support this policy making goal.\(^541\) A positive science is a body of systematized knowledge about what “is” as compared to a normative science that is systematized knowledge discussing the criteria for what “ought to be”.\(^542\) William Frazer described how this movement changed the purpose of economics:

Above all, the purpose of economic theory, in an empirically oriented economics is prediction for the purposes of hypothesis testing and evaluating alternative policies.\(^543\)

Between the 1950’s and the 1990’s, based on this belief of economics as the one science of rational choice, economic theory spread out from economic departments into all areas of society, including the law, through the law and economics movement, and into corporate law.\(^544\) This expansion in the domain of economics was welcomed by society

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\(^{537}\) *Ibid* at 54.

\(^{538}\) For a discussion of Milton Friedman’s contributions to this movement see Karl Brunner, “Milton Friedman in Our Time” in Karl Brunner, ed., *Economics and Social Institutions* (Boston: Martinus Nijoff Publishing, 1979) at 29 where the author argues that Freidman resurrected Adam Smith’s view that man’s behavior in all aspects of life can be explained by economic analysis.

\(^{539}\) See William Frazer, *Power and Ideas: Milton Friedman and the Big U-Turn* 2 volumes (Gainesville: Gulf/Atlantic Publishing Company, 1988).


\(^{541}\) See generally Frazer *supra* note 539 at 107-142. For a description of Friedman’s methodology see Fraser - Chapter 4. For his original work on methodology see Friedman *ibid*.

\(^{542}\) This distinction is similar to the distinction between normative corporate theories and positive corporate theories that was discussed in Chapter 3. Friedman refers to normative economics as “welfare economics”. See Milton Friedman, “The Methodology of Positive Economics” in *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953) at 3.

\(^{544}\) For a description of economics as an “expansive imperialist discipline” see Hirshliefer *supra* note 536 at 53.
The expansion of economic theory was welcomed by American society because at the time economics chose to expand, the United States was in the middle of the Cold War with the U.S.S.R. Economic theory’s view of man as a rational self-interested individual and rejection of state intervention in the market was in direct opposition to insights offered by socialist theory. Sociologists Hirsch, Michaels and Friedman have argued that the assumptions of economics are consistent with American culture:

More important, perhaps, is the comfortable fit between economic theory and American culture. To trace all action back to individual rational behavior is to make understandable within our peculiarly individualistic and rationalistic culture.

In fact, Milton Friedman purposefully politicized economics when he linked capitalism with freedom and democracy. Thereby aligning economics with the then prevailing normative beliefs in American society.

545 See Brunner supra note 538 at 32 where he states: “The cognitive vision of Friedman’s work collides with major intellectual positions and well established customs of our times. It offers a rational alternative to the inherently metaphysical view of man propogated by socialist thought.” [Emphasis added]. The article concludes with the following cryptic statement potentially referring to the Cold War: “Some rationally inspired crusading in this matter seems not quite inappropriate in our time and in this place.”


547 See Milton Freidman, Capitalism and Freedom (Chicago: Chicago University Press, 1962). For a criticism of this view see John Ralston Saul (2005) supra note 25, where he argues that democracy has been around since Ancient Greece and that capitalism only arose after the industrial revolution and that it was advances in democracy and freedom that made capitalism possible and not the other way around.
To see the extent to which economics became politicized during the Cold War, one need only reconsider the following quote from Milton Friedman’s famous 1970 article on corporate social responsibility, that was cited earlier:

When I hear businessmen speak eloquently about the ‘social responsibilities of business in a free-enterprise system . . . The businessmen believe that they are defending free enterprise when they declaim that business is not concerned ‘merely’ with profit but also with promoting desirable ‘social’ ends; that business has a ‘social conscience’ and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers. In fact they are—or would be if they or anyone else took them seriously—preaching pure and unadulterated socialism. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades.  

The result of the politicization of economics was an alliance in the United States between economics and the political right that has become known as neoliberalism. This alliance reached its zenith of power during the Regan and Thatcher years. The alliance was characterized by the political application of economic theory to support policies of free trade, globalization and the dismantling of the activist state in favour of the forces of the free market. Through this alliance the prominence of economics was dramatically increased – it is now considered a science by some, it has a Nobel prize and economists are now regular advisors at policy meetings.

550 For a description of the link between economics, Milton Freidman in particular, and the Thatcher and Reagan governments in the U.K. and the U.S. see Frazer supra note 539 in chapters 15 and 16, respectively.
The Alleged Intellectual Appeal of Economic Theory

Another reason that economic theory was welcomed by society at large was because of its alleged intellectual appeal. The alleged intellectual appeal of economic theory comes from its claims to the following characteristics: it is simple, it has universal application, it is good at predicting human behavior, it is objective and value free and there is a large degree of consensus in economics among its practitioners. These characteristics were especially appealing to politicians who wanted to use economics to make policy decisions. Economic theory had answers for them – not just answers – but simple answers that provided universal solutions to problems that would work both in the domestic economy and around the world. Moreover, economic theory could predict the difference in results between two different policy choices. Given these claimed characteristics, it is not surprising that economic theory was so readily accepted in American society, and in particular by policy makers. Each of the characteristics is outlined briefly below:

Economic Theories are Simple

The simplicity of economics stems from the simplifying assumptions present in neoclassical economics. Those assumptions are:

1. People act in their own self-interest
2. People act rationally in the pursuit of their own self-interest
3. People have perfect access to information
4. People and resources are freely moveable
5. There are no artificial restrictions on entry into the marketplace.

6. The current distribution of wealth and resources is taken as a given.\textsuperscript{551}

In effect, these assumptions simplify the complexity of the moral and social
caracteristics (or human characteristics) of markets out of economic theory.\textsuperscript{552} The assumptions of neoclassical economics have been severely criticized as not being realistic
by many scholars both within and outside of economics.\textsuperscript{553} It is important, however, to
be aware of these simplifying assumptions because they are also the assumptions behind
the law and economics movement and the economic conception of the corporation. In
Chapter 3, corporate law theories were investigated to determine their position on three
different assumptions: their conception of human nature, their preferred unit of analysis
in society and their position on the public vs. private nature of the corporation. Economic
theory’s position on these three assumptions, as drawn from the list provided above, are:
a self-interested view of human nature, and the individual as the preferred unit of analysis
and for the corporation as a private entity.\textsuperscript{554}

\textit{Economic Theories Have Universal Application}

The effect of the simplifying assumptions is that all decisions made by individuals
can be explained by a single concept: rational choice. In rational choice theory, social,


\textsuperscript{552} These simplifying assumptions have led some critics to refer to economics as a ‘reductionist’ account of the economy. For an example see Mark Granovetter, “A Theoretical Agenda for Economic Sociology” in Mauro Guillen et al., \textit{The New Economic Sociology} (New York: Russel Sage, 2003) at 36.

\textsuperscript{553} A discussion of these criticisms is outside the scope of this paper. For an example of the criticisms see Dallas (2005) supra note 55 – Chapter 1.

\textsuperscript{554} These three assumptions correlate roughly to the following three assumptions identified in Dallas’ work: Human Behavior, Regulation and Unit of Analysis see Dallas (2005) supra note 55 at 27-28.
cultural or institutional differences between actors, markets or societies are irrelevant and so economic theories apply equally to all societies at all times. This characteristic allows economists seek to derive:

universally applicable hypotheses . . . which transcend institutional, systematic, and historical variations. 555

This is referred to as “arm chair” economics. 556 This characteristic has also led to the belief among economists that economics is the “only social science” because all behaviour, everywhere in the world can be explained by rational choice. 557

Economic Theories are Good at Predicting Human Behaviour

Economists defend the simplifying assumptions of neoclassical economics because they increase the predictive power of economic theory. Milton Friedman made this claim in his 1953 essay on methodology. In support of his belief that economics should be an empirical science that supports policy making, he favoured predictive accuracy over descriptive accuracy:

In so far as a theory can be said to have “assumptions” at all, and in so far as their ‘realism’ can be judged independently of the validity of predictions, the relation between the significance of a theory and the “realism” of its ‘assumptions’ is almost the opposite of that suggested by the view under criticism. Truly important and significant hypotheses will be found to have ‘assumptions’ that are wildly inaccurate descriptive representations of reality, and in general, the more significant the theory, the more unrealistic the assumptions (in this sense) . . .

The reason is simple. A hypothesis is important if it ‘explains’ much by little, that is, if it abstracts the common and crucial elements from the mass of complex and detailed circumstances surrounding the phenomena to be explained and permits
valid predictions on the basis of them alone. To be important, therefore, a hypothesis must be descriptively false in its assumptions; it takes account of, and accounts for, none of the many other attendant circumstances, since its very success shows them to be irrelevant for the phenomena to be explained.

To put the point less paradoxically, the relevant question to ask about the ‘assumptions’ of a theory is not whether they are descriptively ‘realistic’, for they never are, but whether they are sufficiently good approximations for the purpose at hand. And this question can be answered only by seeing whether it yields sufficiently accurate predictions. The two supposedly independent tests thus reduce to one test.\(^{558}\)

In espousing this view Friedman was not concerned with solving the philosophical problems of society but focusing on generating practical policy solutions to market problems.

Similarly, Richard Posner when talking about these assumptions in relation to the law and economics movement explains how they increase the predictive quality of economic theories:

\[\ldots\text{the assumptions of economic theory are one-dimensional and pallid when viewed as descriptions of human behavior.}\] But abstraction is the essence of scientific inquiry, and economics aspires to be scientific. Newton’s laws of falling bodies is unrealistic in its basic assumption that bodies fall in a vacuum, but it is still a useful theory because it predicts with reasonable accuracy the behavior of a wide variety of falling bodies in the real world. Similarly an economic theory of law will not capture the full complexity, richness and confusion of the phenomena \ldots\text{ that is seeks to illuminate. But its lack of realism in the sense of descriptive completeness, far from invalidating the theory, is a precondition of the theory. A theory that sought faithfully to reproduce the complexity of the empirical world in its assumptions would not be a theory – an explanation – but a description.}^{559}\]

\(^{558}\) Friedman (1953) supra note 540 at 14-15.

Economic Theories are Objective and Value Free

By focusing on rational choice and empirical evidence and treating itself as a science, economics was able to make the claim that it was objective and value free.\textsuperscript{560} Economics was no longer making ‘normative’ claims about the way the world should be – as it did during the years of the New Deal. Instead it was now just trying to explain the way the world is. By using economics, policy decisions could be made using one objective value free criteria: ‘Efficiency’.

There was Consensus Among Economists

The final characteristic of the intellectual appeal of economic theory is that, in contrast to other disciplines in the social sciences\textsuperscript{561}, there was a general consensus within economics about its most basic theories.\textsuperscript{562} As such, economists put forward a united front to policy makers when providing advice and to the public when presenting their ideas. The effect that this had on the legitimization of economics in U.S. society cannot be understated.

\textsuperscript{560} For example, Mary Zey has written that “Neoclassical economics is the only social science discipline that still clings to the assumption of value neutrality” Mary Zey, Rational Choice Theory and Organizational Theory: A Critique (London: Sage Publications, 1998) at 101. For an economic source for this proposition see Kurt Klapfholz, “Value Judgments and Economics” in Daniel Hausman, ed., The Philosophy of Economics: An Anthology (Cambridge: Cambridge University Press, 1984) at 276-292.

\textsuperscript{561} As an example of a discipline that lacks consensus, consider sociology where there are at least three distinct major schools of thought completely unrelated to each other and each based on the theories of the three founding fathers of sociology: Karl Marx, Max Weber and Emile Durkheim.

\textsuperscript{562} For a discussion of how this consensus in support of neoclassical economics is a result of the education process of young economists see Peter Earl, “A Behavioral Theory of Economists’ Behaviour” in Alfred Eichner, ed., Why Economics is Not Yet a Science (New York: M.E. Sharpe Inc., 1983) at 61.
Summary of the Rise of Economics

The rise of economic theory in corporate law can be seen as part of this larger societal movement towards the use of economic theory in general. The political, normative and alleged intellectual appeal of economic theory had a significant impact on the acceptance of the theories into society in general, the law and corporate law.

The Law and Economics Movement

As part of the expanding domain of economics, economic theory began to be applied to the law beginning in the early 1960's. It has been argued that law and economics is a uniquely American invention. While law and economics had a long history in the United States in the area of antitrust, the birth of the general law and economics movement has been attributed to the point in time when economic theory began to be applied to other areas of the law. The earliest articles that applied economic theory to the law are: Ronald Coase’s 1960 article where he introduced the ‘Coase Theorem’ to explain property and nuisance rights; Guido Calabresi’s economic analysis of tort law; and Gary Becker’s economic analysis of criminal law. Henry Manne also

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563 See Ugo Mattei, The Rise and Fall of Law and Economics: An Essay For Judge Guido Calabresi (2005) 64 Maryland Law Review 220 at 229. The intellectual roots of the law and economics movement can be found in the works of Jeremy Bentham who argued that man was a rational utility maximizer in all areas of life and not just economics see Posner supra note 559 at 4 and Adam Smith who was the first person to conduct a “sustained treatment of law from an economic perspective.” see Keith Hylton, “Calabresi and the Intellectual History of Law and Economics” (2005) 64 Maryland Law Review 85 at 87. For a discussion of the early intellectual roots of the law and economics movement see Hylton at 86-91. For a completely different view of the early roots of the law and economics movement see Heath Pearson, Origins of Law and Economics (Cambridge: Cambridge University Press, 1997) where the author argues that the law and economics movement is based on the work of the German and English historical school of economics and the early American institutionalists.

564 See Ronald Coase, “The Problem of Social Cost” (1960) 3 J.L. & Econ 1. The Coase Theorem states that when transaction costs are nil the initial assignment of property rights will not affect its ultimate use; Guido Calabresi, “Some Thoughts on Risk Distribution and the Law of Torts” (1961) 70 Yale L. J. 499;
made an early contribution to the movement by applying economic analysis to corporate law.\textsuperscript{565}

The most well-known law and economics scholar is Richard Posner. In his 1972 book \textit{The Economic Analysis of the Law} Posner generalized the theories of Coase and Calabresi to make them applicable to all fields of law. Posner is known for his view that the common law is essentially consistent with the principles of ‘economic efficiency.’\textsuperscript{566} He is also well known for his concept of ‘wealth maximization’, which states that the laws fundamental goal is to maximize the wealth of society by promoting the efficient use of scarce resources.\textsuperscript{567}

The law and economics movement has now applied economic analysis to almost all areas of the law. The areas relating to corporations where law and economics has been


\textsuperscript{566} Economists generally talk about two different kinds of efficiency. The first is Pareto Superiority where a transaction is considered to be 'efficient' if it makes at least one person better off and no one worse off. Pareto Superiority is characterized by the fact that everyone could unanimously agree that the transaction is efficient. The other type of efficiency is Kaldor-Hicks efficiency where a transaction is considered efficient if it results in an overall increase in wealth - even if one person might be harmed by the transaction. The idea is that the person who is better off can compensate the person who is worse off - although the compensation is not required . For a description of these two types of efficiency as used in law and economics see Posner \textit{supra} note 559 at 12-13; For a critique of these concepts see Dallas (2005) \textit{supra} note 55 at 1-35.

\textsuperscript{567} 'Wealth Maximization' is really just the application of Kaldor-Hicks efficiency to the law. See Posner \textit{supra} note 559 at 13 where he states: "In the less austere concept of efficiency mainly used in this book - called the Kaldor Hicks concept of efficiency, or wealth maximization . . ."
applied include: corporate law, antitrust law, fraud, unfair competition, bankruptcy, secured transactions, securities regulation and taxation.\textsuperscript{568}

As stated earlier, the rise of the law and economics movement in legal scholarship can be attributed to the rise in normative support for economic theory in general. Ugo Mattei has described this phenomenon in the following way:

The globalization of the economy and the global demise of the activist state, crucial to the neoliberal project and commenced in the early 1980's by the so-called Regan-Thatcher revolution, proved to be the ideal nurturing environment for the rise of law and economics as the most influential global mode of legal thought in the aftermath of the Cold War. With (conservative) economists taking over the major role as policymakers both in the United States and abroad, it has been a natural consequence that those lawyers (mostly American) able to engage in a dialogue with economists, the masters of hegemonic social science, would enjoy a major advantage.\textsuperscript{569}

To add to Mattei's insight by drawing on Fligstein's conclusions, we could say that lawyers who were also able to talk with the C.E.O.s and managers in control of American corporations would also enjoy a major advantage.

The ability of the law and economics movement to communicate with the influential in society is evidenced by the fact that the law and economics movement was, from the start, a very well funded academic movement with many research facilities, endowed professorship chairs, and fellowships available for those pursuing law and economics scholarship.\textsuperscript{570} The John M. Olin Foundation, in particular, donated millions of dollars


\textsuperscript{569} Mattei supra note 563 at 225. It may also have been an intellectual reaction against legal realism and sociological jurisprudence. For a discussion of legal realism see Gary Minda, “Jurisprudential Movements of the 1980’s” (1989) 50 Ohio St. L.J. 599 at 604-614 at 633-641.

\textsuperscript{570} See Mattei supra note 563 at 234 where he describes the funding phenomenon the following way: “Law and economics would not have attained a dominant, global role, if it had not been leveraged, beginning in the Regan years, by a full-fledged political agenda and a real industry, capable of flooding with cash any movement that gave cultural prestige to deregulation and other reactionary politics of those years...the multiplication of prestigious law professor chairs, endowed research facilities, and fellowships, such as the U.S. academia (the global graduate school), created a certain recipe for global success. It is certainly true, nevertheless, that for the young American scholar graduating in the early 1980’s it was a smart career move to get into law and economics rather than, say, comparative law.” See also Nan Aron, Barbara
for the development of law and economic research centres at some of the most prestigious universities in the United States including Harvard, Yale and Berkeley.\textsuperscript{571} It is interesting to note that in Europe, where the institutional conditions in society were different, the law and economics movement did not become as dominant as in the United States.\textsuperscript{572}

The intellectual appeal of the law & economics movement was the same as the intellectual appeal for the economic theories in general: it was simple, it had universal application, it was good at predicting human behavior, it was objective and value free and there was a large degree of consensus among its practitioners.\textsuperscript{573}

The law and economics movement grew extremely fast and had established itself at the elite law schools in the U.S. by 1970. It spread to other law schools during the

\textsuperscript{571} See Mattei \textit{supra} note 563 at 234.

\textsuperscript{572} See R. Cooter and J. Gordley, “Economic Analysis in Civil Law Countries: Past, Present, Future” (1991) 11 International Review of Law and Economics 261. The article highlights the ideas of scholars from a symposia that was held to determine the extent to which national legal cultures resist economic theory. The article notes that as of 1991, there were no active law and economics scholars in France, Eastern Europe, Africa and Latin America. Other articles presented at the symposia show that law and economics received a difficult reception in other countries, for example Germany, Switzerland, Spain and Sweden. For a representative article from the Symposia see Christian Kirschner, “The Difficult Reception of Law and Economics in Germany” (1991) 11 International Review of Law and Economics 277 at 279. For the opposite argument that there is no reason why law and economics cannot take hold in civil law countries (although the authors admitted that law and economics was still a work in progress in Italy) see Ugo Mattei and Roberto Pardolesi, “Law and Economics in Civil Law Countries: A Comparative Approach” (1991) 11 International Review of Law and Economics 265.

\textsuperscript{573} For example, the simple intellectual appeal of the law and economics movement has been described in the following way: “[T]he simplicity of the law and economics paradigm was one of its chief virtues; simplicity makes ideas more accessible, applications more obvious.” See Robert Ellickson, “Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics” (1989) 65 Chi.-Kent L. Rev. 23 at 24.
1980’s. The limited empirical data that has been collected on the growth of the law and economics movement shows that: the number of articles in the Chicago, Harvard, Stanford and Yale law journals relating to law and economics increased from 6% of total articles in 1960 to 24% of total articles in 1985 and the number of law faculty members with Phd’s in economics increased from 2% in 1960 to 6% in 1988.

4.2.3 The 1980’s to the Present: The Rise of the Economic Conception of the Corporation

The economic conception of the corporation was first developed in economics. In 1972, Alchain & Demetz first proposed that the firm be conceived as a Nexus of Contracts instead of an entity. Their work was built on Ronald Coase’s article *The Nature of the Firm* and Oliver Williamson’s work on transaction costs. Their idea was further developed in 1976, by Jensen & Meckling in their article, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*. This article is widely perceived to be the foundational source for the economic conception of the corporation. The theory offered by Jensen & Meckling viewed the corporation as merely an aggregate of various inputs acting together to produce goods and services.

The primary difference between Jensen & Meckling’s model and Coase’s model, is that the distinction between the transactions taking place inside the firm and the transactions taking place outside of the firm was eliminated. This resulted from the fact

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574 The movement was particularly strong at Chicago, Yale and Stanford.
575 Throughout this section the corporation will be referred to by the term used in economics: “the firm”.
that Jensen & Meckling’s model treated firms as contractual in nature. In other words, the economic conception of the corporation ignores the corporation as an entity altogether and simply treats it as a ‘mini-market’ within the larger market. The corporation has no real existence and the people involved in the corporation are assumed away. In this regard, it shares the characteristics of the neoclassical economic model.

This economic theory of the firm then began to be discussed in corporate law literature in the 1980’s. In 1991, Fischel and Easterbrook wrote their classic book *The Economic Structure of Corporate Law* which laid out the basic application of economics theory to the corporation and, in particular, the application of transaction costs to corporate law problems. Johnston described the significance of the book:

Easterbrook and Fischel’s great revolutionary accomplishment, however, has been to use the transaction cost approach inspired by Coase as a tool of detailed analysis. The key to this accomplishment is Easterbrook and Fischel’s perception of corporate law itself as an element of corporate contractual structure. This makes it possible to analyze corporate law as the product of the same long-term process of competition-induced adaptation that constrained private actors to minimize transaction costs. In this analysis, corporate law determines the participation rights of the various participants in the corporate enterprise. The

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578 This characterization has led Melvin Eisenberg to claim that the nexus of contracts theory is not a theory of the corporation because it fails to distinguish between the corporation and markets in general see Melvin Eisenberg, “The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm” (1999) 24 J. Corp. L. 819.
579 For example see William J. Carney, “The Legacy of ‘The Market for Corporate Control’ and the Origins of the Theory of the Firm” (1999-2000) 50 Case Western Res. L. Rev. 215 at 218-219, where the author writes that economists don’t really know “exactly what a firm is but that it isn’t vital to know. To this day, defining the firm remains difficult, apparently with much work to be done before economics provides a full explanation of the existence, size and shape of firms.”
580 The version of economic conception of the corporation outlined here is the version associated with neoclassical economics. William Bratton has argued that there is another weak version of the economic conception of the corporation that is more closely associated with institutional economics and the work of Ronald Coase. Bratton states that there is not much difference between the two conceptions. For a description of the institutional economics version of the conception see Bratton supra note 90 at 1480-1482.
fundamental economic question regarding corporate law then becomes how alternative allocation of legal rights to participate in corporate decision-making affect the comparative cost of alternative methods of corporation operation and governance.\footnote{Johnston supra note 483 at 232. This quote shows how Fischel and Easterbrook's view of the development of corporate law as an evolutionary process of economic efficiency is similar to Alfred Chandler's view on the development of the corporation. See note 524.}

The law and economics movement had spectacular success in corporate law. In fact, law and economics now completely dominates the field. Stephen Bainbridge has commented on this dominance:

> Over the last couple of decades, law & economics scholars have mounted a largely successful hostile takeover of the corporate legal academy.\footnote{Bainbridge supra note 16 at 1.}

Law & economics remains the most successful example of intellectual arbitrage in the history of corporate jurisprudence. It is virtually impossible to find serious corporate law scholarship that is not informed by economic analysis. Even those corporate law scholars who reject economic analysis spend most of their time responding to those of us who practice it. . . Perhaps the most telling evidence of the success of law and economics in our field, however, is that many leading corporate law judges and lawyers are now adept at its use. Both judicial opinions and practitioner publications are filled with the jargon of law and economics. This is a claim that no other modern school of jurisprudence can make.\footnote{Ibid.}

There are two reasons why the movement met with such instant success: First, as was shown earlier, there was a vacuum in corporate theory leftover from the events of the 1930's that was waiting to be filled. Second, the economic conception of the corporation preserved the status quo.\footnote{This is a characteristic of economic theory in general. It can often be used to support the status quo because it assumes that the current system exists because it is the most efficient. If it was not, then another system would have developed instead. This characteristic is very closely linked to the assumption in neoclassical economics that the current distribution of wealth and resources are taken as a given.}

From a practical point of view, the economic theory of the corporation required no changes to the way corporations were treated in the law. In fact, it was remarkably similar to Managerialism. Both theories support the concept of shareholder primacy. Managerialism supported the concept of shareholder primacy based
on the shareholder’s property rights in the corporation as owners. The economic conception of the corporation supports shareholder primacy based on the fact that shareholders are the residual claimants in the corporation and thus have the most at stake, or alternatively, because from a transaction cost point of view they are the stakeholder group most able to monitor management efficiently. Both theories are focused on the issue of policing the actions of corporate managers, albeit for different reasons. Managerialism conceptualized the managerial problem as stemming from the separation of ownership from control, while the Nexus of Contracts theory conceptualizes it as an agency problem.

The economic conception of the corporation had the promise to overcome the narrow focus of Managerialism because of its focus on analyzing the inputs into the corporation. However, in practice it just became a theory that justified the status quo.

The Impact of the Economic Conception of the Corporation

The result of the rise to dominance of the economic conception of the firm, in combination with the other economic theories, has been significant. Since the 1980’s, there has been a dramatic increase in merger and acquisitions activity and constant restructuring of the North American economy. Although it is difficult to conclude that there is a direct causal relationship between the events, it is clear that the theories played

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587 This has led some commentators to label it the property rights theory see Yalden supra note 90.
589 William Bratton makes the argument that the economic conception of the corporation is similar to Managerialism. See Bratton supra note 90. See also Millon supra note 90 at 231.
a role in legitimizing the activities.\textsuperscript{590} William Bratton described the legitimizing role of the economic conception of the corporation:

Even so, the new economic theory has a place in all of this. The restructuring has met with little effective opposition, and any number of legislative moves might have deterred it. The theory persuasively manifests the wider antiregulatory and contractualist environment in a respectable academic form specific to the context.\textsuperscript{591}

Progressive law theories arose during the 1980's in response to the wave of hostile takeover bids that swept North America.\textsuperscript{592}

\textit{Conclusion}

As has been shown, the rise to dominance of the economic conception of the corporation was the result of two major sets of events: First, the events of the 1930's that effectively set the stage for its rise by introducing the intellectual concepts that it would eventually be based upon and by the loss of relevance of corporate theory as a result of the criticism leveled against it and the development of Managerialism. Second, it was a small part of the normative shift in American society to accept economic analysis during the middle part of the 20\textsuperscript{th} century.\textsuperscript{593}

\textsuperscript{590} See Bratton \textit{supra} note 90 at 1518 where he argues that the change in the market for corporate control (takeover bids) necessitated a change in economic theory. Oliver Williamson also explained that takeover bids were the result of the rise in the multidivisional corporate structure, see Bratton \textit{supra} note 90 at 1519 discussing Oliver Williamson, "Organizational Form, Residual Claimants and Corporate Control" (1983) J.L. \& Econ 361 at 362. This would be consistent with the findings of Neil Fligstein see Fligstein (1990).

\textsuperscript{591} See Bratton \textit{supra} note 90 at 1525. See also Millon \textit{supra} note 90 at 243-251.

\textsuperscript{592} Millon \textit{Ibid} at 203. For a complete description of the Progressive Law Critiques see Chapter 3 – "Progressive Law Theories".

\textsuperscript{593} This is consistent with the views of Ugo Mattei on the rise of the law and economics movement. Ugo Mattei has very recently argued that while Law \& Economics played a large role in stabling the worldwide dominance of U.S. legal scholarship – that its over-formalism, parochialism and western-centrism is leading to its downfall and that with it will go the U.S. legal scholarship dominance. Mattei argues that the movement begins during the heart of the Cold War, reached its zenith just after the Berlin Wall came down and started its decline at the turn of the millennium. He argued that law and economics is political and full of ideology. Mattei \textit{supra} note 563.
4.3 The Criticisms Of Economic Theory, Law And Economics And The Economic Conception Of The Corporation

The purpose of this section is show that the economic conception of the corporation is not an intellectually superior or positive theory. This will be done by highlighting the criticisms of the theory. This section is structured to show that the criticisms of the economic conception of the corporation that were described in Chapter 3 are simply part of the larger criticism of economic theories in general and that they are equally applicable to economic and the law and economics movement. It will also show that these criticisms result from the simplifying assumptions of economic theory and if progress is to be made in corporate theory it will most likely have to be made outside of economics.

The critiques offered in this section relate only to neoclassical economics, the law and economics of Richard Posner and the economic conception of the corporation that is based on neoclassical economics.\textsuperscript{594} The simplification of the economic theories into this narrow subgroup does not do justness to the richness of the progressive economic scholarship that is occurring in modern economic theory. For example, behavioral economics, binary economics, socioeconomics etc.\textsuperscript{595} In fact, sociologist Neil Fligstein, one of the strongest advocates against economic theory, has written the following about the progress being made in economics:

\textit{[N]on-economists have been fixated on a stylized reading of the neoclassical view of perfect competition. Current economic thinking about the structure of firms}

\textsuperscript{594} William Bratton has argued that there are two versions of the economic conception of the corporation. The strong version which is linked to neoclassical economics and the weak version that is more closely linked with institutional economics. The neoclassical version is the version associated with the work of Alchian and Demetz and Jensen and Meckling. The institutional version is more closely associated with the work of Ronald Coase. See Bratton \textit{supra} note 90 at 1477.

\textsuperscript{595} These progressive theories are discussed later in this chapter under “Consensus”.

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and markets contains some sophisticated notions about the role of social relations in markets. Economists have come a long way in their views about rational action and perfect information.\footnote{Neil Fligstein, \textit{The Architecture of Markets: An Economic Sociology of Twenty-First-Century Capitalist Societies} (Princeton: Princeton University Press, 2001) at 8.}

The simplification in this section also does not give enough credit to the tremendous amount of progressive work that has been going on in the law and economics movement since the 1980's. Unfortunately, to conduct a critique of all three theories together requires a certain level of simplification. In this case, the choice of the more 'conservative' (for lack of a better descriptive term) economic theories is realistic, because the main purpose of the analysis is to show that many of the criticisms of the economic conception of the corporation are really part of larger criticisms of economic theory in general, and the current form of the economic conception of the corporation that is dominant is a very conservative version of the theory.\footnote{For a description of this theory see Chapter 3 – “Nexus of Contracts Theory”.} This is not to take away from the exciting work that is being done by progressive corporate law scholars like Margaret Blair, Lynn Stout, Lynn Dallas and Robert Ashford. It is just an acknowledgement that their alternate theories of the corporation have not yet become widely accepted.

The longer economics, law and economics and the economic conception of the corporation have remained dominant, the more critics have realized that the original intellectual appeal of the theories is losing its luster.\footnote{Portions of the structure of the critique presented in this chapter was inspired by John Ralston Saul’s analysis in John Ralston Saul, \textit{The Collapse of Globalism and the Reinvention of the World} (Toronto: Viking Publishing, 2005). The critique offered of the law and economics movement in this section relates solely to the mainstream or first generation law and economics movement best evidenced by the early work of Guido Calabresi and the work of Richard Posner. Space limitations precluded a full critique of the complete body of work of the movement.} The critiques of economic theories are organized below under the five different characteristics of the intellectual appeal that were offered at the beginning of this chapter, namely: they were simple, they
had universal application, they were good at predicting human behavior, they were objective and value free and there was a large degree of consensus among their practitioners.

4.3.1 Economic Theories are Simple

While simplicity was one of the early advantages of the economic theories, it has now become one of their most limiting characteristics. Economic theory purposefully removed the moral and social or human complexity of society and markets in creating its simplifying assumptions to increase its predictability. This aspect of economic theories was identified as far back as 1916, when J. Maurice Clark wrote:

"...[L]aissez faire economics may well be characterized as the economics of irresponsibility, and the business system of free contract is also a system of irresponsibility when judged by the same standard. Of static theory we must simply say that while it does not deny social responsibilities it does to a large extent ignore them. Since its abstract premises leave out most of the facts on which they are based, they are left to be taken account of in other departments of the science. Liberal economics or business economics in general accomplishes much the same result by separating business sharply off from the rest of life."

Stephen Bainbridge has also admitted that the Nexus of Contracts theory was incomplete and simplistic and useful only to understand certain things:

In sum, the progressives are right that contractarianism is incomplete, but so what? Admittedly this distinction is not always acknowledged in the contractarian literature, but I suggest that the nexus of contracts model is properly viewed as a metaphor rather than a positive account of economic reality. Contractarianism is analogous to Newtonian physics, which no longer credibly claims to be true, but still provides a simple model that adequately explains a large and important set of physical phenomenon. According to its proponents, contractarian theory similarly offers a useful heuristic for studying firms. It is this claim against which the progressives are more properly would be addressed.


600 Bainbridge supra note 16 at 18.
Sociologist Emile Durkheim wrote about this aspect of economic theory back in 1887. Durkheim believed that economics erred — not by making abstractions to increase predictive power — but by making the wrong abstractions:

Is not the use of abstractions a legitimate tool of economics? No doubt — it is only that all abstractions are not equally correct. An abstraction consists of isolating a part of reality, not in making it disappear altogether.\(^{601}\)

The obvious result of this is that the theories are unable to take positions on moral or ethical issues. They are also unable to explain social behaviour that is not motivated by self-interest. But even more troubling is the fact that as the theories have risen to dominance they have been used to justify immoral or unsocial behaviour. Any transaction is justifiable regardless of its immorality provided it has a positive cost/benefit or wealth maximization outcome or it is Kaldor-Hicks efficient.\(^{602}\)

This characteristic of the economic theories has led to some very disturbing analyses and conclusions. For example, in the law and economics movement it has led to the development of a theory that is unable to recognize crimes against humanity or racism. Posner wrote the following two passages explaining the value neutrality of his theory of wealth maximization:

If Nazi Germany wanted to get rid of its Jews, in a system of wealth maximization it would have had to buy them out . . . \(^{603}\)

But one must not overlook the possibility of extending the logic of certain nuisance cases to Jews, blacks and other racial, religious, or ethnic minorities. If a funeral parlor can depress land values, because people living near it are upset to be reminded of death, and on this ground can be condemned as a nuisance, likewise the presence of Jews or blacks in a neighborhood might so upset their neighbors as to depress land values by an amount greater than the members of the

\(^{601}\) Swedberg *supra* note 33 at 20 providing an English translation of Emile Durkheim, “La Science Positive de la Morale en Allemagne” [1887] 24 *Revue Philosophique* 33 at 47.

\(^{602}\) Kaldor-Hicks efficiency is explained by Richard Posner. See Posner *supra* note 559 at 13.

minority would be willing to pay to remain in the neighborhood. In these circumstances some form of segregation would be wealth maximizing. 604

Similarly, in the realm of corporations it has led to the use of cost/benefit analyses that value profit over human life. For example, the famous decision by General Motors not to recall the Chevy Malibu, because it was more cost effective to pay death settlements than to actually recall and fix the vehicles. 605 And in corporate law, it has provided intellectual support for ‘shareholder maximization’ transactions where companies are sold, employees are laid off, communities are impacted - all so that shareholders can obtain short term return on profits. 606 Why are these results disturbing? They are disturbing because the behavior that is justified by the theories is different than the behaviour that an individual would find acceptable in a social setting or in their personal lives. What if the president of General Motors had to meet face to face with the families of each of the people killed in Chevy Malibus? Would he have made the same decision? 607 In a more personal example, what if a corporate lawyer was close friends with the dozens of people who were laid off as part of a shareholder maximization transaction that he or she worked on? Would the lawyer still believe that the interests of shareholders are the only interests to take into account? J. Maurice Clark argued that the personal contact would affect the behaviour:

Many men would fulfill their responsibilities in a very different spirit if they were put before them in present and tangible shape: for example, if they had to bargain with their laborers directly. 608

604 See ibid at 84-85.
605 For a description of this case see Lawrence Mitchell, Corporate Irresponsibility (New Haven: Yale University Press, 2001) at 25-26 and Bakan supra note 39.
606 And often these shareholders have only been shareholders for short periods of time because by the time these transactions occur long-term shareholders have long since exited their positions.
The use of economic theory to separate the moral and social considerations from business has been acknowledged for a long time. It is the characteristic that has led to the justification among businessmen that work behaviour has a different standard of acceptability than the behavior that they engage in their private lives. Those in the business world can hear the expression: “Don’t take it personally. It is just business.” Should there be a difference? Is the difference the outcome of the disembedding of the market from society? If it is then Polanyi and Saul have warned that serious negative consequences may result.

This moral and neutral characteristic of the economic theories has been heavily criticized. An example of such a criticism of the law and economics movement has been made by Robin Malloy:

Posner, by rejecting the need for moral judgment as a part of his model of law and economics, has, in effect, deferred to economists on the very point on which economists have deferred to others. Posner’s theory of wealth maximization results in a situation where the concept and process of maximizing wealth becomes the ultimate social morality. Consequently, although purporting to be neutral and objective, Posner’s theory of wealth maximization, allows a sleight of hand to determine, in selection of input variables and assumptions, the moral choices that define human dignity and individual liberty within society.

Similar criticisms of the lack of morality and trust in the corporate law have been made by Lawrence Mitchell. Lynn Dallas has extensively criticized the inability of law and economics and the economic conception of the corporation’s to take into account the

609 Clark wrote the preceding quote in 1916.
610 To review this concept see Chapter 1 – “Balance”.
611 Malloy supra note 551 at 252.
social behaviour of individuals.\textsuperscript{613} The separation of ethics and morals from business was also the basis behind the stakeholder theory of the corporation.\textsuperscript{614}

Another aspect of this criticism is that, simple economic theories have outlived their usefulness and that the theory of rational choice offers only limited insight into understanding the market, society and corporations. In other words, we have learned everything from them that we can.\textsuperscript{615} In order to move forward in our understanding of how markets, societies and corporations work we need to have theories with more complexity. The time is right to trade away some of the predictive power of the economic theories in favour of theories that are more descriptive of the way markets and societies actually work. Ellickson provided the following reply to Posner's analogy of Newton's theory of falling bodies:

The trade-off between theoretical simplicity and predictive power is a difficult one. Kepler's theory of elliptical planetary movement is more complex than any Copernican theory of circular planetary movement. Yet, because Kepler's theory enabled astronomers to forecast where find the planets, they came to accept it despite its greater complexity.\textsuperscript{616}

\textsuperscript{613} See Dallas (2005) \textit{supra} note 55 - Chapter 1 which contains her critique of neoclassical economics and law and economics and Chapter 11 which contains her application of socioeconomics to the corporate social responsibility debate.

\textsuperscript{614} Freeman refers to this as the Separation Thesis. For a description of this see Chapter 3 – “Stakeholder Theory” and R. Edward Freeman, “The Politics of Stakeholder Theory: Some Future Directions” (1994) Vol. 4 Issue 4 \textit{Business Ethics Quarterly} 409.

\textsuperscript{615} Many commentators have noted that the big gains in law and economics scholarship were in the early years as the theories were applied to new areas of the law – but now that the theory has basically been applied to every area of the law the gains area now more in minutia or tweaking. For example, see Robert Ellickson \textit{supra} note 573 at 24 where he states: “The first generation of law and economics scholars has essentially accomplished the straightforward applications of the basic economic model in virtually every legal field. Current scholarship is more technical and interstitial...and Leff, if he were still alive, would likely regard current law and economics scholarship as too humdrum and undynamic to be worthy of his fury.” See also page 33 where he states: “Twenty years ago, a young scholar like me who had but a few courses of college economics under his belt could aspire fruitfully to apply basic economic principles to central common law issues. Today, when many of the obvious and easy applications have been done, a young scholar, with only a modest amount of technical training can no longer be as optimistic about being able to make a contribution. In short, for the typical young law professor, the benefit-cost ratio of law and economics scholarship has been falling.”

\textsuperscript{616} Ellickson \textit{supra} note 573 at 25.
Simple economics theory has proved useful in explaining the economic functioning of classical markets but it is not a substitute for understanding the moral or social (human) aspects of issues. In *The Collapse of Globalism and the Reinvention of the World*, John Ralston Saul argues that we as a society have already come to the realization that economics cannot take us any further in our understanding:

A shrinking number of people believe that economics could actually set a broader course for any civilization. I’ve noticed that not many people even bother listening when the old assertions of global economic inevitability are made. Inside the small, closed world of economists and officials and interest group associations and specialist writers, that sort of talk does go on. Why not? But most of us are elsewhere. And so, therefore, is the world.\(^\text{617}\)

### 4.3.2 Economic Theories Have Universal Application

As the western world has attempted to export its economic theories to other countries, we have realized that they are not very good predictors of what occurs in other markets or societies. In short, we have discovered that they are western centric. This is probably because they fail to take cultural or social factors into account. Economics, law and economics and corporate law each have their own western-centric theories that assume the superiority of the Anglo-American capitalist economic system. In economics, globalization theory claims that inevitable economic forces are more powerful than nation states\(^\text{618}\) and the rights hypothesis of new institutional economics claims that enforceable

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\(^{618}\) For descriptions of globalization theory see Martin Wolf, *Why Globalization Works* (London: Yale University Press, 2004) and Jagdish Bhagwati, *In Defense of Globalization* (New York: Oxford University Press, 2004). For a criticism of globalization theory see Potter (2001) at 5 where he states: “While the capacity of the liberal industrial economies to promote visions of globalization derives as much from political and economic power as from the inherent wisdom of the ideas themselves, there is little doubt that the influence of liberal ideals of private property have spread dramatically in the past decade. . . . liberal legal norms associated with globalization constitute a belief system driven by changing historical conditions of socio-economic and political relations in Europe and North America. The essentially one-
contract rights and security of private property rights are both necessary for economic development.\textsuperscript{619} In law and economics, the law and finance literature claims that common law legal systems are superior to civil law legal system for supporting a market economy.\textsuperscript{620} And in corporate law, corporate convergence theories claim that due to the competitive forces of economic efficiency there will be a global convergence in corporate governance rules towards the Anglo-American shareholder oriented model. In fact, the strong-form of convergence theory advocated by Henry Hansmann and Reinier Kraakman in their 2001 article \textit{The End of History for Corporate Law}\textsuperscript{621} actually
predicted ‘the end of history’ for corporate law because, in the authors’ view, global ideological convergence on the U.S. shareholder oriented corporate governance model had already occurred. The authors went so far as to say:

There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value. This emergent consensus has already profoundly affected corporate governance practices throughout the world. It is only a matter of time before its influence is felt in the reform of corporate law as well.  

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The common theme of these theories is that global convergence on the Anglo-American economic model is inevitable because of economic competitive pressures. All of the theories tend to ignore the fact that economies with institutional structures very different than Anglo-American economies have shown the ability to grow, and in some cases, grow at a rate that far exceeded the growth of Anglo-American countries regardless of the fact that they did not have an Anglo-American set of contract and property rights, common law system or corporate governance system. China is the perfect example of such a country but there are others.  

623 The theories also tend to ignore

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The End of History and the Last Man where he makes the western centric argument that: “a remarkable consensus concerning the legitimacy of liberal democracy as a system of government had emerged throughout the world over the past few years, as it conquered rival ideologies like hereditary monarchy, fascism, and most recently communism. More than that, however, I argued that liberal democracy may constitute the ‘end point of mankind’s ideological evolution’ and the ‘final form of human government,’ and as such constituted the ‘End of history.’” See Francis Fukuyama, The End of History and the Last Man (Toronto: Maxwell-Macmillan Canada, 1992) – Introduction.

622 Ibid at 439.

623 For a description of the institutional structure in China relating to corporate governance and the prospects for corporate governance convergence see Michael Cody, “Selective Adaptation and Corporate Governance Reform in the P.R.C.” (on file with author). Other examples of countries with different institutional structures that have experienced periods of hyper-economic growth include Japan and the Asian Tigers including Korea and Taiwan. For examples of studies highlighting the different institutional structures of these economies and the way those institutional structures contributed to the countries hyper-economic growth see: for Japan – Chalmers Johnson, MITI and the Japanese Miracle (Stanford: Stanford University Press, 1982); for Korea – Eun Mee Kim, Big Business, Strong State (Albany: State University of New York Press, 1997); and for Taiwan – Hamilton, “Organization and Market Process in Taiwan’s Capitalist Economy” in Orru, Biggart and Hamilton, eds., The Economic Organization of East Asian Capitalism (Thousand Oaks: Sage, 1997) at 237-293.
Over the last quarter-century economics has raised itself to the level of a scientific profession . . . Yet over the same 25 years, economics has been spectacularly unsuccessful in its attempts to apply its models and theories to the reality of our civilization. It's not that the economists' advice has not been taken. It has in great detail, with great reverence. And in general, it has failed.  

4.3.4 Economic Theories are Objective and Value Free

Many critics have also pointed out that economic theory, the law and economics movement and the economic conception of the corporation are far from being value free. Economist William Frazer has gone so far as to call economics ideological:

Few people outside of the study of economics could imagine anything less ideologically charged than the policy-oriented economics that surfaces in the media, the halls of the U.S. Congress, the corridors of Westminster, Bonn, Frankfort, Brussels, and other centers of the European Community.

But are economics, law and economics and the economic conception of the corporation ideological? They have the potential to be. Posner himself warns us of the danger of losing sight of ideology: “Once a viewpoint becomes dominant, it ceases to be perceived as having an ideological character.”

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628 Saul, supra note 17 at 4. Saul focuses on the inability of economic theory to predict the outcomes of globalization.

629 For examples of discussions of economics as being ideology see Ben Fine, Economic Theory and Ideology (London: Edward Arnold, 1980) at 1-17 and of ‘Chicago School’ economics as being ideology see Peter Wiles, “Ideology, Methodology, and Neoclassical Economics” in Alfred Eichner, ed., Why Economics is Not Yet a Science (New York: M.E. Sharpe Inc., 1983) at 671. For a discussion of economics as being full of value judgments but not ideological see Homa Katouzian, Ideology and Method in Economics (London: Macmillan Press, 1980) at 135. For critiques of the law and economics movement as being ideological see Baker, “The Ideology of Economic Analysis of the Law” (1975) 5 J. Phil & Public Affairs 3 where the bias in the law and economics movement is identified; Malloy supra note 551 where Posner’s ‘wealth maximization’ theory is referred to as sleight of hand because even though it claims to be value free it is ridden with values; and Markovitz, “Legal Analysis and the Economic Analysis of Allocative Efficiency: A Response to Professor Posner’s Reply” (1983) 11 Hofstra L. Rev. 667 where Posner’s law and economics are viewed as conservative. For the argument that corporate governance systems are ideological see Thomas Courchene, “Corporate Governance as Ideology” (1995-1996) 26 Canadian Business Law Journal 202 at 207. See also Scott Bowman,  


631 Posner (2003) supra note 559 at 27. Curiously he was referring to the policies of a liberal state when he wrote this sentence and not law and economics.
But, there is a difference between value judgments and ideology.\textsuperscript{632} Value judgments are conscious decisions to support certain moral norms. The assumptions in the normative core of each corporate theory that were outlined in Chapter 3 are examples of value judgments.\textsuperscript{633} For example, the assumption that corporate law should be private in character and regulate only the internal relationships in the corporation and not the corporation's relationship with society is a value judgment. Value judgments are required in order to develop any theory and their use is allowable provided that the decisions that are made are conscious and the theorist makes his or her value judgments apparent. Ideology, on the other hand, is an 'unconscious' world view or set of beliefs about society, that is unexamined.\textsuperscript{634} Ideology is dangerous because it represents value judgments within a theory that the theorist is unaware of.

The economic theories are full of value judgments. Whether they have reached the status of ideology is unclear. Alfred Eichner argues that economics is a political theory (or a theory of value judgments) and not an objective theory:

\cite{eichner:1977}

\textit{[C]onventional economic theory seems to make sense only when one realizes that it is a political, and not economic, argument which is being made. The argument runs as follows: The economic system can be viewed as a self-regulating mechanism, one that requires little or no interference by the government to insure the best possible results. Indeed, government intervention is likely to impair the economy's performance since any decisions based on the dynamics of the political system will probably be inferior to those made impersonally through the market. From the largely self-regulating nature of a market economy, it then follows that the role of government in economic matters, can and should, be sharply limited... Those who constitute the 'establishment' within economics are more concerned about the worst possible outcomes in politics than they are about the worst possible outcomes in economics...} 

Still it is one thing to develop an argument in political theory, based on a model of the state that can be empirically validated by historical evidence, and quite

\textsuperscript{633} For a complete description of this term see Chapter 3 "Politics and Assumptions".
\textsuperscript{634} Katzoukian \textit{supra} note 632.
another to develop a myth about the efficaciousness of the market so that the rest of society will not be tempted to turn to the state for a solution to its economic problems. . . the latter, however justified it may seem by the concerns economists have as witnesses to history, defeats any hope of economics ever becoming a science.\footnote{635}

The value judgments in the economic theories arise because, contrary to claims that economics is a science, some of its most basic assumptions have never been subjected to empirical testing.\footnote{636} This aspect of economics was identified by Emile Durkheim in the 1890’s when he argued that economics was non-empirical and that economists substitute their own ideas for empirical reality – something Durkheim refers to as “the ideological tendency of economics”.\footnote{637} Similarly, it has been argued that economic models ignore real data. A study of the articles in the \textit{American Economic Review} from 1977-1981 found that 54\% of the articles used mathematical models without data and only one-half of one percent used original data generated by their authors.\footnote{638} Therefore, the conclusions of economics, like for example, that markets function better with less government influence, are normative statements because they were not generated by the scientific method. If a theory is neither scientific nor objective and it is merely normative – then we need to look at its underlying assumptions because in doing so we gain

\footnote{636} Alfred Eichner has argued that there are four key propositions of neoclassical economics that have never been subjected to empirical analysis. \textit{See} Alfred Eichner, “why Economics is Not Yet a Science”, in Alfred Eichner, ed., \textit{Why Economics is Not Yet a Science} (New York: M.E. Sharpe Inc., 1983) at 210. The four theoretical constructs that have never been tested are: “(1) a set of indifference curves, based on a postulated utility function for each and every individual, when aggregated for all households, represent the relative preferences for any two or more goods by the society as a whole, (2)a set of continuous, or smooth, isoquants, based on a postulated production function for each and every good that is produced, which, when taken together, represent all the combinations of labour and other inputs which can be used to produce those goods, (3) a set of positively sloped supply curves for all the different firms and industries which comprise the enterprise sector of the economy, and (4) a set of marginal physical product curves for all inputs used in the production process...” (pg. 210).
\footnote{637} \textit{See} Emile Durkheim, \textit{The Rules of Sociological Method} (New York: Free Press, 1964) at 24-25. It was originally published in 1895.
\footnote{638} Reported in Hirsch, Michaels and Freidman \textit{infra} note 1033 at 51-52.
important insights into the ultimate worth that can be drawn form the conclusions of the theory.

The law and economics movement and the economic conception of the corporation both rely on the assumptions of neoclassical economic theory and therefore are subject to the built in value judgments inherent in economic theories in general. So in a sense they are also normative theories. Posner agrees with this interpretation to the extent that it applies to law and economics. He adamantly contends that law and economics is not ideological although he has admitted that it is a political (normative) theory. In corporate law the normative basis of corporate theory has been pointed out by feminist legal scholars and it was explored in detail in Chapter 3. The problem with the economic theories does not lie in the fact that they are normative theories and contain value judgments – all theories do. The problem is the fact that they represented themselves as being value free.

639 Although Posner has rightly stated that his wealth maximization theory never assumed perfect information or accepts the current distribution of wealth as a given. See Richard Posner, "The Ethics of Wealth Maximization: Reply to Malloy" (1987/1988) 36 U. Kan. L. Rev. 261 at 264..
640 For the argument that corporate governance systems are ideological see Thomas Courchene, "Corporate Governance as Ideology" (1995-1996) 26 Canadian Business Law Journal 202 at 207 where he states: “Thus, it is not just that different corporate governance structures reflect the different cultures and histories of various countries. They also embody deep-seated philosophical differences; that is they are also ideological.” Based on the definitions being used in this chapter the word “ideological” in the foregoing quote should be read as “full of value judgments”.
641 Posner has stated both of the following: “Perhaps the best evidence that economic analysis of the law is ideologically neutral or balanced is the significant number of prominent practitioners who are decidedly neutral.” And “It must also be emphasized that it is a political philosophy that I am expounding”. See Poser (2003) at 27 and Richard Posner, “Wealth Maximization Revisited” (1985) 2 Notre Dame L.J. L. Ethics & Public Policy 85 at 103.
643 For a discussion of the value-free claims of economics see Chapter 4- “Economic Theories Are Value Free”. For a description of this claim related to the nexus of contracts theory see Chapter 3 – “The Nexus of Contracts Theory".
4.3.5 There is Consensus Among Practitioners of Economic Theory

The consensus in economics is also disappearing. As a discipline it is far more fractured now than it ever has been in the past with the development of new sub-branches of economics each trying to deal with one or more of the limitations of neo-classical economics. Examples of the new sub-branches of economics include: behavioral economics, binary economics, socio-economics etc. 644

In law and economics, consensus had fallen apart by the late 1980's. A second generation of law and economics scholars arose that challenged the assumptions of the strong supporters of the "wealth maximization" principle. 645 These scholars were less likely to assert that legal rules should "be affirmed or rejected on the basis of efficiency". 646 However, the methodology and language of the new generation of law and economics scholars is still much embedded in the traditional law and economics claims. 647 The main purpose of the movement can still best be explained "in terms of a

644 The explanation of each of these sub-branches of economics is beyond the scope of this chapter. A brief introduction of each is included in this note. Evolutionary economics is based on the work of Joseph Schumpeter and the ideas of evolution from biology. It is the application of evolutionary ideas to economics and it focuses on the concepts of innovation and path dependence. For an introduction to evolutionary economics see Ulrich Witt, ed., Evolutionary Economics (Aldershot: Elgar, 1993) and Jan Fagerberg, "Schumpeter and the Revival of Evolutionary Economics: An Appraisal of the Literature" (2003) 13 Journal of Evolutionary Economics 125. The classic evolutionary economics text is Sidney Winter and Richard Nelson, An Evolutionary Theory of Economic Change (Cambridge: Harvard University Press, 1982). Behavioural economics focuses on the cognitive and emotional aspects of how people make decisions and it critiques the neoclassical view of the rational actor. It is based largely on insights from psychology. The classic source for behavioral economics is Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision Under Risk" (1979) XVLII Econometrica 263. Prospect theory focuses on the way the subjective framing of issues by actors affects their decisions. Socio-economics was described in Chapter 3 – "Socioeconomic". It is based on insights from economics and sociology.

645 For a description of this movement see Minda supra note 569 at 604-614 where the movement is referred to as the New Haven or Reformist School; Gary Minda, Postmodern Legal Movements: Law and Jurisprudence at Century's End (New York: New York University Press, 1995) at 83-105; and Robert Ellickson supra note 573.

646 Ibid.

647 See Minda supra note 569 at 606 footnote 24 where he states: "However, while the second generation of L/E scholars have sought to distance themselves from the conservative influence of their founding
world view which assumes that rationality and economic self-interest establish a universal principle for the understanding law and adjudication."

In corporate law, the economic conception of the corporation is now being challenged not just by progressive law scholars by also by practitioners of economic theory. For example, there are two new competing conceptions of the corporation based on economic theory that are gaining support: Socioeconomics and Team Production Theory. Both of which challenge the basic assumptions of the Nexus of Contracts theory. In the case of Socioeconomics, the challenge is broad and includes the questioning of most of the assumptions of neoclassical economics. In the case of Team Production theory, it is the assumption that shareholders are the residual claimants that is challenged.

The consensus among the practitioners of the economic theories appears to be waning, largely as a result of the movement away from the assumptions of neoclassical economics.

648 Minda supra note 569 at 611.
Conclusions of the Criticisms of Economic Theories

The economic conception of the corporation, law and economics and economic theory in general were originally thought to have intellectual appeal because: they were simple, they had universal application, they were predictive, they were objective and only dealt with the value free concept of efficiency, and there was a consensus among their practitioners. However, as the theories have risen to prominence we have realized that: they are too simple because their assumptions did away with all of the complexity of real life, their universal application only holds within the institutional structure of western capitalist societies, their predictive value in capitalist societies has been questioned, their objectivity has been recognized as political theory and their own proponents are starting to question their most basic assumptions. This is not a reassuring position for a dominant theory to be in.

The Performance of the Economic Conception of Corporation

What has the result been of 25 years of the dominance of economic theory in American society? The results are not surprising for a theory that purposefully assumed away the moral and social aspects of human society. The American economy appears to be performing well. American corporations are by far the largest and most profitable in the world. North America has one of the highest standards of living in the world and is the envy of many other countries. Although, cracks are starting to be seen. Debts levels in the America have reached all time highs and it cannot seem to combat its

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650 Remember, 25 years is a long period of time for a single theory to hold dominance over a society. As John Ralston Saul reminds us: "This is a very long trial period – five times the length of a world war, double the reign of Napoleon who changed the face of Europe, longer than the reign of Stalin or Roosevelt, whose regimes had such fundamental impacts." See Saul, Supra note 617 at 136-137.
ever growing trade deficit. In effect, the United States may be living the high life on borrowed money. In stark contrast, and not surprisingly, U.S. society seems to be performing extremely poorly on the moral and social level. The chronic problems with unemployment, poverty, crime and education are but a few examples.651

What about the performance of the economic conception of the corporation? Has it achieved its own identified goals? While it would be extremely hard to make any serious empirical claims about the economic conception of the corporation, we can gauge the performance of the economic conception of the corporation by asking two simple questions related to two of its dominant characteristics: First, has the conception ensured that the corporation is run in the best interest of shareholders as the residual claimant? Second, has the conception effectively policed managers of the corporation to ensure that they do not act in their own self-interest?

The Returns to Shareholders

One potential way to measure the effectiveness of the economic conception of the corporation in achieving its stated objective of ensuring that the corporation is run in the best interest of shareholders, is to track overall returns to shareholders. If the economic conception of the corporation was effective, in this regard, then we would expect to see an increase in returns to shareholders, especially in the period following 1932 that signaled the beginning of shareholder primacy.

651 For a critique of these social issues see Saul supra note 617.
Jeremy Siegel, a Professor of Finance at the Wharton business school, has compiled a dataset of U.S. annual stock returns from 1802-1990. He showed that returns on equity – or the returns to shareholders of corporations – in the United States has stayed relatively constant from 1802 to 1990. This finding is surprising. In fact, Siegel himself notes this observation:

One of the striking aspects of these data is the relative constancy of the real returns on equity across all the sub periods.

In particular, for the period between 1871-1925 that corresponds roughly to the rise of the large industrial corporation in the United States and period before official shareholder primacy, annual real returns on equity were 6.6%. For the period of 1926-1990, that roughly corresponds to the period of official shareholder primacy, annual real returns on equity were 6.4%. This data indicates that that shareholder primacy has had little effect on the returns of shareholders.

**The Policing of Corporate Managers – The Agency Problem**

One possible way to measure the performance of the policing function of the economic conception of the corporation, is by looking at historical trends in the level of executive compensation. Until quite recently, this was a difficult task because there was no single study that covered executive compensation from 1930 to the present day. In
an as yet unpublished work Carola Frydman, from Harvard University, and Raven Saks, from the Federal Reserve, have constructed the first comprehensive dataset of executive compensation, covering most of the 20th century. The data set was compiled from proxy statement information filed with the SEC from 1936 to the present day. The sample of the dataset included the 50 largest publicly traded corporations ranked according to value of sales in each of 1940, 1960 and 1990. The total sample size was 102 firms. It includes compensation data for the 3 highest paid officers in each corporation. The compensation measured included salary, bonus, long-term incentive payments and options but did not include pensions or perquisites.

The data is again surprising. On an absolute basis executive compensation has grown dramatically since 1936. A closer look at the data shows that executive compensation actually declined by more than 20% during World War II and increased only gradually during the period between the 1950's and 1970's (less than 1% per year). Then in the 1970's, compensation increases started to accelerate. They increased an average of 3.1% annually through the 1970's, 5.6% through the 1980's and a startling 18.5% in the 1990's.

The data from the relative measures of executive compensation are even more surprising. When compared to the average salary of a worker in society, executive

1968); Harold Wattel et al., Chief Executive Officer Compensation (New York: Hofstra University, 1978); and Kevin Murphy, “Corporate Performance and Managerial Renumeration: An Empirical Analysis” (1985) 7 Journal of Accounting and Economics 11.


657 Ibid at 3.
658 Ibid.
659 Ibid.
660 For a discussion of the methodology of the study see ibid at 3-8.
661 Ibid at 9.
compensation stood at 63 times the average salary before World War II. By 2000, it had
sky-rocketed to 330 times the average earnings in the economy. More than triple the
level of the 1930’s. Again, when the data is analyzed more closely, executive
compensation actually declined on a relative basis from 1950 to 1970, when it was
around 30 times earnings. Then in the 1970’s, executive compensation increased
dramatically on a relative basis to its high in 2000.662

This data highlights two points. First, Managerialism, or the Adolph Berle and
Gardiner Means version of shareholder primacy,663 may have been successful at policing
managers. Executive compensation in the years following 1932 declined or stayed
relatively stable until the 1980’s. It is difficult, however, to draw a conclusion that a
causal relationship exists. Second, the economic conception of the corporation appears to
have been a spectacular failure at policing managers. Executive compensation has been
growing at an alarming rate since it rose to dominance in the 1980’s.

Summary on the Performance of the Economic Conception of the Corporation

From this limited data, there is reason to question whether the economic
conception of the corporation has achieved its goal of ensuring the accountability of
managers.664 The data on shareholder primacy is inconclusive.

662 Ibid at 13-14.
663 For a complete description of Managerialism see Chapter 3 – “Managerialism”.
664 For a discussion of the failure of the current corporate structure to control manager’s pay see Lucian
Bechuk and Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation
(Cambridge: Harvard University Press, 2004); Lucian Bechuk, David Walker and Jesse Fried,
4 Journal of Economic Perspectives 72.

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4.4 Conclusion

This chapter has illustrated two very important points: First, the economic conception of the corporation is not a value free and objective theory. It is a normative theory. Furthermore, the value judgments that form the normative core of the theory are not moderate. Remember the location of the economic conception of the corporation on the Assumptions Chart in Chapter 3. The strong bias of the theory in favour of the individual over the group and private markets over government intervention were forged during the Cold War, in direct opposition to socialist principles, and they reflect that polarization. The dominance and political nature of the economic conception of the corporation creates a danger that it will become ideological. Second, the original intellectual appeal of the economic conception of the corporation that contributed to its rise to dominance is no longer persuasive. All of this indicates that we need to be careful in applying the economic conception of the corporation in our society.

The problem with western economic theory, law and economics, and the economic conception of the corporation, is that human complexity has been assumed out of them. In order, to move our understanding forward we need to make our theories more complex – or as was discussed in the Introduction to this book move ‘up’ the systems chart. Currently, it looks like any progress that we make in that regard will be in either integrating moral and social aspects into economics or dealing with new theories that focus on those human complexities.

The big question to ask is: do we try doing that within the framework of economics and modify a theory that was originally designed to assume no moral or social complexities in markets. Or, do we move into new territory to see what other theories can
offer to our understanding of society, markets and the corporation? No doubt progress is being made in accommodating insights from psychology and sociology into economics by behavioral economists; into the law and economics movement, by the second generation law and economics scholars; and into corporate theory through the work of Lynne Dallas and other practitioners of law and socioeconomics. But, as this chapter has shown, the limiting characteristics of economic theory’s basic assumptions, make it ill suited to deal with the moral and social aspects of society, markets and corporations. Thus, as corporate theory moves forward, the economic conception of the corporation’s period of dominance may be come to an end and the focus may shift to social theories that are better at explaining the complexity of human social life.

CHAPTER 5: THE LINK BETWEEN ORGANIZATIONAL THEORY AND CORPORATE THEORY

5.1 Introduction

The corporation is a social institution. Therefore, it needs to be analyzed as one.\(^{666}\) It can no longer be analyzed solely with economic analysis. The analysis must be broadened out to include the incredible number of theories and amount data that have been generated about organizations and social institutions in other disciplines and, in particular, organizational theory and economic sociology. To date, most of this literature has been vastly underrepresented in modern corporate law literature. It is a curious fact that modern Anglo-American corporate law, that is in essence the law of a particular type of organization, has been so uninterested in the broader developments in the social sciences that relate to how organizations are created, maintained and change.\(^{667}\)

The next two chapters provide a summary of the insights from organizational theory and economic sociology that are relevant to corporate theory. The goal of these two chapters is to provide a basic introduction to the concepts from each field and to provide roadmaps of the fields for those interested in delving deeper into the literature. These chapters are important because they introduce theorists, concepts, studies and ideas that are very important to corporate theory and have largely been overlooked. In fact, the insights offered by organizational theory and economic sociology, when combined, make it possible to develop an updated version of the social theory of the corporation. The basic building blocks of the ‘social theory’ of the corporation are outlined in Chapter 6.

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\(^{666}\) See Berle and Means supra note 35 at 309 where they state: “The institution here envisaged calls for analysis, not in terms of business enterprise but in terms of social organization”.

\(^{667}\) With the exception of the organizational theories mentioned in Chapter 5 – “The Link Between Corporate Theory and Organizational Theory.”
5.1.1 Sociology, Economic Sociology and Organizational Theory

Sociology is the study of human society and social action. As a field it is very broad. However, it has always been concerned with the relationship between society, the economy and organizations, and, in particular, business organizations. This interest in the economy can be seen in the work of the three founding fathers of sociology Max Weber, Emile Durkheim and Karl Marx.\(^{668}\) Unfortunately, summarizing all of the insights from sociology that are relevant to corporate theory is beyond the scope of this book.\(^{669}\) The choice was made in this book to focus only on economic sociology and organizational theory for two reasons: First, they are the areas of sociology that are the most relevant to corporate theory and therefore offer the most insight. Second, they are the most multi-disciplinary fields in sociology because they have been heavily influenced by economics and other disciplines. This makes them easier to understand for non-sociologists.\(^{670}\)

Economic sociology is “the study of how the material production and consumption of human populations depend on social processes for their structure and dynamics.”\(^{671}\) Economic sociology differs from economics because it takes into account

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\(^{668}\) The representative works of the three founding fathers are outlined in the following notes: Max infra note 806; Emile Durkheim infra note 807 and Karl Marx infra note 808. It is also interesting to note that both Max Weber and Karl Marx were also lawyers. Therefore, these two theorists brought the insights from three disciplines into their work: economics, sociology and law.

\(^{669}\) Examples of other fields in sociology that could have been included in this book include social stratification studies, racial studies, gender studies, cultural studies etc. For examples of how cultural studies are important to the analysis of corporations see Viviana Zelizer, “Enter Culture” in Mauro Guillen et al., eds, The New Economic Sociology (New York: Russell Sage, 2003) at 101

\(^{670}\) Sociologists have a habit of communicating in ways that are only understandable to other sociologists. The summaries provided in this book have been presented in the most straightforward way possible.

\(^{671}\) See Fliigstein supra note 596 at 6. It should be noted that the term “Economic Sociology” as used in this book refers to “New Economic Sociology”. This term was coined by Mark Granovetter in 1985. It is used to differentiate the newer studies in economic sociology that have a more confrontational stance with economics from the older works in economic sociology that did not. For a discussion of the labeling of “New Economic Sociology” see Richard Swedberg supra note 33 at 32-33 where he provides: “According to Granovetter, new economic sociology ‘attacks neoclassical arguments in fundamental ways,’ and it
the effects of society and social structures on the economy. Economic sociology is detailed in Chapter 6.

Organizational theory is the study of how organizations are created, maintained and changed. Both economic sociology and organizational theory are sub-fields of sociology. They are also both closely related to economic theory. This close relationship among sociology, economics, economic sociology and organizational theory is depicted in Figure 5-1. The lines in the diagram are all dashed because it is becoming increasingly difficult to make clear distinctions between economics and sociology and between the various sub-fields.

This chapter will illustrate the strong link between organizational theory and corporate theory. Many of the advances in corporate theory over the last half century have been the result of advances that occurred first in organizational theory. This is not a surprise because both theories try to answer the same question. In organizational theory the primary question is: “What is an organization?” Corporate theory is simply a

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Economist Joseph Schumpeter has described this difference: “To use a felicitous phrase: economic analysis deals with the questions how people behave at any time and what the economic effects are they produce by so behaving; economic sociology deals with the question how they came to behave as they do. If we define human behavior widely enough so that it includes not only actions and motives and propensities but also the social institutions that are relevant to economic behavior such as government, property inheritance, contract, and so on, that phrase really tells us all we need.” See Joseph Schumpeter, *History of Economic Analysis* (London: Allen & Unwin, 1954) at 21.

Mauro Guillen and others have argued that organizational theory has drifted away from sociology over the years and that organizational theories (including resource dependence, population ecology and transaction cost analysis) have few connections with other sociological areas. Although, this trend has reversed in recent years. For a discussion of this see Mauro Guillen, Randall Collins, Paula England and Marshall Meyer, “The Revival of Economic Sociology” in Guillen, Randall Collins, Paula England and Marshall Meyer, *The New Economic Sociology: Developments in an Emerging Field* (New York: Russell Sage, 2003) at 3.

For example, the Nexus of Contracts theory was a direct result of advances in the economic branch of organizational theory in the 1970’s with Oliver Williams transaction cost analysis and the agency theory of Jensen & Meckling. For a brief description of these theories see “Transaction Cost Theory” and “Agency Theory” below.

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subset of that question: "What is a corporation?" The answer to corporate theory’s question is that the corporation is a specific type of organization: a social institution.

Organizational theory is important to corporate theory for three reasons: First, an acceptable corporate theory cannot be generated without understanding the social phenomenon that it is explaining. This was the major insight of Hallis’ early sociological theory of the corporation. D.P. Derham has also explained it this way:

All the [corporate] theories have much to say of value about the non-legal phenomenon comprehended by the legal rules. It is necessary for the lawyer and legislator to be informed about human personality, about the nature of groups and their activities, about human purposes whether individual or communal, about the actual relations developed or developing between men in society, for this is the stuff without which law as an applied science has no content or meaning.

Second, in order to truly understand our dominant corporate theory, and its limitations, we need to understand the organizational theories that it is based upon, their normative assumptions and the context in which they were developed. Third, corporate theory needs to keep pace with the advances made in organizational theory. As our understanding of organizations increases so should our understanding of corporations.

Unfortunately, corporate theory has not kept pace with developments in organizational theory. The current dominant corporate theory, the Nexus of Contracts theory, is based on a set of organizational theories that were developed in the 1970’s. Since that time, organizational has evolved and progressed to a new set of organizational theories. The new theories have become accepted because they have moved past simplistic analysis and become more complex. This allows them to provide a richer

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675 See Chapter 3 – “Early Sociological Theory”
676 Derham supra note 15 at 11.
677 These theories are best described as rational open systems theories. A description of these theories see “The Historical Development of Organizational Theory” below.
678 These theories are referred to as natural open systems theories. For a description of these theories see “Natural Open Systems Theories” below.
explanation of how organizations work. Despite efforts by some progressive corporate law scholars, most notably Lynn Dallas, Anglo-American corporate theory has not incorporated these developments.\textsuperscript{679} The result is that Anglo-American corporate theory and corporate law are based on outdated theories that are more simplistic than they need to be. This deficiency should be remedied. If there is a more complex theory of organizations that is as good or better at describing the corporation and its environment, predicting behaviour and it is still consistent with the normative assumptions of our societies, we should start to use it.\textsuperscript{680}

This chapter has three primary goals. The first goal is to provide an introduction to organizational theory by outlining its various theoretical paradigms. Organizational theory is a complex field, but, as was stated in Chapter 2, this is understandable because the field deals with complex social phenomena.\textsuperscript{681} The classification of organizational theories provided in this chapter should help to make the theories accessible.\textsuperscript{682} The second goal is to provide a brief summary of the historical development of organizational theory. The aim of this analysis is to show the link between the development of organizational theory and the development of corporate theory. The third goal is to illustrate that organizational theory has advanced to a new level of analysis that is able to

\textsuperscript{679} For example, Lynn Dallas' Power Coalition Theory is a natural open systems model of corporate theory. This theory did not receive much support and Dallas has since moved on to support a socioeconomic theory of the corporation.

\textsuperscript{680} These three criteria are the criteria for a 'better' corporate theory that were outlined in Chapter 3. This sentence is complicated by the fact that there is really no single organizational theory that is better. There is a set of organizational theories that are better. So the sentence should really read: "If we have a more complex set of theories of organizations that the one we are using and those theories are as good at describing the corporation and its environment, predicting behaviour and are consistent with the normative assumptions of our society, we should use them." This is explained in more detail in the "Introduction to Organizational Theory" below.

\textsuperscript{681} Organizations are level 8 systems on the Systems Classification Chart provided in Chapter 2.

\textsuperscript{682} The classification scheme presented in this chapter is W. Richard Scott's classification scheme. See W. Richard Scott, \textit{Organizations: Rational, Natural and Open Systems}, 5\textsuperscript{th} ed. (Toronto: Pearson Education, 2003).
accommodate more complex relationships and that corporate theory has not kept pace with these developments.

The chapter is organized into four parts. The first part is an introduction to corporate theory. The second part is a summary of the historical development of organizational theory. The third part explains the link between organizational theory and corporate theory. The fourth part concludes with a note about the increasing complexity of theory in both organizational theory and corporate theory.

5.2 Introduction To Organizational Theory

5.1.2 The Importance of Organizations in Modern Society

Corporations are not the only large scale organizations that are important in modern western societies. Organizations of all kinds have become a regular part of our everyday lives. In fact, organizations have found their way into almost every area of our social existence. W. Richard Scott, in his text on organizational theory emphasized more than once the importance of organizations in modern society:

Organizations play a leading role in our modern world. Their presence affects - some would insist that the proper term is infects - virtually every sector of contemporary social life. Peter Drucker observes, ‘Young people today will have to learn organizations the way their forefathers learned farming.’

There is no need to belabor the assertion that ours is an organizational society – that organizations are a prominent, if not the dominant, characteristic of modern societies.

683 Ibid at 5.
684 Ibid 683 at 1.
685 Ibid at 3.

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Neil Fligstein, another organizational theorist, has argued that organizational theory has become prominent because of the increasingly important role of organizations in society:

Organizational theory is one of the most vibrant areas in sociological research. Scholars form many subfields have felt compelled to study organizational theory because of the obviously important role that complex organizations play in their empirical research.\textsuperscript{686}

Examples of other important organizations in society are: the government, non-profit organizations, hospitals, school and universities, and social clubs, to name a few.

5.1.3 Definition of Organizational Theory

Organizational theory is the study of how organizations are created, maintained and changed. Organizational theory focuses on two primary relationships: the internal structure of the organizations and the relationship between the organization and its external environment. Neil Fligstein has described the scope of organizational theory in the following way:

Organizational theory is concerned with how the internal organizational structure works to motivate participants and produce outcomes consistent with the goals of those who control the organization. It is also interested in how the world external to an organization effects what is going on inside of a particular organization. Finally, it is concerned with how the internal organization and the external world can effect organizational survival.\textsuperscript{687}

5.1.4 The Strengths of Organizational Theory

The most significant strength of organizational theory is that it has been a multidisciplinary pursuit since the Second World War. The importance and complexity of

\textsuperscript{686} Neil Fligstein \textit{supra} note 157 at para 1.
\textsuperscript{687} \textit{Ibid} at para 5.
organizations have captured the interests of scholars from such diverse fields as psychology, sociology, economics, management science and anthropology, to name a few.

5.1.5 The Weaknesses of Organizational Theory

There are two significant weaknesses with organizational theory. The first weakness is the tendency of organizational theory to overemphasize the effect that social structures have on individual decision making. The second weakness is the sheer number of different organizational theories.

The tendency of organizational theory to enslave individuals to social structures has been noted by many scholars. Scott referred to this danger in organizational theory when talking about the dual structure of social institutions:688

This conception helps to correct for an all-too-common sociological bias: *an emphasis on the power and weight of existing social arrangements coupled with a discounting of the importance of individual imagination and initiative.* Sociological work on organizations all too often carries an overly deterministic perspective. On the other hand, it also guards against the more common individualistic bias, particularly pervasive in American culture, that disembeds individuals from their social moorings and attributes all developments to individual interests and will.689 [Emphasis added]

This ‘oversocialized’ view of human actors was predominant in sociology and organizational theory in the 1950s and 1960s. It resulted from the development of grand social theories that did not leave room for individual choice or action.690 Since that time, organizational theorists have resisted the urge to create grand social theories, for fear of

688. The dual structure of social institutions refers to the ability of a social institution to be a socialization process and an outcome of a socialization process. See the discussion of the work of Lynn Zucker presented in Chapter 2 – "Social Institutions, Sociology and Organizational Theory."

689. Scott *supra* note 683683 at 22. Fligstein advocates the adoption of a ‘political cultural’ approach to these questions. This theory is a natural and open systems theory of organizations and markets and it is characterized by its conflict approach. This theory is discussed in more detail in Chapter 6 – "The Social Theory of the Corporation."

690. Examples of such theories include the work of Talcott Parsons see note 813 for his representative works.
repeating the same mistakes. However, using new insights in organizational theory, models can be developed that take into account the significance of both social structures and individual action.⁶⁹¹ Mark Granovetter outlined this possibility:

Most sociologists have veered away from theoretical arguments based on actors’ shared value commitments because of the excesses of mid-twentieth century sociology. This view, which has been called ‘oversocialized’, leaped from observing that such commitments are a significant force in social life to the conclusion that all social action flows from them. The opposite extreme is to imagine that moral sense about the economy is entirely subordinated to and derived from some theological quest for efficiency pursued by social systems, so that observed norms, though admitted to be important, can be assumed to have been selected out for their economic efficiency. The time has come to find a balanced account, that is, to acknowledge the importance of such norms and conventions while fitting them into a broader frame of social theory.⁶⁹²

As will be shown in the next two chapters, organizational theory and economic sociology are beginning to overcome this limitation.

The second weakness of organizational theory is that the sheer number of theories makes the field difficult to understand for everyone including students and scholars. W. Richard Scott described it this way:

The current profusion of multiple competing theoretical perspectives necessarily poses difficult problems for all of us – from beginning student to seasoned scholar – working in the field. . . Suffice it to say that while the existence of multiple paradigms may reduce consensus and support, it may also reflect the complexity of the phenomenon addressed and improve our analytic capacity by providing multiple lens through which to observe the world.⁶⁹³

In contrast to Scott, Neil Fligstein has argued that modern sociology is too focused on narrow practical studies and does not focus enough on grand theories of how society and

⁶⁹¹ Scott’s ‘Layered Approach’ to organizational theory allows such developments, see Chapter 5 – “Scott’s Account of the Historical Development of Organizational Theory”. This approach of combining structures with individual action is used in the construction of the social theory of the corporation offered in Chapter 6.


⁶⁹³ See Scott, supra note 683 at 121.
markets work. In his mind, the only thing that holds the field together is its critique of the economic view of markets. His view is illustrated in the following quote:

Over the past 20 years, a large number of important books and papers have defined the terrain of a sociological approach to market processes. As it stands, however, the field lacks a coherent intellectual structure. It remains a set of insights into the difficulties that economic analysis runs into when confronted by the real world of firms, states, and courts.

Scott’s view is that there is a valid reason why grand theories have not yet been developed. In his opinion, organization theories do not yet have the complexity of analysis to explain all of society. Organizational theories have only progressed so far. Using the Systems Classification Chart from Chapter 2 – they have only progressed to the point where we have level 4 systems. As of yet, no single theory explains the functioning of an entire human social system. Therefore, it is premature to choose one theory, over all others, as the theory that explains organizations the best. In fact, Scott argues that each theory is particularly good at explaining a certain type of organization or a certain aspect of organizations. The result is that the most complete analysis that we can currently make of an organization may include the use of more than one organizational theory. This is completely acceptable. It recognizes the limitations of our theories. Scott refers to this as a “Layered Approach”.

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694 For example, Fligstein has written: “Unlike the sociological classics, the modern sociology of markets rarely connects its theoretical ideas to a broader vision of society or societal change. Instead, most studies focus on their empirical object and the literature in which it is embedded. The element that holds the field together is its opposition to the neoclassical model of perfect competition.” Fligstein, supra note 696 at 8.

695 Ibid. This interpretation of modern sociology is consistent with the interpretation of the progressive law movement that was advocated in Chapter 2. See Chapter 2 “Progressive Law Critiques and Theories.”

696 Fligstein supra note 596 at xiii.

697 The abundance of theories in organizational theory and economic sociology has been referred to by Carlo Trigilia as “Interpretive Pluralism” – or the coexistence of different interpretive models. Trigilia agrees with Scott. He argues that interpretive pluralism is a characteristic of any field that studies society because society itself is so complicated. See Carlos Trigilia supra note 42 at 11-12.

698 Remember back to Boulden’s systems chart in Chapter 2.

699 This layered approach is discussed later in Chapters 6 and 7.
Neil Fligstein disagrees. He has advocated the creation of a consensus among sociologists of how markets function from a sociological point of view. His 2001 book *The Architecture of Markets* was a first attempt to generate such a view. In the preface to that book, he outlines his argument:

I think the real frontier here, however, is to create an alternative sociological view of markets in capitalist society. But to do so requires that one look at these social relations from a sociological point of view. . . A coherent sociological view must begin by developing a distinctly sociological view of markets, market participants, and what actors around markets are doing that takes social relations, power, and meaning as its core elements.

I had not intended to write this book. But I found myself frustrated by the contemporary sociological literature, which lacked coherent theorizing about social structures, social relations, and institutions and how they operate to produce stable markets. Sociologists have not done a very good job of thinking about first principles in this context. For instance, what is a market from a sociological point of view? What are actors doing in markets that differs from what economics says they do? What social relations are necessary to provide the 'non-contractual basis of contract' that makes markets possible?700

“My criticisms lead me to the following conclusion. To have more impact, the sociology of markets needs to be clarified theoretically.701

The reason Fligstein offers for requiring this consensus view is that sociological theories will never be listened to by economists, policy makers or society at large, until they offer predictive tools for policy making.702 This argument is persuasive. In Chapter 4, it was shown how consensus within economics contributed to the rise of economic analysis in American society. In effect, Fligstein is making the same argument in support of sociology. He has argued that until consensus is achieved, sociological work may continue to be ignored outside of the field:

[T]here is an even more important reason why economists ignore the body of noneconomic work. Put simply, it is because the work has failed to provide

700 Fligstein, *supra* note 596 at xiii.
701 Ibid at 9.
702 See *ibid* at 9.
alternative theoretical tools to make sense of economic processes. Scholars have demonstrated that market processes are shaped by social structures. Yet we have done little to generate systematic theory about what we mean by structure and how, why, and which structures are consequential for market organization. This is because sociological approaches lack a broader, organizing frame to understand economic processes as generic social processes operating in a particular institutional situation, that is, the construction of markets. In essence, the sociology of markets lacks a theory of social institutions.  

Fligstein’s view is shared by two of the most prominent European sociologists: Nicholas Luhmann and Pierre Bourdieu. Luhmann has argued that economic sociology needs a full theory of the economy as an embedded subsystem in society:

[Economic sociology can only develop if its approach is overhauled and it sets out . . . from the concept of the economy as a subsystem of society.]

Bourdieu has argued passionately that sociologists need to leave their ‘ivory towers’ and become engaged in the political process and policy making decisions:

For reasons no doubt relating to my own person and to the state of the world, I have come to believe that those of us who have good fortune to be able to devote their lives to the study of the social world cannot stand aside, neutral and indifferent, from the struggles in which the future of that world is at stake.

In the end, both Fligstein and Scott are correct. The field would definitely benefit from some consolidation of the insights offered by the various theories to present a more complete theory of how people, organizations and markets work from a sociological perspective, if for no other reason than to act as a foil for the economic theories that have become so popular but which bear so little resemblance to reality. Similarly, Scott’s

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703 Ibid at 8. As a solution, Fligstein proposes a redefining of the field to focus on five common questions: 1. What social rules must exist for markets to function, and what types of social structures are necessary to produce stable markets? 2. What is the relation between states and firms in the production of markets? 3. What is the ‘social’ view of what actors seek to do in markets, as opposed to an ‘economic’ one? 4. What are the dynamics by which markets are created, attain stability, and are transformed, and how can we characterize the relations among markets? 5. What are the implications of market dynamics for the internal structuring of firms and labor markets more generally? see pages 10-15.


insight is equally valid. No matter how much consolidation occurs in the field, at this time, no single theory will be able to explain an entire social system. Therefore, the combination of theories will still be required to understand social phenomenon.

5.1.6 The Definition of an Organization – The Three Theoretical Perspectives

The definition of an organization in organizational theory depends on which theoretical perspective is adopted. W. Richard Scott in his book *Organizations: Rational, Natural and Open Systems* classifies organizational theories into three dominant perspectives: rational, natural and open systems. Scott’s classification scheme will be used in this chapter because it is particularly effective at highlighting the differences between organizational theories, making the theories easy to understand and making the theories accessible. His classification scheme is widely used by organizational theorists. Scott’s classification of the theories is summarized below.

*Rational Systems Perspective*

The rational systems perspective views organizations as tools designed to attain specific goals. The perspective defines organizations in the following way:

Organizations are collectivities oriented to the pursuit of relatively specific goals and exhibiting relatively highly formalized social structures.

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706 Scott’s use of the terms “perspective” to refer to these three groups of theories was purposeful: “The term *perspective* is used advisedly since we are dealing in each case not with a single unified model of organizational structure but rather with a number of varying approaches that bear a strong family resemblance.” See Scott, *supra* note 683 at 31.

707 See Scott *supra* note 682 at 33.

708 *Ibid* at 27. Other examples of rational systems definitions of organizations are: Blau and Scott (1962) at 2, where the authors state: “Since the distinctive characteristic of...organizations is that they have been formally established for the explicit purposes of achieving certain goals, the term ‘formal organizations’ is used to designate them”; Adam Etzioni, *Modern Organizations* (Upper Saddle River, N.J.: Prentice Hall, 1964) at 3, where the author states: “Organizations are social units (or human groupings) deliberately constructed to seek specific goals.”; and James March and Herbert Simon, *Organizations* (New York: John
This definition illustrates the two structural features of organizations that the rational systems perspective argues differentiates organizations from other social groups: goal specificity and a high degree of formalization. Goal specificity refers to the fact that organizations have clear goals that provide “unambiguous criteria for selecting among alternative activities.” The clearer and more ‘specific’ the goals the more successful the organization will be because it can more easily be designed to meet those goals. Formalization refers to the deliberate structuring of the roles and relationships among participants in an organization. Organizations achieve their goals by implementing these formal systems to obtain maximum efficiency (meaning in this case - goal attainment).

This perspective tends to view organizations as if they were mechanical devices that operate in specific predetermined ways. Scott describes this belief as follows:

Thus, in a fundamental sense, the organizational structure is viewed as a means, as an instrument, which can be modified as necessary to improve performance.

The appropriate metaphor for this perspective would be that of a clock or other mechanical device. One of the implications of this perspective is that the structure of the

Wiley, 1958) at 4, where the authors state: “Organizations are assemblages of interacting human beings and they are the largest assemblages in our society that have anything resembling a central coordinative system. . .The high specificity of structure and coordination within organizations-as contrasted with the diffuse and variable relations among organizations and among unorganized individuals-marks off the individual organization as a sociological unit comparable in significance to the individual organism in biology.”

For example, Scott writes: “Specific goals not only supply criteria for choosing among alternative activities; they guide decisions about how the organization structure itself is designed. They specify what tasks are to be performed, what kinds of personnel area to be hired, and how resources are to be allocated among participants. The more general or diffuse the goals, the more difficult it is to design a structure to pursue them.”

This idea has led to the development of organizational charts, work-flow diagrams and other process mapping technologies.
organization is more important than its participants and the human and individual characteristics of the participants in the organization become irrelevant. The organizational structure becomes independent of its participants, participants are not required to have any special skills and they are simply slotted into roles as interchangeable parts of the overall machine. Early rational systems theories also did not take into account the effects of the larger social or cultural context on an organization or its structure. They were primarily focused on the internal structure of the organizations.

Examples of organizations that fit this perspective are the army and certain government bureaucracies. The definition and characteristics of the perspective are summarized in Table 5-1. The best example of a rational systems theory is Frederick Taylor’s scientific management theory. Other examples of rational systems theories are Weber’s bureaucracy theory, Fayol’s administrative theory and Simon’s decision making theory. These theories are included in Table 5-2 which is a reproduction of Scott’s classification scheme.

The scientific management approach to organizations was developed by Frederick Taylor. It can be seen as part of the larger movement in the United States during the period between 1880 and 1920, when engineers took control of large U.S. corporations and began to rationalize the organizations in the same way they rationalized the

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715 See ibid at 37 where he states: “Formalized structures are thus rendered independent of the participation of any particular individual. A related consequence is that it becomes less essential to recruit unusually gifted individuals for key positions. The power and influence of leaders can be determined in part by the definition of their offices and not made to depend on their personal qualities — their charisma.”

716 See ibid at 55.

717 Each of these theories is summarized in Scott ibid.

manufacturing process. Fligstein referred to this movement as the ‘Manufacturing Conception of Control’. Taylor believed that the tasks of an individual worker could be scientifically analyzed and redesigned to ensure that the maximum output was received from the minimum input of time and energy. This movement met with significant social unrest. Workers resisted attempts to standardize their jobs and rejected incentive programs designed to entice them to work continuously at peak efficiency. This is an example of Polanyi’s double movement: Scientific management attempted to commodify labour and society responded by trying to protect people.

The rational systems definition of an organization is the dominant perspective in organizational theory and also in practice among managers of organizations.

**Natural Systems Perspective**

The natural systems perspective emphasizes that organizations are collectivities of human actors and not tools designed to meet specified goals. The following quote from Peter Blau illustrates this point:

> To administer a social organization according to purely technical criteria of rationality is irrational, because it ignores the nonrational aspects of social conduct.

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720 This was discussed in Chapter 4. See Chapter 4 – “The Finance Conception of Control.”
722 See *Ibid at 38,* where he states: “The extension of standardization principles to workers was associated with an increase in industrial rest during the period 1900-1920.”
723 See *Ibid at 40.*
724 See *Ibid at 25* where he states: “Special attention is accorded here to the [rational systems] definition because it continues to be the dominant perspective in the field, not only in guiding the work of the majority of organizational scholars, but also by being embraced at least implicitly by most real-world managers and other practitioners.”
725 Peter Blau, quoted in Scott *ibid* at 56.
This perspective emphasizes that organizations are social groups attempting to survive and adapt in their particular circumstances.\(^{726}\) Organizations are similar to all other types of social groups and, therefore, are subject to the forces that affect all social systems.\(^{727}\)

The perspective defines organizations in the following way:

Organizations are collectivities whose participants are pursuing multiple interests, both disparate and common, but who recognize the value of perpetuating the organization as an important resource. The informal structure of relations that develops among participants is more influential in guiding the behavior of participants than is the formal structure.\(^{728}\)

This definition recognizes the emphasis of the natural systems perspective that the primary goal of an organization is the survival and maintenance of the organization itself.\(^{729}\) In direct contrast to the rational systems perspective, this perspective acknowledges that organizations are characterized by: goal complexity and the importance of informal structures. Goal complexity is the ability of an organization to pursue a multitude of goals at the same time.\(^{730}\) This perspective also emphasizes that the informal structures (norms, culture, beliefs etc.) of an organization are as important as its formal structures (roles and responsibilities, rules, codes of conduct etc.). Scott describes the importance of informal structures to this perspective:

Natural systems analysts emphasize that there is more to organizational structure than the prescribed rules, the job descriptions, and the associated regularities in the behavior of participants. Individuals are never merely ‘hired hands’ but bring

\(^{726}\) See *Ibid* at 57.

\(^{727}\) *Ibid* at 28.

\(^{728}\) *Ibid* at 28.

\(^{729}\) *Ibid. See also* Alvin Gouldner, “Organizational Analysis” in Robert Merton, Leonard Broom, and Leonard Cotrell, eds., *Sociology Today* (New York: Basic Books, 1959) at 405, where he stated: “The organization, according to this model, strives to survive and to maintain its equilibrium, and this striving may persist even after its explicitly held goals have been successfully attained. This strain toward survival may even on occasion lead to the neglect or distortion of the organization’s goals.” To illustrate this point, Scott provides the example of the National Foundation for Infantile Paralysis that changed its name and continued on after a cure was found for its disease.

\(^{730}\) *Ibid*. The classic example of multiple goals is that an organization, in addition to pursuing its stated objective, must also spend time and energy maintaining itself. Other examples include personal goals of participants or goals of specific departments or subgroups within the organization.
along their heads and hearts; they enter the organization with individually shaped ideas, expectations, and agendas, and they bring with them distinctive values, interests and abilities.

Expressed through interaction, these factors come together to create a reasonably stable informal structure. One of the most important insights of the natural systems perspective is that the social structure of an organization does not consist of the formal structure plus the idiosyncratic beliefs and behaviors of individual participants but rather of a formal structure and an informal structure: informal life is itself structured and orderly. Participants within formal organizations generate informal norms and behavior patterns: status and power systems, communication networks, sociometric structures and working arrangements.\textsuperscript{731}

This perspective tends to view organizations are if they were living organisms. The appropriate metaphor for this perspective would be that of the human body. An example of an organizational type that fits this perspective is the Japanese Keiretsu during the 1980's.\textsuperscript{732} The definition and characteristics of the perspective are summarized in Table 5-1. Examples of natural systems theories are Philip Selznick’s early institutional theory, Elton Mayo’s human relations school, Barnard’s cooperative systems, and Talcott Parsons AGLI model of society.\textsuperscript{733} These natural systems theories are included in Table 5-2.

Natural systems approaches are characterized by two different types of models: social consensus models and social conflict models. Social consensus models emphasize the common goals and co-operative behaviour of individuals within organizations. These models generally receive more support in North America.

In contrast, Social conflict models find their roots in the work of Karl Marx. These models emphasize that participants in organizations often have divergent interests that come into conflict. Change occurs as often as stability and what stability there is

\textsuperscript{731} Ibid at 59.
\textsuperscript{732} In fact, as an example of this, Sony had an internal corporate structure diagram that depicted the organization as a living tree.
\textsuperscript{733} For a description of these theories see Scott, supra note 682 at 61-76.
results from the dominance of one group (or coalition) of participants over the others. Conflict models generally receive more support in Europe.\textsuperscript{734}

Scott summarizes the differences between the conflict and consensus models in the following quote:

[W]e find replicated in the [natural systems] perspective, the two contrasting versions of the bases of social order in the sociological literature at large: one emphasizing social consensus, the other, social conflict.

The first, social consensus, version emphasizes a view of collectivities as comprised of individuals sharing primarily common objectives. The assumption underlying this conception is that social order (of any type) is a reflection of underlying consensus among the participants; that organizational stability and continuity reflect the existence of cooperative behavior and shared norms and values. This widely held and influential view of the basis of social order is generated in the writings of Durkheim (1961 trans.) and Parsons (1951), among others, and reflected in the organizational theories of Barnard (1938) and Mayo (1945), among others.

The contrasting, social conflict, version views social order as resulting from the suppression of some interests by others. Order results not from consensus, but from coercion, the dominance of weaker by more powerful groups. And analytic attention is devoted not to the appearance of consensus, but to the reality of underlying conflicts, which provide a basis for understanding instability and change. The social progenitors of this view include Marx (1954 trans.) and Coser (1956). Applications to organizations are provided by such theorists as Gouldner (1954), Bendix (1956) and Collins (1975).\textsuperscript{735}

\textit{Open Systems Perspective}

Both the rational systems and natural systems perspective tend to view the organization as a closed system separate from its environment with an easily identifiable

\textsuperscript{734} Scott describes these models in the following way: "Scholars proposing a social conflict model of organizations were a distinct minority, particularly among students of organizations in the United States, and they remain so to this day. Nevertheless, the concerns they addressed are real: conflict and change are a part of organizational life no less than consensus and stability. Interest in these issues developed rapidly after the 1970s and has been reactivated by feminist and critical theorists."

\textsuperscript{735} Ibid at 28.
and stable set of participants. This is considered to be a clear boundary. However, organizations are not closed systems – they are open to and interact with their environments. This is the key insight of the open systems perspective. The open systems perspective emerged as part of the systems theory movement after the Second World War. Systems theory was briefly introduced in Chapter 2 in the discussion surrounding Boulden’s systems classification chart.

The open systems perspective defines organizations in the following way:

Organizations are congeries of interdependent flows and activities linking shifting conditions of participants embedded in wider material-resource and institutional environments.

Open systems organizations are open to their environments and thus it is often difficult to determine their boundaries. For example, which stakeholders are participants in a corporation? Are creditors participants or are shareholders, managers and workers the only participants? Because of the difficulty of defining boundaries, organizations need to expend resources in order to maintain their boundaries.

Open systems also adapt to their environment and become more specialized and complex. This leads to the development of a greater degree of complexity and variability among the different component parts that make up the organization, as those components adapt to deal with circumstances of the specific environments with which they interact. Scott describes it this way:

From an open systems point of view, there is a close connection between the condition of the environment and the characteristics of the systems within it: a complex system could not maintain its complexity in a simple environment. Open systems are subject to what is termed the law of limited variability. A system will

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736 Ibid at 28.
737 Ibid.
738 Ibid at 82.
739 Ibid at 29.
exhibit no more variety than the variety to which it has been exposed in its environment.\textsuperscript{740}

There are two more key concepts associated with the open systems perspective. The first is the hierarchical nature of systems.\textsuperscript{741} The second is that many systems are loosely coupled – especially social systems.\textsuperscript{742}

The hierarchical nature of systems refers to the insight that every system is not only a system in and of itself but it is also a part of a larger system and has other smaller sub-systems within it.\textsuperscript{743} For example, the corporation is a system, but it is also a part of a larger system - the market - and it has smaller systems within it – its various departments.

The loose coupling of systems refers to the fact that many of the components of a system are only weakly connected to the other components of the system and, as a result, can behave in a fairly autonomous way.\textsuperscript{744} In these types of systems it is very difficult to determine cause and effect or predict outcomes. Scott provides the following example of how loose coupling can affect organizations:

Often there is a weak connection between ‘talk’ and ‘action’ in organizations. Executives and managers may talk convincingly about the total quality management (TQM) programs in their organizations, but researchers find little or no evidence of such activities in production and service departments.\textsuperscript{745} [footnotes omitted]

The loose coupling of components in systems together with the difficulty in identifying the boundaries around organizations, have caused a dramatic change in the definition of organizations. New definitions focus less on the entity of the organization and more on

\textsuperscript{740} Ibid at 91.
\textsuperscript{741} This concept gives rise to the three different levels of analysis concept that is discussed at the beginning of Chapter 6.
\textsuperscript{742} See Scott, supra note 682 at 88.
\textsuperscript{743} For a discussion of this concept, see ibid at 85-88.
\textsuperscript{744} Ibid
\textsuperscript{745} Ibid at 88.
the processes of the organization.\textsuperscript{746} The nexus of contracts theory of the corporation is an example of an open systems definition of an organization.

One example of an open systems theory in organizational theory is contingency theory. Contingency theory makes three assumptions about organizations that illustrate the open systems approach. First, there is no single best way to organize. Second, not all methods of organizing are equally effective. Third, the best way to organize depends on the environment in which the organization is situated.\textsuperscript{747}

Even though open systems theories were the last of the organizational perspectives to develop, they have “spread rapidly and have had an enormous effect on organizational theory.”\textsuperscript{748}

\textit{Normative Assumptions Underlying Organizational Theories}

Scott recognized that the three perspectives outlined above differ in their underlying assumptions.\textsuperscript{749} In this regard they are similar to corporate theories.\textsuperscript{750} Scott identified that the rational systems perspective and the natural systems perspective held different normative assumptions about two important moral and philosophical issues: human nature and the structure of society. Scott outlines the difference in assumptions about human nature between the rational and natural systems perspectives in the following way:

\begin{quote}
Natural and rational systems theorists base their approaches on differing assumptions about human nature: the interests that guide and the factors that
\end{quote}

\textsuperscript{746} See ibid at 100.
\textsuperscript{747} Ibid at 96.
\textsuperscript{748} Ibid at 92.
\textsuperscript{749} See ibid at 29.
\textsuperscript{750} In fact, Scott’s classification of the normative assumptions behind organizational theories was used in Chapter 3 to classify corporate theories. Scott’s two assumptions were borrowed: human nature and the unit of analysis in society.
motivate behavior in organizations. Natural system theorists posit a more expansive, social, and motivationally complex actor than do rational system analysts. Also, theorists from the two schools hold differing conceptions of the actual and the proper relation of individual participants to organizations. Rational system theorists argue that only a subset of behaviors of participants are relevant to the organization. Natural system theorists expand the definition of organizationally relevant behavior to include a broader range of an individual’s activities and attitudes.

Similarly, Scott outlined the difference in the assumptions about the structure of society in this way:

Further, the two approaches are characterized by quite divergent views of the fundamental nature of social systems. These differences are reflected in the contrasting imagery and metaphors employed by the two schools. For the mechanistic model of structure the rational systems perspective, the natural system substitutes an organic model. Rational systems are designed, but natural systems evolve; the former develop by conscious design, the latter by natural growth.

Scott goes on to acknowledge that the debate between these competing sets of normative assumptions is a long standing one and that it is not likely to be resolved anytime soon:

Lest we regard these images of social structure as being of recent vintage, Wolin reminds us that they have a long history in political and social thought. The view of organizations as economic, technological, efficient instruments is associated with the work of such social theorists as Hobbes, Saint-Simon, and Lenin – the precursors of Taylor, Weber, Fayol and Simon. The view of organizations as communitarian, natural, nonrational, organic systems may be traced back to the social theories of Rousseau, Proudhon, Marx, Burke and Durkheim, the intellectual ancestors of Mayo, Barnard, Selznick, Parsons, Gouldner and Bendix. With such lengthy and distinguished pedigrees, it is unlikely that either of these two lines of thought will soon end, or that their differences will be quickly resolved.

Scott’s view is consistent with the presented in Chapter 3. These normative assumptions cannot be proven by scientific analysis. They are choices we make about the way we think the world ‘ought to be’.

751 Ibid.
752 Ibid at 80.
753 Ibid at 80.
In Scott’s classification of normative assumptions underlying organizational theories we see a replication of the pattern that was discovered in Chapter 3 with regard to corporate theories. The similarities result from the close link between organizational theories and corporate theories. For example, compare how similar Table 5-6 is to the discussion of the normative assumptions of corporate theory that was included in Chapter 3. Table 5-6 was compiled by sociologists in 1990 to explain the normative differences between economics and sociology. The similarity illustrates the link between organizational theory and corporate theory. However, before this link is explored further, it is useful to summarize briefly the historical development of organizational theory.

5.3 The Historical Development Of Organizational Theory

A complete analysis of the historical development of organizational theory is beyond the scope of this book. However, it is important to briefly discuss its development, because many of the advances in corporate theory in the last half century have resulted from advances that came first in organizational theory. This should not be a surprise because, as was mentioned earlier, corporate theory is really just a subset of organizational theory.

Two accounts of the development of organizational theory are summarized in this section: W. Richard Scott’s account and Neil Fligstein’s account. While the two accounts are similar, they were developed with different aims in mind. Scott’s account

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754 Especially note how similar this chart is to Lynn Dallas’ chart that was included in Chapter 3. This chart was compiled in 1990. Fifteen years before Lynn Dallas identified these differences between economics and socioeconomics.

755 For another account of the historical development of organizational theory see Richard Swedberg supra note 33 at 74-103. Swedberg classifies the theories in a way that is more similar to Fligstein’s classification. Swedberg classifies the theories into two groups: economic theories and sociological theories.

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was developed as part of a framework to help the modern organizational theorists
determine which theory to use for a particular problem. Therefore, it emphasis is on
classifying the theories. The primary goal of Neil Fligstein’s account was to show the
historical roots of organizational theory and the incredible amount of convergence and
interdisciplinary work that has occurred in the field. Therefore, its emphasis is on how
the theories developed from and influenced each other.

Both of these accounts highlight the close connection between organizational
theory and corporate theory. Many of the names and theories mentioned in this chapter
will be familiar to the reader, at this point, because they have been mentioned in previous
chapters.

5.3.1 Scott’s Account of the Historical Development of Organizational Theory

Scott emphasizes that context is important to understanding organizational theory
because of the link between the development of organizations and our theories explaining
them. Scott’s contextual approach is consistent with the contextual approach to corporate
theory that was adopted in Chapter 2.\textsuperscript{756} Scott described the importance of context top
organizational theory:

The perspectives should be understood in two senses. On the one hand, they are
historical products - systems of ideas and practice that developed and held sway in
specific times and circumstances. To completely divorce them from their context
would be a mistake, since much of their meaning is historically situated. But at
the same time, the perspectives selected are not just of historical interest. Each
has shown great resilience and has been invented and reinvented over time so that
each has persisted as an identifiable, analytic model. In our discussion, we try to
do justice to both moments: the historically specific versions and the underlying
analytic features.\textsuperscript{757}

\textsuperscript{756} In fact, Scott’s analysis of organizational theory together with the work of Mrton Horwitz and David
Millon were the conceptual basis for the organization of Chapter 2.
\textsuperscript{757} Scott supra note 682.
Organizational theory developed first with rational systems theories, then natural system theories and finally into open system theories.\textsuperscript{758} As time passed organizations become more complicated and more loosely coupled and, as a result, our understanding of them also changed.\textsuperscript{759} Scott recognized that there was a reflexive relationship between the development of organizations themselves and the development of corporate theory. Scott illustrated this belief in the following quote:

> Reality and theorization are coupled, but only loosely so. Sometimes ideas lead practice; sometimes the reverse. Ideas change independently of what is being studied for many reasons.\textsuperscript{760}

Organizational theory dramatically changed with the arrival of open system theories. Scott explains the phenomenon:

> With the arrival of the open system arguments in the 1960s, it quickly became clear that to the extent that previous perspectives were grounded on closed system views of organizations, they would need to be radically revised. To remain credible, all subsequent theories have had to take into account the openness of organizations to their environments.\textsuperscript{761}

After the 1960’s, rather than replacing rational or natural systems, the open systems models began to be incorporated into the rational and natural systems perspectives and rational open system models and natural open system models started to be developed. As

\textsuperscript{758} Organizational theory really began as a distinct field of sociological inquiry in North America in the late 1940’s. The defining moment was the translation into English of Max Weber’s and Michel’s work on bureaucracies. These works sparked Robert K. Merton and Herbert Simon to begin studying organizations. See Scott supra note 682 at 9.

\textsuperscript{759} The changes in modern organizations have accelerated since the 1970’s with organizations becoming much more loosely coupled. Alliances and joint ventures are becoming more common and flatter more flexible hierarchical structures are also becoming more common. The result is that the boundaries around firms are becoming harder and harder to identify or, in other words, organizations are becoming more open. For descriptions of how modern organizations have changed since the 1970’s see Paul DiMaggio, ed., The Twenty-First-Century Firm: Changing Economic Organization in International Perspective (Princeton: Princeton University Press, 2001) a collection of essays on the changes occurring to modern firms; Carlo Trigilia, Economic Sociology: State, Market and Society in Modern Capitalism (Oxford: Blackwell Publishing, 2002) at 197-237 discussing the crisis in the Fordist model of the corporation that occurred in the 1970’s; and Meir Dan-Cohen supra note 32 at 13-25 discussing changes to our modern conception of organizations.

\textsuperscript{760} Scott supra note 682 at 101.

\textsuperscript{761} Ibid.
a result of this fact, the development of organization theory can best be described as a four stage process:

1. Rational closed systems theories,
2. Natural closed systems theories,
3. Rational open systems theories, and
4. Natural open system theories.

This process is depicted in Table 5-4 together with the corresponding time periods. The process of development was described by Scott in the following way:

We now propose now a more complex time line – namely, that there have been not three but four distinct phases in the development of organization theory created by cross-classifying or layering the three perspectives.

On both sides of the watershed representing the transition from closed to open system models, a second trend can be identified: a shift from rational to natural system models of analysis. It appears that this shift occurred twice! It occurred for the closed system models of the late 1930s and early 1940s . . .the rational system formulations of Weber and Taylor giving away to the natural system approaches of Mayo and Barnard – and it occurred again during the late 1970s as the neorational approaches of Lawrence and Lorsch and Williamson were challenged by the neonatural perspectives of Hannan, Pfeffer, Meyer ...  

Examples of open rational system models include Oliver Williamson’s transaction cost analysis and Jensen’s agency theory. Examples of open natural system models include organizational ecology, resource dependence and institutional theory.  All of these theories are shown in Scott’s classification scheme in Table 5-2 and they are briefly summarized below:

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762 Scott, supra note 682 683at 107.
763 Network analysis could also be included here as a natural open systems perspective in organizational theory. However, the choice was made to include it in the discussion of economic sociology in the next Chapter.
Transaction Cost Analysis

Transaction Cost analysis was developed by Oliver Williamson based on the earlier work of Ronald Coase. Williamson was the first economist to propose that the focus of organization theory should be transaction costs:

In mechanical systems we look for frictions: do the gears mesh, are the parts lubricated, is there a needless slippage or other loss of energy? The economic counterpart of friction is transaction cost: do the parties to the exchange operate harmoniously, or are there frequent misunderstandings and conflicts that lead to delays, breakdowns, and other malfunctions?

Transaction costs are the costs of entering into contractual arrangements. Williamson defines them in the following way:

The ex ante costs of drafting, negotiating, and safeguarding an agreement and, more especially, the ex post costs of maladaptation and adjustment that arise when contract execution is misaligned as a result of gaps, errors, omissions, and unanticipated disturbances; the costs of running the economic system.

The most important of Williamson’s works is *Markets and Hierarchies*. In that book Williamson proposed that markets and firms were alternate methods (“governance structures”) of organizing production. The governance structure that is chosen in any given situation will be the structure that minimizes transaction costs in the circumstances. The firm is the preferred governance structure where transactions are frequent, the results are uncertain and when asset-specific investments are required. The reverse is also true – market actors will select the market as the governance structure when transactions occur only once, the results are certain and no asset specificity is involved. Shareholder’s

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765 Williamson (1985) *ibid* at 552.
766 *Ibid*.
768 Asset specific investments are investments in the firm that cannot be redeployed without a substantial loss in value *see* Oliver Williamson (1985) supra note 764 at 11, 47, 52-67.
under this theory have made the most significant asset-specific investments in the firm and thus are the correct party to determine the functioning of the corporate governance system because they have the most at stake.

In contrast to other economic theories, transaction cost analysis assumes that actors do not follow the law. Instead, it assumes that actors are opportunistic and will break the law if there are no consequences. Williamson described his concept of opportunism in the following way:

[The consequences of opportunism are incompletely developed in conventional economic models of firms and markets. As Diamond has noted, standard ‘economic models . . . [treat] individuals as playing a game with fixed rules which they obey. They do not buy more than they know they can pay for, they do not embezzle funds, they do not rob banks.’ But, whereas behavior of these kinds is disallowed under conventional assumptions, opportunism, in a rich variety of forms, is made to play a central role in the analysis of markets and hierarchies herein.]

The concept of opportunism makes transaction cost theory an extreme form of the self-interest concept of human nature.

Agency Theory

The Nexus of Contracts theory in corporate law is essentially just agency theory from economic organizational theory. Both theories use the same foundational source: The 1976 article by Michael Jensen and William Meckling: “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”. The theory is built on the concept that if human beings are self-interested and one party is in control of assets owned by another party – there will be incentive for the agent not to act in the best interests of the principal. Jensen and Meckling emphasized this point:

769 Williamson (1975) supra note 764 at 7.
We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.\footnote{\textit{Ibid} at 308.}

The key problem in this paradigm is aligning the interests of the agent to ensure that they always act in the best interest of the principle. There are two ways to align the interests of the parties: by monitoring of the agent or offering incentives to the agent. Both of these methods are accomplished by the writing of a contract. The contract includes a monitoring ability for the principal and incentives to ensure both sides carry out their contractual obligations. This theory views all social relations in the economic sphere as simply a set of contracts between principals and their agents. The firm is simply a fictitious entity that is created to represent that nexus of contracts. In this theory the firm is not much different than the market. In the modern corporation, the interests of managers (the agents) and shareholders (the principals) are aligned through a variety of mechanisms including: managerial pay linked to performance, monitoring by boards of directors and the market for corporate control – the threat of hostile takeover bids.\footnote{It should be noted that even though agency theory is an economic theory it has received some support form sociologists because the concept of agency is consistent with the insights from sociology. Agency is intensely personal and depends on the social relationship between the parties. Sociologists that have used agency theory include Harrison White, \textit{Identity and Control: A Structural Theory of Social Action} (Princeton: Princeton University Press, 1992) and James Coleman, \textit{Foundations of Social Theory} (Cambridge: Harvard University Press, 1990). For a discussion of this see Swedberg \textit{supra} note 33 at 84-85.}

Both transaction cost analysis and agency theory are rational systems perspectives because they rely on the assumption of human nature as self-interested. In fact, the primary governance features in both systems are designed to provide checks and balances

\footnote{\textit{Ibid} at 308.}

\footnote{It should be noted that even though agency theory is an economic theory it has received some support form sociologists because the concept of agency is consistent with the insights from sociology. Agency is intensely personal and depends on the social relationship between the parties. Sociologists that have used agency theory include Harrison White, \textit{Identity and Control: A Structural Theory of Social Action} (Princeton: Princeton University Press, 1992) and James Coleman, \textit{Foundations of Social Theory} (Cambridge: Harvard University Press, 1990). For a discussion of this see Swedberg \textit{supra} note 33 at 84-85.}
to self-interested behavior. In transaction cost analysis the governance structure (the firm) limits opportunism. In Agency theory the governance structure (the nexus of contracts between principals and agents) limits the self-interest of the agents.\textsuperscript{773}

Population Ecology

Population ecology approaches organizations from an evolutionary perspective. It is based in large part on the insights offered by Charles Darwin's natural selection theory. This approach is most often associated with the work of Hannan and Freeman.\textsuperscript{774} The focus in population ecology is on groups of organizations and what makes certain organizations survive while others do not. Population ecology argues that the environment selects organizations for survival based on the fit between the organizational form and the environment. The selection process is based on three processes: the creation of a variety of organizational forms, the retention of forms that fit with the environment and the diffusion of the selected forms.\textsuperscript{775} This is clearly an open system model: the importance of both survival and the organizations interaction with the environment could not be more emphasized.\textsuperscript{776} The weakness of population ecology is that it is not good at explaining how organizations change over time.\textsuperscript{777}

\textsuperscript{773} In this sense they are not much different than the Managerialism of Berle and Means see Chapter 3 - "Managerialism".
\textsuperscript{775} See Scott, \textit{supra} note 683 at 117.
\textsuperscript{776} See Scott, \textit{supra} note 683 at 118.
\textsuperscript{777} See Swedberg at 41.
Resource Dependence

This theory emphasizes that an organization's survival is dependent on its ability to obtain resources from its environment. This theory emphasizes organizational adaptation and the ability of leaders to develop strategies to cope with external constraints. It assumes that organizations and their leaders can act to improve the chances of the organization's survival.

The need for the organization to acquire resources (capital, labour, supplies etc.) makes it dependent on its environment. The scarcity of the resources determines the dependency of the organization. Dependency is the opposite of power. Organizations are more active in this model than in population ecology. In this model organizations can affect their environment to decrease their resource dependencies and increase their power.

5.3.2 New Institutionalism - Institutional Theory

The ideas of new institutionalism can be traced to a 1977 article by John Meyer and Brian Rowan. That article outlined that modern corporations (firms) cannot be understood by the concept of efficiency. Instead, modern organizations have two conflicting demands that they must meet: First, to get things done, and second, to incorporate features from its environment to endow it with legitimacy. Firms incorporate features into their environment through the concept of isomorphism. Isomorphism is

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simply the idea that organizational mimicry is more important than economic efficiency in determining organizational behaviour:

Structural change in organizations seems less and less driven by competition or by the need for efficiency. Instead . . . bureaucratization and other forms of organizational change occur as the result of processes that make organizations more similar without necessarily making them more efficient.\(^780\)

The definition of an institution was included in Chapter 2. Institutions are social practices that create stability and meaning in social life.

Institutional theory in sociology arose as a critique of the neo-classical economic model that is based on the assumptions of the rational profit maximizing self-interested individual as the basic unit of analysis and the invisible hand of the market automatically allocating resources (through aggregation of individual choice) to their most profitable uses. Guthrie explains the counter-perspective aspect of sociological institutional theory:

Institutional theory offers a counter perspective to the rationalist and efficiency view of economic decisions making. Scholars in this area of research have argued that the desire to appear legitimate and market savvy in the face of political or social pressure, or simple uncertainty, in the marketplace is the primary rationale behind organizational decision making. Organizations are as likely to act according to social norms and mandates of the institutional and cultural environments in which they are embedded as they are to act according the nebulous push of the market's invisible hand. . . Embedded in social and political environments, organizations adopt decisions fast. Market pressures and fiscal constraints surely also play a role in organizational decision making, but economic pressures comprise only one of many areas of constraint that organizations and their managers face. In the institutional perspective the assumption of rational action is set aside, as patterns of decision making and individual (or organizational) choices are empirical questions, not to be simplified as assumptions for the convenience of economic modeling.\(^781\)

The best example of a modern institutional analysis of the corporation is Neil Fligstein's book, *The Transformation of Corporate Control*, which was discussed in


Chapter 4. Institutional theory has mostly been used up to this point to study the differences between capitalist systems.  

*Fligstein’s Account of the Historical Development of Organizational Theory*

Neil Fligstein’s historical account argues that organizational theory had three origins: Sociological, economic, and managerial. The sociological theories find their roots in Max Weber’s work on bureaucracies. The economic theories find their roots in the industrial organization literature. The managerial theories were based in business schools and focused on the improvement of management control over the work process. He describes the three different sets of theories in the following way:

Not surprisingly, the economic and managerial literatures tend to start with the efficiency assumption, while the sociological literature has tended to be more agnostic about the question of efficiency. Sociologists are perfectly prepared to believe that organizational actors often find themselves in murky worlds where organizational survival is not so tenuous. They also think that organizational actors will do anything to survive, and the efficient allocation of resources might only be one such strategy to do so.

Fligstein provided a graphic description of his History of Organizational Analysis. A copy of his chart is reproduced as Table 5-6. The top of the chart starts from the three origins of organizational analysis.

Fligstein argues that there was a convergence of theories around the concept of rational adaptation in the 1960’s. This was the result of scholars appreciating the

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782 These studies are discussed in more detail below in the section on “Corporate Governance Convergence”.
783 Fligstein supra note 157 at para 1.
784 Ibid at para 1.
785 Ibid at para 8.
786 Ibid at 13.
importance of organizations to modern life, reading each other’s work and searching for common ground. He described the process in the following way:

My cursory history of organizational thought shows why scholars from these fields might come to orient themselves to each other. Economists, scholars in business schools, and sociologists, understood that organizations were at the core of modern life. How organizations worked, whether they were efficient, and if they could adapt to changing circumstances were questions that motivated scholars in all three fields.

Rational adaptation was developed by March and Simon when they began work with the concept of ‘bounded rationality.’ It was a critique of the economic rational choice theory and it recognized that actors could not process all the options that were available to them and rarely had perfect information. Therefore, actors rarely made the profit maximizing decision. This theory created the possibility of a synthesis in the organizational literature because it provided a more realistic model of actors and answered many of the questions raised by the various theories. Fligstein argues that a consensus emerged in organizational theory around rational adaptation – at least for a time.

787 Ibid.
788 Ibid at 14.
789 See March and Simon supra note 708.
790 Fligstein supra note 157 at 17. On page 18 he outlines the attractiveness of Rational Adapation theory to each of the three schools: “The beauty of the Simon-March perspective is that provided answers to many of the questions raised by economists, business school scholars, and sociologists. Firms might not be efficient as economists hoped. But with a more reasonable model of rationality (bounded rationality) and the idea that actors never had perfect information, the people who ran firms began to look like people who got the most from their inputs given the human limitations of human cognition. For scholars in business schools, the Simon-March perspective honored the fact that human psychology was important to organizational functioning. It also meant that managers were important because of their role in framing goals, designing standard procedures, monitoring organizational performance, and altering organizational activities in response to information that could be relatively easily processed. Sociologists found some of this attractive because they realized that organizations seemed more flexible than Weber suggested. It helped explain a lot of what sociologists were observing empirically. . . It also helped explain how organizations were making constant adjustments to environmental conditions . . . Simon and March nicely tied together the problem of the link between the environment, the organization, its internal structuring, and the ability of the organization to alter its course of action in the face of failing to meet organizational needs.”
791 Ibid.
But, beginning in the 1970’s and 1980’s, the consensus started to fall apart again. The main impetus for this was the emergence of the open systems theories and their emphasis on the environment. Fligstein describes this time in the following way:

The 1970s and 1980s were a period of great intellectual ferment in the field of organizational studies. Scholars were attacking the conventional wisdom of the rational adaptation and strategic contingencies models. These attacks came from many directions and reflected dissatisfaction with all or some of assumptions of the model. One of the main sets of criticisms came from those who were trying to understand the nature of the environment more clearly.  

*Similarities Between the Two Accounts*

There are two significant similarities between the Scott and Fligstein accounts of the development of organizational theory. Both accounts acknowledge the move from closed to open systems beginning in the 1960’s and both accounts recognize the difference between the rational and natural systems perspectives. Fligstein refers to this distinction as the difference between the economic based theories and the sociology based theories.

*Differences Between the Two Accounts*

The only significant difference between Fligstein’s classification of the theories and Scott’s classification is the treatment of Fligstein’s own theory. Scott classifies Fligstein’s theory as an institutional theory. Fligstein labels his own theory as the political-cultural approach and separates it from institutional analysis. He sees it as being closer to resource dependency than institutionalism. He describes his own theory in the following way:

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792 Ibid at 20.
Fligstein has created . . . what he calls a political cultural approach. He argues that the basic problem facing organizational actors is to create a stable world so that the organization can continue to exist. This necessitates the construction of an organizational field in which actors come to recognize and take into account their mutual interdependence. . . Generally, the largest organizations develop a collective way to control the organizational field and they impose it on the smaller organizations. . . From this perspective, states are implicated in all features of organizational life. The organizations and institutions of the state make and administer the rules governing economic interaction in a given geographic area and they are prepared to enforce those rules, in the last instance, through force. The state’s claims to set the rules for economic interaction is social in origin, and as such it is contestable. . . It follows from this that the local politics and existing practices of nations will have profound effects on the form, content, and enforcement rules in organizational fields.  

In either case, the theory is treated as a natural and open systems theory. This theory is important because it will be used to describe the social construction of markets in Chapter 6.

5.4 The Link Between Organizational Theory And Corporate Theory

There is a strong link between organizational theory and corporate theory. They both developed in the same general way: from rational theories, to natural theories and then to the incorporation of open system theories.

It is easy to see the similarity between the rational systems definition of an organization and Managerialism and any other corporate theory based on shareholder primacy because they all rely on goal specificity in their definition of a corporation. In fact, for Managerialism, it is the basis of the theory itself. Adolph Berle said back in the 1930’s – that there needs to be clear accountability in a corporation to ensure that managers act accordingly. The assumption behind Berle’s statement is that corporations (or organizations) can only exist if there is clear goal specificity. Berle could not

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793 Fligstein at 30.
conceive of goal complexity. But organizational theory shows that while goal specificity may have been a characteristic of earlier forms of organization, modern organizations are increasingly characterized by goal complexity.

It is also easy to see the similarities between the natural systems perspective and Entity theory and its related theories. Both sets of theories conceive of the corporation as a living entity. The link between organizational theory and corporate theory becomes even clearer in modern times because corporate theories for the last half-century have been directly based on organizational theories. For example, the Nexus of Contracts is a rational and open systems theory. The institutional form of the theory is based directly on the transaction cost work of Oliver Williamson\textsuperscript{794} and the strong form of the theory is based directly on the Agency theory work of Jensen & Meckling and Eugene Fama.\textsuperscript{795} Similarly, Power Coalition theory was purposefully constructed by Lynn Dallas from the insights offered by Resource Dependence theory, which is a natural and open system theory.\textsuperscript{796}

The result is that we see the same development pattern in corporate theory as there was in organization theory: from rational to natural to open systems theories. In fact, it is possible to classify corporate theories using Scott's classification scheme. An illustrative example of this kind of classification is included in Table 5-3. Where a corporate theory was specifically based on an organizational theory it has been indicated. Also, the similarities between Fligstein's historical development chart and the chart of

\textsuperscript{794} See Bratton supra note 90
\textsuperscript{795} See Scott supra note 682 and Fischel and Easterbrook supra note 348.
\textsuperscript{796} See Dallas (1995) supra note 445 at 50 where she states: "The power coalition theory . . . combines resource dependency and social construction theories in order to better explain corporate behaviour and to regulate it effectively." The theories that Dallas refers to as 'social construction theories' are theories like Pfeffer's theory. In both Scott's and Fligstein's classification scheme they are referred to as resource dependency theories. Therefore, for the purposes of this chapter power coalition theory is built on resource dependency theory.

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corporate theory development included in Chapter 3 are striking. Fligstein’s chart has been updated in Figure 5-2 to show the overlay of corporate theories on top of the organizational theories that they are based upon.

While the development of the two sets of theories is similar, there are two major differences. First, in the case of corporate theory, the development lags behind the advances in organizational theory by about 10-20 years. This time lag is illustrated in Table 5-5. Second, as Table 5-5 clearly indicates corporate theory has not yet developed from an open rational systems perspective to an open natural systems perspective. The dominant Nexus of Contracts corporate theory is still an open rational systems perspective.

Power Coalition theory was a move in the right direction.\textsuperscript{797} It was an attempt to create an open natural system theory of the corporation and engender a much better understanding of corporations. However, Power Coalition theory has not been widely accepted. As was stated in Chapter 3, the issue with Power Coalition theory, was its reliance on power, authority and conflict to describe the internal relations among corporate participants. This ‘social conflict’ paradigm, as it is called, is not a widely accepted view in North America. Most North American natural and open theories prefer to use a social consensus paradigm to describe the internal relations among organizational participants.

Without getting into the question of whether the social consensus paradigm or the social conflict paradigm is more descriptive of reality, since corporate theories are

\textsuperscript{797} Dallas made an argument in favour of power coalition theory similar to the one made in this chapter - that power coalition theory was “better” than the Nexus of Contracts theory because: “This theory, by taking into consideration important factors left out by market theories, better explains corporate behaviour and governance structures.” Lynn Dallas, “Working Towards a New Paradigm” in Lawrence Mitchell, eds., \textit{Progressive Corporate Law} (Boulder: Westview Press, 1995) at 36-37.
normative theories, then it is unlikely in the current normative environment in Anglo-American countries that a conflict perspective theory of one of our most dominant institutions is likely to receive widespread acceptance. Therefore, if progress is to be made in our understanding of the corporation and in corporate theory and an open natural perspective is to be developed and accepted – the social consensus paradigm is the correct view to adopt.

5.5 **Increasing Complexity Of Theory**

As time passes, organizations are changing. They are changing from tightly coupled easily identifiable entities to loosely-coupled networks and alliances.\(^{798}\) As organizations become more complex it becomes increasingly difficult to draw boundaries around organizations. Similarly, as organizations become more complex, our study of organizations needs to involve experts from a wider range of disciplines. The result is that the study of organizations is increasingly becoming interdisciplinary. Scott has written about this phenomenon:

> Organizations change, but so too do our ideas about organizations and organizing. . . Two are of particular importance. First, organizational scholars are drawn from a widening array of disciplinary backgrounds. Early students of organizations were primarily social psychologists and sociologists. These social scientists were joined next by political scientists and economists, both institutional and behavioral. There has followed a range of other types of scholars, including anthropologists, cognitive psychologists, industrial engineers, management, international business, and strategy scholars.

> Second, the locus of scholarship has migrated and dispersed over the past decades so that today’s scholars are to be found spread throughout all of the social science departments and all of the university’s professional schools. Business schools, engineering schools, schools of education and social services, nursing and medical schools – all boast a variety of folks whose primary interest is in

\(^{798}\) Scott, *supra* note 682 at x.
examining the organizational forms within which the work of interest is being conducted.\textsuperscript{799}

The theme that runs throughout this chapter is that our theories progress when they are able to accommodate more and more of the complexity of human relations and move and more of the insights from many disciplinary fields. The move from rational to natural systems was an advance. Similarly, the move to adopt the open systems perspective was also an advance.\textsuperscript{800} The argument in this chapter is that a similar movement from rational open systems to natural open systems will also be an advance. The current dominant corporate theory – nexus of contracts – is a rational open theory. In order to provide a better theory, one that is more descriptive of reality, better at predicting outcomes and at least as consistent with the normative views of society, we need to develop one that is natural and open in its perspective. That is the primary goal of the next chapter.

\textsuperscript{799} *Ibid* at x-xi.

\textsuperscript{800} Scott pointed this out when he wrote: ""Enormous benefits have been realized by students of organizations simply in elevating their conceptual level from 1 and 2, frameworks and clockworks, up to level 3, where organizations are viewed as cybernetic systems, and to level 4, where they are viewed as open systems."" See *ibid* at 85.
FIGURE 5-1

THE RELATIONSHIP AMONG SOCIOLOGY, ECONOMICS, ECONOMIC SOCIOLOGY AND ORGANIZATIONAL THEORY
TABLE 5-1

ORGANIZATIONAL ANALYSIS
DEFINITION OF ORGANIZATION WITHIN RATIONAL, NATURAL AND OPEN THEORETICAL PERSPECTIVES

Note: This page was removed for copyright restrictions. It was a chart summarizing the differences between the Rational, Natural and Open Systems Perspectives in Organizational Analysis. It was joint-authored by: Julian Dierkes, Maclean Brodie, Takeshi Hamamura, Soohyun Jung, Rachael Qi Zhang, Estelli Reyes, Alexandra Ho and Michael Cody.
TABLE 5-2
DOMINANT THEORETICAL MODELS AND REPRESENTATIVE THEORISTS: A LAYERED MODEL

Note: This page was removed for copyright restrictions. It was a modified version of Richard Scott’s Layered Approach to the classification of organizational theories. Source: W. Richard Scott, Organizations: Rational, Natural and Open System, 5th ed. (Toronto: Pearson Education, 2003) at 108.
TABLE 5-3

CLASSIFICATION OF CORPORATE THEORIES USING SCOTT TYPOLOGY

Note: This page was removed for copyright restrictions. It organized corporate theories using Scott Layered Approach. It was a modified version of W. Richard Scott, *Organizations: Rational, Natural and Open System, 5th ed.* (Toronto: Pearson Education, 2003) at 108.
### TABLE 5-4

SCOTT'S FOUR STAGES IN THE DEVELOPMENT OF ORGANIZATIONAL THEORY

<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
<th>Time Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Rational closed systems models</td>
<td>Turn of century to late 1930’s</td>
</tr>
<tr>
<td>2.</td>
<td>Natural closed systems models</td>
<td>Late 1930’s – 1960’s</td>
</tr>
<tr>
<td>3.</td>
<td>Rational open system models</td>
<td>1960’s – late 1970’s</td>
</tr>
<tr>
<td>4.</td>
<td>Natural open system models</td>
<td>Late 1970’s to present</td>
</tr>
</tbody>
</table>
### TABLE 5-5
THE "THREE" STAGES IN THE DEVELOPMENT OF CORPORATE THEORY

<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
<th>Organizational Theory Time Period</th>
<th>Corporate Theory Time Period</th>
<th>Example Corporate Theories</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Rational closed systems models</td>
<td>Turn of century to late 1930’s</td>
<td>1880’s – 1970’s</td>
<td>Contractual Theory Managerialism</td>
</tr>
<tr>
<td>2.</td>
<td>Natural closed systems models</td>
<td>Late 1930’s – 1960’s</td>
<td>1880’s – 1930’s</td>
<td>Entity Theory</td>
</tr>
<tr>
<td>4.</td>
<td>Natural open system models</td>
<td>Late 1970’s to present</td>
<td>Not yet accepted Dallas (1985)</td>
<td>Power Coalition Theory</td>
</tr>
</tbody>
</table>
TABLE 5-6

DIFFERENCE IN NORMATIVE ASSUMPTIONS BETWEEN ECONOMICS AND SOCIOLOGY

Note: This page was removed for copyright restrictions. It was a chart outlining the differences in assumptions in economics and sociology. It was from Paul Hirsch, Stuart Michaels, and Ray Friedman, “Clean Models vs. Dirty Hands: Why Economics is Different from Sociology” in Sharon Zukin and Paul DiMaggio, Structures of Capital: The Social Organization of the Economy (New York: Cambridge University Press: 1990) 39 at 43.
FIGURE 5-2

A HISTORY OF ORGANIZATIONAL THEORY

Note: This page has been removed for copyright restrictions. It was a graphic representation of the historical development of organizational theory. It was from Fligstein, Neil. “Organizations: Theoretical Debates and the Scope of Organizational Theory” in Craig Calhoun, Chris Rojek and Brian Turner, Handbook of Sociology (London: Sage Press, 2005)
FIGURE 5-3

A HISTORY OF THE LINK BETWEEN ORGANIZATIONAL THEORY AND CORPORATE THEORY

Note: This page has been removed for copyright restrictions. It was a graphic representation of the historical development of corporate theory laid on top of the development of organizational theory. It was from Fligstein, Neil. “Organizations: Theoretical Debates and the Scope of Organizational Theory” in Craig Calhoun, Chris Rojek and Brian Turner, Handbook of Sociology (London: Sage Press, 2005)
CHAPTER 6: THE SOCIAL THEORY OF THE CORPORATION

6.1 Introduction

The primary goal of this chapter is to update the social theory of the corporation by providing the building blocks for a natural and open systems version. The theory offered is, to the extent possible, based on the consensus paradigm and not on the conflict paradigm. To accommodate the fact that no single natural open systems theory is capable of explaining completely the corporation – the social theory outlined in this chapter is a broad social theory of the corporation drawing on insights from all four of the major natural open systems perspectives: network theory, population ecology, resource dependence and new institutionalism. However, emphasis is placed on institutional analysis because it is the most consensus based model.

However, providing a social theory of the corporation is not enough. In order for the theory to be useful it must be situated within a broader theory of how actors behave and markets work from a sociological perspective. To this end, a sociological view of

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801 The social theory of the corporation was outlined in Chapter 3. It is based on the works of Otto Gierke, F.W. Maitland and, most importantly, Frederick Hallis. Hallis’ early sociological theory of the corporation offered the following insights: First, corporate theory is of limited use unless it resembles reality. Second, corporate theory is political and social in nature. Third, the real issue in corporate theory is in balancing the interests of individuals and groups. See Chapter 3 – “Early Sociological Theory”.

802 The conflict version of a natural open systems theory of the corporation was well developed by Lynn Dallas in Power Coalition theory. In fact, a full conflict version of the sociological view of actors, organizations and markets can be constructed by combining the insights of Mark Granovetter’s embeddedness (actors), Lynn Dallas’ Power Coalition theory (organizations and corporations) and Neil Fligstein’s Markets as Politics approaches (markets). Each of these is discussed in more detail throughout this chapter. By presenting the consensus version of the social theory of the corporation the author is not making a statement of the superiority of one perspective over the other. The key reason for adopting the consensus approach in this book is that the conflict approach is not readily accepted in North America. This was illustrated by the lack of support that Power Coalition theory received. Lynn Dallas has since abandoned Power Coalition theory and moved on to support Socioeconomics. See Chapter 3 – “Socioeconomics”.

803 As opposed to previous attempts to develop such a theory that were based primarily on resource dependence theory – see Chapter 3 – “Power Coalition Theory”.

804 An example of the consensus characteristics of institutionalism is the concept of isomorphism in which corporations mimic each others behavior in order to gain legitimacy. For a brief description of isomorphism see Chapter 5 – “Institutionalism”.

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actors, organizations and markets is also presented in this chapter based mostly on insights from economic sociology.

This chapter is organized into five parts: First, a summary of the sociological view of markets, organizations and individuals is provided. Second, the insights about corporate theory collected through the historical analysis of corporate theories in Chapter 3 are summarized. Third, the basic building blocks of the updated social theory of the corporation are presented. Fourth, the social theory of the corporation is examined to determine if it is better than the current Nexus of Contracts theory. This is done by evaluating its descriptive, illustrative and normative aspects. Finally, a conclusion is offered that argues that the social theory of the corporation has the potential to be better than the Nexus of Contracts theory of the corporation.

6.2 The Sociological View Of Markets, Organizations And Individual Actors

The insights in this section are drawn primarily from economic sociology and to a lesser degree from organizational theory. Economic sociology, while closely related to organizational theory, takes a step back from organizations and looks at the totality of our social system from a sociological perspective. The social system includes: society, the economy, the market, organizations (including corporations) and individual actors. By combining the insights from economic sociology relating to actors and markets, with the insights from organizational theory, relating to organizations, it becomes possible to construct a complete sociological version of how the economy works.

This section proceeds in five parts. First, a general introduction to economic sociology is provided. Second, the ‘Levels of Analysis’ concept is introduced. Third, the
limitations of the economic view of actors, organizations and the market are highlighted. Fourth, the sociological view of individual actors, organizations (including corporations) and markets is provided. Finally, a summary is provided that explains the primary differences between the economic view of markets and the sociological view of markets.

6.2.1 Introduction to Economic Sociology

Economic sociology is:

[A] body of study and research aimed at establishing the links between economic and social phenomenon.\(^{805}\)

Economic sociology was popular in the period between 1880 and 1930. This period corresponded roughly with the rise of the modern corporation. The early theorists associated with economic sociology include Max Weber,\(^{806}\) Emile Durkheim,\(^{807}\) Karl Marx,\(^{808}\) Alexis DeToqueville,\(^{809}\) Georg Simmel,\(^{810}\) Joseph Schumpeter,\(^{811}\) Karl


\(^{807}\) Representative works from Emile Durkheim include: The Division of Labor in Society (New York: Free Press, 1984); and Professional Ethics and Civic Morals (Westport, Conn.: Greenwood, 1983).


\(^{809}\) Representative works from Alexis de Toqueville include: Alexis de Toqueville, Democracy in America (New York: Vintage 1945); Alexis de Toqueville, The Old Regime and the French Revolution (New York: Doubleday: 1955); and Alexis de Toqueville, Memoir on Pauperism (London: IEA Health Welfare Unit, 1997).


Polanyi and Talcott Parsons. Economic sociology then fell out of favour until interest in it was rekindled in the mid 1980's. Current economic sociologists include: Neil Fligstein, Richard Swedberg, Frank Dobbin, Ronald Burt, Frank DiMaggio and Walter Powell, Mark Granovetter, Mauro Guillen, Pierre Bourdieu and Harrison White. A chart outlining some of the most important classic and modern economic sociologists and their works is included in Table 6-1.

812 Polanyi’s most important work is: Karl Polanyi, The Great Transformation. See Polanyi supra note 19.
813 The early historical development of economic sociology has been well summarized by Richard Swedberg. The sources provided for the early theorists in the preceding footnotes are a selection of the sources that Swedberg identifies as being relevant to Economic Sociology. Representative works from Talcott Parsons include: Talcott Parsons and Neil Smelser, Economy and Society: A Study in the Integration of Economic and Social Action (New York: Free Press, 1956); and Talcott Parsons, The Structure of Social Action (New York: Free Press, 1968).
814 It is a curious fact that economic sociology fell out of favour in Anglo-American countries at roughly the same time as the social theory of the corporation and both re-emerged at roughly the same time in the 1980’s. For a description of this see Carlo Trigilia supra note 805 at ix. It may be that the argument concerning politics and corporate theory made in Chapter 4 can also explain the low profile of economic sociology between 1930 and 1980, but proof of such is beyond the scope of this book.
817 A representative works of Frank Dobbin include: Frank Dobbin, Forging Industrial Policy: The United States, Britain and France in the Railroad Age (Cambridge: Cambridge University Press, 1994).
821 A representative work from Mauro Guillen is: Guillen supra note 805
There are three basic differences between economic sociology and economics:

1. Economic sociology assumes that human beings have complicated decision making processes that cannot be explained by rational choice theory,

2. Economic sociology studies group behaviour in its own right and not just an aggregation of individual choices, and

3. Economic sociology assumes that economic relations are embedded in society.  

*The Strengths of Economic Sociology*

Economic sociology has two main strengths. First, it is interdisciplinary and draws on insights from many different perspectives including economics, sociology, organizational theory, psychology and other disciplines. Second, it is based on observations of reality. The methodological approach of economic sociology is to observe reality, collect data and then develop theories based on the observations and data.  

*The Weaknesses of Economic Sociology*

There are two main weaknesses of economic sociology. First, because it is based on observations of reality, most of its theories are complex and have circumscribed

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825 This list is based on the list offered by Guillen et al. see Guillen, *supra* note 804 at 6. There are many other significant differences between economics and economic sociology. They are outlined in more detail in Chapter 7.

826 This is in contrast to economics that builds its theories based on abstractions.
ability to predict behaviour or outcomes. Second, it is a relatively new field. While there have always been practitioners of economic analysis, the modern interest in the field can be traced to Mark Granovetter’s 1985 article: “Economic Action and Social Structure: The Problem of Embeddedness”. Widespread interest did not develop until the early 1990’s largely because markets and the economy were felt to be the domain of economics. The drawback of being a new field is that the current theories are not yet fully matured. While there has been a lot of empirical work conducted, the theories still have a lot of untested components, and there is more work to be done to make the models more robust. While this is a drawback, the sociological theory of markets is at least as robust as the economic theory of markets because, by and large, economics does not have a theory of markets. Instead, it assumes a perfectly competitive market.

6.2.2 Levels of Analysis – The Layered Approach

The ‘Levels of Analysis’ concept emphasizes that each social phenomenon has different levels that are capable of being analyzed. For example, there are at least three different levels of analysis that are of interest to organizational theory and economic sociology: individuals, organizations and groups of organizations. Scott refers to these three levels as the social-psychological, organizational structure and ecological

See Mark Granovetter (1985) supra note 820.

For example, Harrison White’s W(y) theory of the markets has not yet been subjected to empirical testing and Neil Fligstein’s Markets as Politics theory still has a number of untested key propositions. Each of these theories is described below under “Markets”.

This is further discussed below under “Limitations of the Economic View of Actors, Organizations and Markets.”

Scott, supra note 682 at 16. Although Scott admits that the division of analysis into these three levels is somewhat arbitrary: “Admittedly, distinguishing among these three levels of analysis is somewhat arbitrary. Many more refined levels of analytical complexity can be identified as one moves from organizational-individual to societal-organizational relations.
levels, respectively.\textsuperscript{831} The social psychological level of analysis focuses on the behavior of individuals within organizations.\textsuperscript{832} The organizational level focuses on the structural features that characterize organizations.\textsuperscript{833} The ecological level focuses on the actions of an organization (when viewed as a collective entity) within a larger system of relations.\textsuperscript{834} A summary of Scott’s classification of these three levels is presented in Table 6-2. The reason for identifying these different levels of analysis is that different theories are better at explaining different levels. Scott refers to this as the ‘Layered Approach’.

The levels of analysis concept can be applied to corporate theory to generate at least three distinct levels of interest: individuals, organizations (including corporations) and the market. The individual level focuses on the behaviour of individual corporate participants including directors, managers, employees and other stakeholders. The organization level focuses on the structural features that characterize organizations and, in particular, the corporation. The market level focuses on the actions of organizations as collective actors in society.

Of primary interest to corporate theory is the organizational level of analysis. This level of analysis seeks to answer the question: “What is a corporation?” However, the other two levels of analysis are also of interest because they are crucial to answering the question: “What is the purpose of corporate law?” It is impossible to determine what the purpose of corporate law should be unless we understand what motivates people to act the way that they do and what role corporations play in society.

\textsuperscript{831} Ibid at 17.
\textsuperscript{832} Ibid.
\textsuperscript{833} Ibid.
\textsuperscript{834} Ibid.
The analysis presented in this book also adds a fourth level of analysis to this framework: society. In corporate theory, the ecological level is split into two levels: society and the market. This extra level of analysis emphasizes the fact that the market is embedded in society (and not vice versa). Therefore, there are four levels of analysis that are relevant to corporate theory and each of these levels needs to be taken into account when developing or updating a corporate theory:

1. Individual
2. Group (e.g. organizations and corporations)
3. Market and Economy
4. Society

The classification of these four levels of analysis is presented in Table 6-3.

Unsatisfactory results can occur when these levels are confused. In corporate theory, this has happened at each level. The early debates about corporate personality in which the corporation was treated as a person are an example of confusion between the individual level and the group level. In order to provide groups with rights and duties in an individualistic legal system the corporation was deemed to be a person. But the corporation is not a person – in fact there are significant differences between a person and a group. This was one of the key insights of Entity theory. In 1905, W. Jethro Brown warned that groups (or corporations) were different than individual human beings:

835 This argument has been made by Meir Dan-Cohen: “The legal personality of corporations (and other collective entities) has been firmly established, but at the cost of ignoring them as distinctive social and legal phenomena. But using the ambiguous concept of 'person,' applying it to both individuals and organizations, the law has assimilated the organization into its preexisting individualistic framework.” See Meir Dan-Cohen, Rights, Persons and Organizations: A Legal Theory for Bureaucratic Society (Berkeley: University of California Press, 1986) at 14.
The corporate person must be carefully distinguished from the actual or physical person. Other recent works also have highlighted the difference between individuals and groups. The confusion between these two levels led to unsatisfactory results such as corporations successfully arguing for freedom of speech rights. This is also a legacy issue in corporate law because most statutes now recognize the corporation as a person.

The nexus of contracts theory confuses the market level with the organization level by treating the organization as a mini-market. This is a mistake because there are significant differences between markets and organizations. The most important being that organizations have boundaries and are identifiable 'chunks' of the social order. Markets do not have boundaries.

Finally, economic theory confuses the market with society when it disembeds the market and makes society subordinate to it. This is a mistake. Society should not be run

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836 W. Jethro Brown, "The Personality of the Corporation and the State" (1905) 21 L. Q. Rev. 365 at 372. Brown was a proponent of Entity theory. He believed that there were at least two distinct differences between individuals and groups: their origins and their will and actions, see Ibid at 372-374.
837 Ibid at 376.
838 See Günter Teubner, "Enterprise Corporatism: New Industrial Policy and the 'Essence' of the Legal Person" (1988) 36 American Journal of Comp. L. 130, arguing that we need to "rediscover the social dimension of the legal person". See also Dan-Cohen supra note 835. Dan-Cohen argues that there are at least 8 characteristics of groups that are different than people: structure, permanence, decision-making, size, formality, complexity and goal orientation. See Dan-Cohen at 18-19. This list is consistent with a rational systems perspective view of organizations with its inclusion of structure, formality and goal orientation.
839 For example, the Canada Business Corporations Act R.S. 1985 c. C-44, section 15(1) provides: "A corporation has the capacity and, subject to this Act, the rights, powers and privileges of a natural person".
840 For example, Alchain and Demetz have written: "The firm serves as a highly specialized surrogate market," and, "As a consequence of the flow of information to the central party (employer), the firm takes on the characteristic of an efficient market in that information about the productive characteristics of a large set of specific inputs is not more cheaply available. See Alchain and Demetz (1972) supra note 576 at 793 and 795, respectively.
by economics. The economy is a way for society to satisfy its needs. Society is not a way for the economy to satisfy its needs.

These four levels of corporate theory analysis will be used to construct the sociological view of actors, organizations and the market.

6.2.3 Limitations of the Economic View of Individuals, Organizations and Markets

Before outlining the sociological view of individuals, organizations and markets, it is useful to point out that the sociological view is able to overcome some of the limitations of the economic view of individuals, organizations and markets. It is able to do this because it is based on observation and does not rely on simplifying assumptions. Economists Joseph Stiglitz and Carl Walsh, in the latest edition of their introductory economics textbook, have argued that, among others, three of the simplifying assumptions of economics have proven not to be true.\(^{842}\) These three assumptions are relevant to the current analysis because they each relates to one of the levels of analysis outlined above: the individual level, the organization level and the market level.

First, at the individual level, the assumption in economic theory that individuals always have perfect information and are always able to make rational choices is incorrect. Stiglitz and Walsh outline this issue in the following way:

Buyers and sellers seldom have all the information that the basic competitive model assumes. In the basic competitive model, buyers know everything about what they are buying . . . Yet in most markets, participants do not have complete information. A buyer of a used car may not know the true condition of the car . . .

\(^{843}\) Stiglitz and Walsh \(supra\) note 531 at 241.

\(^{843}\) Stiglitz and Walsh (2006) \(supra\) note 531 at 241. By the “competitive model” Stiglitz and Walsh mean markets characterized by many firms, each believing that nothing it does will have any effect on the market price. See \(Ibid\) at 243.
Second, at the group level, organizations, firms and actors do not bear all of the consequences of their actions, as assumed in the classic economic model. Instead, organizations, firms and actors are able to 'externalize' some of their costs so that those costs are born by other people. These are called 'externalities' and Stiglitz and Walsh describe them in the following way:

Whenever an individual of firm can take an action that directly affects others but for which it neither pays nor is paid compensation, economists say that an externality is present. (The effect of the action is "external" to the individual or firm). Externalities are pervasive.

They go on later to describe externalities in more detail:

When there are externalities, the market's allocation of goods will be inefficient, because the producer fails to take into account "social costs" in deciding how much to produce. To put it another way, the price of a good such as steel, determined in competitive markets by the law of supply and demand, reflects only private costs, the out-of-pocket costs to the firms. If firms do not have to pay all of the costs (including the costs of pollution), equilibrium prices will be lower and output higher than they would be if firms tool social costs into account. When the production of a good like steel entails a negative externality - such as smoke and its effects on the air - the market level of production is too high.

Third, markets are not as competitive as envisioned in the classic economic model. The assumption in economic theory that actions by an individual or firm do not directly affect other individuals or firms is incorrect. Organizations actually can affect each other in ways other than through the price of the good that those firms are selling. As a result, in the real world, organizations spend a lot of time watching what other organizations are doing. Stiglitz and Walsh emphasize this point:

Because it takes the market price as a given, a firm in the competitive model does not need to consider how other firms will react when it considers changing the quantity it produces. However, when BMW and Nike make production and

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844 Ibid at 241.
845 Ibid. A positive externality is a public good – a good that can be consumed by more than one person. Public goods are underprovided for in real markets.
846 Ibid at 252.
847 Ibid at 240-241.
pricing decisions, they must worry about how their rivals will react. *In the real world, many firms devote enormous resources to efforts designed to anticipate others' actions and reactions.*

The reason for outlining these acknowledged limitations of economic analysis before outlining the sociological theory of market actors, organizations and markets is to show that the major limitations of the economic model stem from its simplifying assumptions. The imperfect information issue arises because economists make the unrealistic assumption that actors have perfect information. The uncompetitive market issue arises because economists make the unrealistic assumption actors are isolated and do not take into account the actions of others. The externalities issue arises because economists purposefully remove the moral, ethical and social issues of behavior in an attempt to increase the prediction ability of their models.

The sociological conception of markets summarized in this Chapter does not suffer the limitations of economic analysis because it is based on observations of reality and not based on unrealistic simplifying assumptions. The result is that the strengths of the sociological conception of markets correspond roughly to the weaknesses of the economic conception of markets.

### 6.2.4 The Sociological View of Individuals, Organizations and Markets

A note on the concept of embeddedness is required before the sociological conception of markets is presented. There are two different notions of embeddedness. The first or strong form of embeddedness is associated with Karl Polanyi. It was

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848 *Ibid* at 241.
849 The issues associated with economics' simplifying assumptions were described in detail in Chapter 4.
850 For descriptions of the differences between strong-form embeddedness and weak-form embeddedness see Swedberg (2003) *supra* note 823 at 36-37.
summarized in the Introduction. It argues that prior to capitalism the economy was always embedded in society. With the arrival of capitalism it became possible to attempt to disembend the economy from society. Although, any attempt to do so would result in significant negative consequences. The weak form of embeddeness is a more recent development. This form of embeddedness is most often associated with the work of sociologist Mark Granovetter. It argues that all economies are embedded in society to a greater or lesser extent. The result is that all actors are ‘embedded’ in social structure and their choices are limited by their social surroundings. Both concepts of embeddedness are consistent with the arguments made in this book. The weak form of embeddedness is discussed below in the section on individuals. The strong form of embeddedness is discussed below in the section on markets and society.

6.2.5 Individuals – Market Participants are Embedded in Social Relations

The important question for a sociological view of markets at the level of individuals is: how do individuals make choices? The answer to this question depends largely on the view of human nature adopted. The sociological approach is to view humans as social beings whose choices and decisions are constrained by their social surroundings. Emile Durkheim was one of the first theorists to argue that men did not act

851 See Karl Polanyi supra note 19.
853 There is a very strong argument to be made that psychology and not sociology is the correct discipline from which to draw insights on individual behaviour. This is a valid argument.
in their own self-interest and that social bonds that affected behaviour. In *The Division of Labour* Durkheim wrote:

> [I]f mutual interest draws men closer, it is never than for a few moments. . . [S]elf interest is the least constant in the world.\(^8\)

Durkheim criticized the economic self-interested version of man as being unrealistic. He argued that real people cannot separate the economic element from social life:

> [R]eal man – the man whom we all know and whom we all are – is complex in a different way: he is of a time, of a country; he has a family, a city, a fatherland, a religious and political faith; and all these factors and many others merge and combine in a thousand ways, converge in and interweave their influence without it being possible to say at first glance where one begins and the other ends.\(^8\)

**Weak Form Embeddedness**

Mark Granovetter developed the weak form of embeddedness to explain his conception of human nature.\(^8\) He locates his conception of embeddedness halfway between what he calls the ‘undersocialized’ and ‘oversocialized’ conceptions of man. The ‘undersocialized’ conception of man is the self-interested conception associated with neo-classical economics and it finds its most extreme form in new institutional economics.\(^8\) This individual is not impacted at all by social relationships or social structure and makes choices free of social considerations.\(^8\) The ‘oversocialized’ conception of man is associated with sociology and it finds its most extreme form in the

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\(^8\) Swedberg *supra* note 33 at 19 citing Durkheim.

\(^8\) Emile Durkheim (1984) *supra* note 807 at 49-50. Durkheim was afraid that economic advances would ruin society by allowing greed to grow unchecked through the advancement of private interest over the general interest.

\(^8\) Granovetter *supra* note 820.

\(^8\) The example used by Granovetter as the extreme form is Oliver Williamson’s ‘opportunistic’ man who will break the law is he or she can get away with it. See Granovetter (1985) *Ibid* at 488-489.

\(^8\) *Ibid* at 484-486.
work of Talcott Parsons. Over-socialized individuals are completely controlled by their social structure and all their behavior can be predicted by simply knowing their position in the social network.

Granovetter locates himself somewhere in between these two conceptions:

A fruitful analysis of human action requires us to avoid the atomization implicit in the theoretical extremes of under and over-socialized conceptions. Actors do not behave or decide as atoms outside of social context, nor do they adhere slavishly to a script written for them by the particular intersection of social categories that they happen to occupy. Their attempts at purposive action are instead embedded in concrete, ongoing systems of social relations.

He went on to argue that individuals are embedded in social relations:

[M]ost behavior is closely embedded in networks of interpersonal relations and that [this] avoids the extremes of under – and oversocialized views of human action.

Therefore, social relations affect decisions but individuals are not completely constrained by their social environments. Individuals always have the ability to make free choice.

One key insight of embeddedness is that the behaviour of individuals in market situations is not different than the behaviour of those individuals in their other social interactions. Trust and relationships are important to economic behaviour. Granovetter argues that networks or social relations are the primary means through which trust is generated and malfeasance is discouraged. Other sociologists have discovered that trust plays a very important role in reasonable economic behaviour. Granovetter’s

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860 Granovetter (1985) supra note 820 at 486.
861 Ibid at 487.
862 Ibid at 504.
863 See Ibid at 490. This is in direct contrast to Williamson’s concept of ‘opportunism’.
864 See Clifford Geertz, Peddlars and Princes: Social Development and Economic Change in Two Indonesian Towns (Chicago: Chicago University Press, 1963) and Ronald Dore, “Goodwill and the Spirit of Market Capitalism” 34 British Journal of Sociology 459. The importance of trust has also made its way
theory of embeddedness has received support because studies have successfully shown that it predicts actual outcomes that rational choice theory cannot.\textsuperscript{865}

Another way to present Granovetter’s theory is that people are complex social beings that act out of mixed motives.\textsuperscript{866} Actors make decisions based on trust and cooperation and power and compliance as often as they make decisions based on self interest.\textsuperscript{867}

Social relations affect decision makers in a number of ways. Economic sociology identifies at least three important ways: available information, social networks and social capital.

\textit{Imperfect Information – “Bounded Rationality”}

The fact that individuals do not always act on perfect information was first identified by Herbert Simon. Simon developed the concept of ‘bounded rationality’ to describe the fact that even within rational organizations an individual’s ability to make rational choices is severely limited by the information they have at their disposal. He wrote:


\textsuperscript{867} \textit{Ibid.}
It is impossible for the behaviour of a single, isolated individual to reach any high degree of rationality. The number of alternatives he must explore is too great, the information he would need to evaluate them so vast that even an approximation to objective rationality is hard to conceive. Individual choice takes place in an environment of 'givens' – premises that are accepted by the subject as bases for his choice; and behavior is adaptive only within the limits set by these 'givens'.

Simon's concept of bounded rationality was a major challenge to the rational choice theory of economics. It was also very important to sociologists because they used it to discover that people's access to information and, consequently, their behavior is limited by their social networks or, in other words, the places from which they gather their information.

Network Analysis

Network analysis is a theoretical approach that emphasizes that relationships between people and positions are important to the social (and economic) process. Networks are important because: they allow for the flow of information, they indicate reciprocity between actors, they generate trust, they allow access to resources and they are indications of power and compliance.

Network analysis was originally associated with the 'conflict perspective'. It was first used to show how capitalist economies were controlled by a small number of people. The early studies generally focused on tracing relationships among and within corporate boards of directors and most often their conclusions were that a small group of people

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869 Swedberg supra note 33 at 38.
controlled most large companies. However, as network analysis developed researchers realized that the networks they had discovered among market participants fulfilled other functions, like: the sharing of information, access to capital and watching competitors.

A key sociologist in network analysis is Ronald Burt. He has argued that social networks are loosely coupled systems. Where connections between different social networks are weak or non-existent, it creates an opportunity for an individual or corporation to benefit by sitting astride that weak connection called a ‘structural hole’. The advantage comes because of the ability to transfer information and the ability to engage in brokerage between the two networks:

Structural holes are an opportunity to broker the flow of information between people and control the projects that bring together people from opposite sides of the hole.

In Burt’s theory, competitive advantage is located in social relationships and not in market position, strategy or other attributes of corporations. Individuals or corporations

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873 Other important network analysts include Harrison White and Brian Uzzi. White’s most important work on networks is: Harrison White (1992) *supra* note 823. Brian Uzzi’s representative work see *supra* note 865.

874 Network analysis is a natural open systems perspective and could have been included in the list of natural open systems perspectives in Chapter 5.

whose relationships span structural holes in social networks have competitive advantages by being the connection to a group that is otherwise unconnected:

structural holes ... create a competitive advantage for an individual whose relationships span the holes.876

Network analysis shows that the decisions individuals make are affected by who they know and what information they are able to collect.

Social Capital

Social capital explains why some market actors are better able to attain their goals and mobilize resources than other actors. It emphasizes that their ability to attain their goals is a result of the position that they fill in the social network, and not necessarily because they are smarter, better able, or more skilled. In effect, they are better ‘connected’ and the social network creates a competitive advantage for them.877 Better connected people get higher returns.878

The modern idea of social capital was developed by French sociologist Pierre Bourdieu. It was one of three types of non-financial capital identified by Bourdieu, including: social, symbolic and cultural. Social capital is defined by an individual’s connections, symbolic capital is defined by loyalty and goodwill, and cultural capital is defined as family background and education.879 Bourdieu and Wacquant provided the following definition of social capital:

876 Ibid at 155. This is a form of social capital based on social location.
877 For Burt, individuals who sit astride structural holes in networks have more social capital. Ibid at 150 and 155.
878 Ibid at 150.
879 Reliance was made on the summary provided in Swedberg supra note 33 because Bourdieu’s article has not yet been translated into English. See Swedberg Ibid at 47-49.
Social capital is the sum of the resources, actual or virtual, that accrue to an individual or group by virtue of possessing a durable network of more or less institutionalized relationships of mutual acquaintance and recognition.\textsuperscript{880} James Coleman has pointed out that most types of social capital are generated as a by-product of other social relationships.\textsuperscript{881} For example, going to church.

An individual’s decisions will be affected by their level of social capital, mostly because, it will affect the options that are available to them.

6.2.6 Summary - Social Actors are Reasonable

It is clear that an individual’s place in the social network affects the decisions that they are able to make and the options that are available to them. This is in direct contrast to rational choice theory that assumes everyone with the same problem will have the same information, the same options to choose from, and, therefore, will make the same choice.

The best way to characterize the sociological conception of market actors is that they are reasonable. Instead of always acting rationally, social beings act reasonably \textit{in their circumstances}.\textsuperscript{882} Their circumstances include the information available to them, their position in the social network, their level of social capital, their past behavior and history, etc.

The sociological conception of market actors overcomes the perfect information limitation of rational actors from economic analysis. Behaviour that might look irrational from a rational choice perspective becomes completely reasonable in this perspective.

\textsuperscript{880} Bourdeiu and Wacquant (1992) infra note 940 at 119.
\textsuperscript{881} Coleman \textit{supra} note 772 at 302. Another related definition is that of Robert Putnam who writes that "Social capital . . . refers to features of social organization, such as trust, norms, and networks that can improve the efficiency of society by facilitating coordinated action." See Robert Putnam, \textit{Making Democracy Work} (Princeton: Princeton University Press, 1993) at 167.
\textsuperscript{882} The “reasonableness” of social actors is a concept borrowed from Pierre Bourdieu.
when all the social factors are taken into consideration. An example of such behavior is a boss that pays out a bonus to employees to recognize hard work and preserve relationships even when the bonus is not required to be paid because the technical criteria of the bonus was not met.

6.2.7 Organizations – Corporations are Natural and Open Systems

The natural and open systems perspective of organizations was introduced in Chapter 5. It provides that the primary goal of any organization is to ensure its own survival. This section provides more detail on the perspective by answering a few key questions about organizations that help explain how the natural and open perspective of organizations fits within the sociological view of markets. The questions that will be explored are:

1. Why do organizations exist?
2. How do organizations interact with their environments?
3. How do you determine the boundaries of an organization?
4. How do organizations structure themselves?
5. How do organizations make decisions?

Each of the questions is briefly explored below.

Why Do Organizations Exist?

Organizations have always existed. However, organizations of the scale and scope that we are used to in the modern world emerged only after industrialization. Scott made this point:

It is only in modern, industrialized societies that organizations dominate the landscape. Their emergence, proliferation, and consolidation as a ubiquitous and
significant building block of society is one of the great social transformations that distinguishes the modern from the premodern world.\textsuperscript{883}

The development of the modern organization can be divided into two distinct phases: The modern organization first emerged due to compelling technical reasons then it became institutionalized.\textsuperscript{884} While there were compelling reasons for the creation of large organizations in the earlier stage, once the organizations were created, they continued to be formed even after the compelling reasons for their creation may have gone away because they became the accepted way to organize.

The two most compelling technical reasons for the emergence of modern organizations around the time of industrialization are: the emergence of individualism and the division of labour. James Coleman has argued that modern large scale organizations became possible as a result of the increase in freedom that resulted from the development of individualism in industrial societies. In his study of corporate bodies in the Middle Ages, he argued that the major differences between modern organizational structure and earlier feudalistic structures was that both individual and corporate actors now have more freedom.\textsuperscript{885} Individuals have their own rights and are no longer fully subsumed within the corporate body that they belong to, for example, a guild or manor.\textsuperscript{886} The result is that individuals only partially belong to modern organizations.\textsuperscript{887} Similarly,

\begin{itemize}
  \item \textsuperscript{883} Scott \textit{supra} note 682 at 151.
  \item \textsuperscript{884} This two stage process has been recognized by both Lynne Zucker and Paul DiMaggio and Walter Powell. \textit{See} Lynne Zucker, "Organizations as Institutions" in Samuel Bacharach, ed., \textit{Research in the Sociology of Organizations}, vol 2. (Greenwich: JAI Press, 1983) at 726 and Paul DiMaggio and Walter Powell \textit{supra} note at 147.
  \item \textsuperscript{885} Coleman \textit{supra} note 772 at 28.
  \item \textsuperscript{886} \textit{Ibid}.
  \item \textsuperscript{887} \textit{See} Scott \textit{supra} note 682 at 152.
\end{itemize}

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corporate bodies themselves have more freedom and do not have to adhere to the strict hierarchical structure of feudalistic society. Scott agrees:

[W]e conclude that there was an intimate, reciprocal, supportive relationship between the emergence of individualism and the development of special-purpose organizations.

Many economists and sociologists have pointed out the importance of the division of labour in industrialized economies to the development of large modern organizations, including: Adam Smith, Durkheim, Max Weber and Karl Marx.

Once the organizational template was set, society developed rationalized beliefs about the benefits of organizations. The result was that organizations continued to be formed even after the compelling reasons for their existence may have passed because it became the accepted way of organizing in society. Institutionalists, Meyer and Rowan have made this point in their classic 1977 article: *Institutionalized Organizations: Formal Structure as Myth and Ceremony*:

The growth of rationalized institutional structures in society makes formal organizations more common and more elaborate. Such institutions are myths which make formal organizations both easier to create and more necessary. After all, the building blocks for organizations come to be littered around the societal landscape; it only takes a little entrepreneurial energy to assemble them into a structure.

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888 Coleman *supra* note 772 at 28.
889 Scott *supra* note 682 at 153.
891 Scott *supra* note 682 at 164.
Over time, as a result of *isomorphpic* pressures or the pressure to mimic each other for legitimacy purposes - organizations began to look more and more like each other. Even further reinforcing the modern form of organization as the preferred way to organize.

The corporate law, and in particular the general incorporation statutes, played a crucial role in this institutionalization process by providing standardized rules by which corporations and business organizations were to be formed.

This institutional analysis, when applied to the corporation, provides a very important insight. Contrary to the claims of transaction cost analysis and agency theory, the modern corporation may not exist because it is the most efficient form of organizing. It may exist only because it has become the accepted way of organizing business in Anglo-American countries. Lynne Zucker has explained it in the following way:

The rush to create organizations cannot be explained either by the need to counterbalance the power of existing organizations or by any distinct advantage inherent in organizational form (such as increased production efficiency). Rather, the rapid rise and continual spread of the organizational form is best interpreted as an instance of institutionalization: early in the process of diffusion, the organizational form is adopted because it has unequivocal effects on productivity while later it becomes seen as legitimate to organize formally, regardless of any net benefit.

This view is consistent with the insight that the corporation is a social institution. It has become a structure in society that promotes stability and provides meaning to social life. It is now the accepted way to organize.

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893 See DiMaggio and Powell, “State Expansion and Organizational Fields” in Richard Hall and Robert Quinn, eds., *Organizational Theory and Public Policy* (Beverley Hills; Sage, 1983) at 147-161. The concept of *isomorphism* was also discussed in Chapter 5 under – “Institutionalism”.


895 Zucker *supra* note 43 at 13.
How do Organizations Interact with their Environments?

Organizations are both affected by their environments and affect their environments. Environments are characterized by two different sets of features: material resource features and institutional features.

The material resource features of the environment are the inputs and outputs that the organization needs to survive. For instance, a corporation needs workers, supplies and capital as inputs and it often sells products and services as outputs. The corporation is dependent on the environment to attain its inputs and often will structure itself in the best way to attain those inputs. Similarly, because of the uncertainty in obtaining inputs and outputs, the corporation will attempt to control its environment to produce stability for getting its inputs. While these material resource factors are important, the more important, and more often overlooked, aspects of an organization’s environment are the environment’s institutional features.

The institutional analysis of environments recognizes that organizations are shaped by political and legal frameworks, market rules, and general belief systems. An institution is essentially a social structure that provides meaning and stability to social life. Institutionalization refers to the process by which social reality is constructed as social actions are repeated and given a similar meaning by individuals and groups.

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896 See Scott supra note 682 at 145-147.
897 See ibid at 133.
898 This is the main contribution of resource dependency and the relationship of this concept to the corporation has been described by Lynn Dallas.
899 This concept of stability is discussed in more detail below in “The Sociological View of Markets”.
900 See Scott supra note 682 at 135.
901 Ibid at 134.
902 Ibid at 136.
Modern societies contain complex sets of institutionalized rules and beliefs. These institutions are created by the state (laws), groups (norms), and society in general (beliefs). These institutions provide a framework within which modern organizations are created and operate. Meyer and Rowan outline the situation in the following way:

Many of the positions, policies, programs and procedures of modern organizations are enforced by public opinion, by the views of important constituents, by knowledge legitimated through the educational system, by social prestige, by the laws, and by the definitions of negligence and prudence used by the courts. Such elements of formal structure are manifestations of powerful institutional rules which function as highly rationalized myths that are binding on particular organizations.

Organizations receive support and legitimacy to the extent that they conform to these rationalized myths. In fact, the myths are so powerful that organizations conform to them even if there is no rational reason for them to do so. For example, the surprising strength of the current belief in North American markets that certain firms should be structured as income trusts has led to it being used in situations where it is clearly not appropriate.

The end result of the institutional environment is that organizations reflect the culture of the society in which they are located. In addition, because of the reflexive relationships between organizations and the environment, organizations are also able to change the culture of the society in which they are located. Neil Fligstein summarized these ideas in the following way:

903 See Meyer and Rowan supra note 892.
904 Meyer and Rowan supra note 892 at 343.
905 See Scott supra note 682 at 137.
906 The income trust form is best used in situations where companies have stable cash flows that will repeat themselves over a long period of time. This is because in the income trust format much of the profit of the company is paid out to the unit holders. Recently, income trust form has been used in conjunction with businesses that have highly variable cash flows. This is bad because the business is unable to retain profits to provide a cushion for difficult times. In some circumstances the result has been either the failure of the business or a drastic cut to distributions.
907 Scott supra note 682 at 138.
Every organization exists in a specific physical, technological, cultural and social environment to which it must adapt. No organization is self-sufficient; all depend for survival on the type of relations they establish with the larger systems of which they are a part.\textsuperscript{908}

\textit{How do organizations maintain their boundaries?}

One of the insights of the open systems perspective in organizational analysis is that all organizations are incomplete and are open to their environment. Organizations must, therefore, maintain their boundaries in order to separate themselves from their environment. If there is no boundary then there is no organization.\textsuperscript{909}

There are three different ways to determine organizational boundaries: by actors, by social relations and by activities.\textsuperscript{910} The most common method that is used in practice to determine the boundary of an organization is by using actors. This method focuses on who is and who is not a member of the organization. For example, most corporations use this method. Generally, employees, directors and shareholders are considered to be within the corporation and everyone else, including creditors, suppliers and others, are considered to be outside the organization. The stakeholder model of the corporation is a perfect example of this method. It argues that more actors should be considered to be within the boundaries of the corporation that are currently recognized.

Another way to determine the boundary of an organization is by analyzing social interactions and not people.\textsuperscript{911} This approach is used mostly by network analysts who study the density of social relationships. The boundary of an organization exists where the social interactions become thin.

\textsuperscript{908} \textit{Ibid} at 23.
\textsuperscript{909} \textit{Ibid} at 184.
\textsuperscript{910} \textit{Ibid} at 186-187.
\textsuperscript{911} See \textit{Ibid} at 186.
The final way to draw the boundary around an organization is using activities. The Nexus of Contracts theory of the firm adopts this approach. The boundary of the firm is the set of contracts that provide the inputs to the corporation.

The important thing to note about boundaries is that there is no correct answer to where the boundary should be drawn. Each particular corporation or organization determines where its boundary is to be and then expends energy to maintain it. However, one general trend is apparent. As modern organizations and corporations become increasingly loosely coupled systems their boundaries are expanding out and becoming more inclusive.

_How do organizations structure themselves?

There is no single best way to design an organization. This was one of the insights of Contingency theory. Organizations structure themselves to accommodate the work to be done and the demands of their surrounding environment. A good example of this is Fligstein's study of the rise of large American business corporations. As outlined in Chapter 4, the rise of the large American business corporation, and its structure, was a result of a complex series of factors that included the tasks that the corporation was engaged in (manufacturing, selling, finance etc.) and the corporation’s environment (including laws and regulations, norms and beliefs).

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912 Ibid at 231.  
913 See Fligstein (1990) _supra_ note 815 and Chapter 4 – “The Finance Conception of Control”.
How do organizations make decisions?

This is one of the more difficult areas of social theory. It is also the hardest area to eliminate the conflict perspective from. The most complete theory on how organizations make decisions was offered by Cyert and March in 1963. They argued that organizations are composed of coalitions. Coalitions are groups of individuals pursuing similar interests. Each group attempts to impose its set of goals on the organization. However, no one group is powerful enough to set the goals of the organization on its own. Therefore, organizational goals are set as a result of a negotiation process that occurs among members of the dominant coalition. The dominant coalition consists of each groups whose interest must be taken into account when defining the goals of the organization. This view characterizes the corporation as a political system.

Lynn Dallas expanded this conception for use with corporations in the Power Coalition model.

Scott has argued that this model of decision making in corporations is better than other models offered by natural open systems perspectives for a number of reasons, including:

1. It recognizes that not all participants in an organization have the same interests or goals
2. It recognizes that the organizations goals are distinct from the goals of any given individual because no single group is powerful enough to impose its goals on the organization
3. It recognizes that some level of consensus and compromise is required among groups in order to develop the goals of the organization

914 See Scott supra note 682 at 296.
915 Ibid at 353.
916 Ibid
4. It recognizes that the size and composition of dominant coalition differs from one organization to another and may change within an organization over time as new coalitions emerge.

5. The dominant coalition can include stakeholders outside of the formal boundaries of the organization.\(^{917}\)

Summary — Organizations are Effective

Organizations pursue effectiveness not efficiency.\(^{918}\) Fligstein provided the following description of effectiveness:

There is a long history in organizational theory of using the idea of ‘effectiveness’, as opposed to ‘efficiency’, as the criterion by which to evaluate how well the social structuring of markets works. Organizations are effective when they find ways to survive. Attaining allocative efficiency is not the only way to survive (although it is one possible strategy if actors can figure out how to do it). Instead, actors who control firms basically do anything they can to survive. Their main efforts is directed at finding ways to stabilize their relations with competitors, suppliers, customers and governments.\(^{919}\)

The sociological view of organizations helps overcome the externalities limitations of economic analysis because it does not arbitrarily create a group of stakeholders who are “outside” of the corporation. The sociological view recognizes that determining the boundaries of organizations is extremely difficult and it is becoming more so all the time. As organizations become more loosely coupled their boundaries will naturally expand to include more of the stakeholders who are affected by the corporation’s actions,

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\(^{917}\) *Ibid* at 297.

\(^{918}\) For a discussion of ‘efficiency’ vs. ‘effectiveness’ see Neil Fligstein, (2003) *supra* note 870. This concept can be found in all of Fligstein’s major works see Fligstein (1990), (1996) and (2001) *supra* note 815. It should be noted that some sociologists do support the concept of efficiency. For example, see Ronald Burt (1983) *supra* note 865 and Brian Uzzi (1996) *supra* note 873.

externalities should not exist. Externalities only exist where the boundaries of an organization have been defined and maintained too narrowly.  

6.2.8 The Market and the Economy

This area of sociology is still developing. There is as of yet no single accepted sociological theory of the market. The lack of a sociological theory of markets is largely due to the fact that markets were thought to be the within the scope of economics. However, as Neil Fligstein has argued, the sociological theory of the markets was required because of the deficiencies in general economic theory and economists' inattention to how markets actually work. Influential economists, such as Douglass North and Ronald Coase, have both pointed out the disinterest economists' show for markets. Douglass North wrote:

"It is a peculiar fact that the literature on economics . . . contains so little discussion of the central institution that underlies neoclassical economics – the market."  

Similarly, Ronald Coase wrote:

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920 This does not mean tha the issues related to the externality go away, it just means that the issues are no longer external to the governance structure of the corporation.
921 Richard Swedberg has done a great summary of the historical development of the sociological theory of markets. See Swedberg supra note 824 at 104-157. The summary of markets provided in this chapter is based on his work. Swedberg shares Fligstein's discontent with the current theories: "Many economic sociologists feel discontent with the current state of knowledge about markets, in economics as well as in economic sociology. While they realize that some good insights into the workings of markets have indeed been produced, they also sense that much – or most – of the work remains to be done." Ibid at 131. Most of the theories developed have been based on the conflict perspective.
922 It should be noted that the economics understanding of how markets work is not much better than the sociologists because economists only focus on price formation. For example, economist George Stigler (a nobel prize winner in economics) wrote: "[E]conomic theory is concerned with markets [and] it is, therefore, a source of embarrassment that so little attention has been paid to the theory of markets." See George Stigler, "Imperfections in the Capital Market" 75 Journal of Political Economy 213. For a discussion of the deficiencies of the economic theory of markets see Swedberg (2003) supra note 824 at 104-118. For a sociological critique see White (2003) supra note 823 at 129 where he states: "Economists take markets as fundamental, but as yet they have no way to characterize the process and structure through which particular firms actually constitute a market; so economists largely pass over particular firms by settling for a stylized story of pure competition.
Although economists claim to study the market, in modern economic theory the market itself has an even more shadowy existence that the firm.\textsuperscript{924}

In contrast to economists, who tend to approach markets as an abstraction, the sociological theories of markets outlined below were based on empirical studies of actual markets.

There are three key theorists who have contributed to the modern sociological view of markets: Harrison White, Pierre Bourdieu and Neil Fligstein.\textsuperscript{925}

\textit{Harrison White – The W(y) Model}

In 1981, Harrison White wrote an influential article titled: \textit{Where Do Markets Come From?}\textsuperscript{926} In it he outlined his sociological theory of the markets: the W(y) Model. It acted as a catalyst for modern interest in the sociological view of markets. White


\textsuperscript{925} Richard Swedberg provided a summary of the sociological theory of markets in his book \textit{The Principles of Economic Sociology}. Swedberg identifies four sociologists as key contributors to the sociological understanding of how markets work: Max Weber, Harrison White, Pierre Bourdieu and Neil Fligstein, see Swedberg supra note 33 – Chapter V. Swedberg’s summary was relied upon in building the following discussion. It should be noted that there are other ways to conceive of markets from a sociological perspective including network analysis, a cultural perspective, and the political perspective of Karl Polanyi. These perspectives are not discussed in this chapter. One of the earliest attempts to define the market from a sociological perspective was Max Weber’s attempt to develop a “sociology of the market”. He characterized a market by a two stage process of social action: competition followed by exchange. Market actors compete to determine who will be the final seller and final buyer. Only once that is determined can the exchange occur. See Max Weber, \textit{Economy and Society} (Berkeley: University of California Press, 1978) at 635-640. Weber described the market as a conflict (or “struggle”) of economic interests between buyers and sellers. For example, Weber talked about the “battle of man against man in the market.” \textit{Ibid} at 108. Weber summarizes this conflict view of the market in the following passage: “A market may be said to exist wherever there is competition, even if only unilateral, for opportunities of exchange among a plurality of potential parties. Their physical assemblage in one place, as in the local market square, the fair (the “long distance market”), or the exchange (the merchant’s market), only constitutes the most consistent kind of market formation. It is, however, only this physical assemblage, which allows the full emergence of the market’s most distinctive feature, viz. dickering.” \textit{Ibid} at 635.

focused on production markets (markets where actors produce goods) because economists largely focused on exchange markets. He argued that markets are social constructions:

The market is like a social molecule of firms rather than a mere abstraction called up in some string-maze of firms in a sea of perfect competition. Producers seek shelter from uncertainty together under a market umbrella induced through their own actions as a set who have come to eye each other and be eyed by others as structurally equivalent in networks of business relations. He defined markets in the following way:

Markets are self-reproducing social structures among specific cliques of firms and other actors who evolve roles from observations of each other’s behavior. White’s model was an advance in market theories, because in contrast to economic assumptions of isolated actors, White suggested that stable markets are only possible when actors took one another into account. Behaviour in markets is based on competitors watching each other and then basing their production decisions on their competitors’ behavior.

The central mechanism in the social construction of markets is its market schedule: W(y). Where “W” stands for revenue and “y” for volume of product. White argued that this schedule was more realistic than supply and demand curves because business people do not really know what consumers think of their products. All they really know is what items sell in what volumes at what prices. The goal of actors in White’s markets is to find a niche for their products when customers buy a certain

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927 Production markets have three roles: producer, supplier and purchaser, as opposed to exchange markets that have only two roles, seller and purchaser. White believed that a production market consisted of about a dozen firms that are recognized by competitors and consumers as defining a market. See White (2003) *ibid* at 130.


volume at a certain price and to avoid head-to-head competition with competitors. Therefore, the structure of the market is based on a producer’s commitments to produce a certain amount of goods based on analysis of each other as opposed to production based on consumer demand.

In the model, prices are a by-product of market equilibrium and profits can be predicted. The model has yet to be empirically tested and has not been worked out in detail. It was important, however, to the extent that it illustrated that sociological conceptions of markets. It also generated further work in the area.

**Pierre Bourdieu – Markets as Fields**

French sociologist Pierre Bourdieu constructed his theory of markets based on empirical studies he conducted of the housing and literary products markets in France. Bourdieu believed that markets could be conceptualized as fields or structures of actual and potential relations. Bourdieu described fields in the following way:

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932 White’s concept of niche seeking was an insight borrowed from population ecology. For example, he wrote: “In my view, firms seek niches in a market much in the same way as organisms seek niches in an ecology. Because each firm is distinctive, they are engaged not in pure competition but in finding and sustaining roles with respect to one another given an environment of discerning buyers.” See White (1981) supra note 823 at 520.

933 Ibid at 543.

934 In order to make the production decisions producers must look both upstream and downstream. See White (2003) supra note 823 at 130.


936 For a description of Bourdieu’s concept of “field” see Pierre Bourdieu, “Les Champs Economique”, 119 *Actes de la Recherche en Sciences Sociales* 48; updated and translated into English: Pierre Bourdieu, *The Principles of Economic Anthropology* (english version forthcoming). Bourdieu developed his concept of field to explain the deficiencies in the economic model of markets that were exposed in his studies of the
In analytical terms a field may be defined as a network, or a configuration, of objective relations between positions. Each field is characterized by constant struggle. Each participant in a field has a number of tools at their disposal in the struggle: financial capital and the three other non-financial forms of capital referred to earlier: social capital, cultural capital and contingent capital. To use an industry as an example, the field would consist of the power relations among the firms in the industry, which are maintained through capital in various combinations. Prices are determined by the structure of the field. Bourdieu’s view of markets is illustrated in the following quote:

What one calls the market is therefore the totality of exchange relations between actors who compete with one another. These interactions depend, as Simmel says, on an “indirect conflict”, that is, on the structure [of the field] that has been socially constructed through power relations. The actors in the field contribute in different degrees to these power relations, through the modifications of these that they can muster, especially by controlling and directing the power of the state.

Interest is what drives individuals to participate in a field. Each field can have a different interest. Interest drives the behavior of individual actors within a field. Bourdieu’s interest is much different than economists’ view of interest. For Bourdieu interest does not need to be related to utility maximization:

anthropology and comparative history show that the properly social magic of institutions can constitute just about anything as an interest.


938 For Bourdieu most organized social settings can be conceived of as a field including: an individual firm, an industry or the economy.
939 In Anthropology: Translated by Swedberg supra note 33 at 127.
Bourdieu's concept of “fields” has been adopted by many North American sociologists to explain the market. The most notable example is Neil Fligstein.

**Neil Fligstein – Markets as Politics**

Neil Fligstein developed his theory of markets based on his empirical study of the European market. It is the most robust sociological theory of markets yet developed. He developed his theory of markets in response to what he saw as a need for such a model because of the weaknesses in the economic models. It is also the first attempt to synthesize the different organizational theory perspectives and present a full social view of how markets work. His model is a combination of insights from institutional theory, network analysis and population ecology. It is based on the conflict perspective.

Fligstein calls his theory the political-cultural approach to markets.

He defines markets in the following way:

Markets are social constructions that reflect the unique political-cultural construction of their firms and nations. The creation of markets implies societal solutions to the problems of property rights, governance structures, conceptions of control, and rules of exchange. There are many paths to these solutions, each of which may promote the survival of firms.

Fligstein emphasizes that the biggest issue facing individuals and organizations in markets is uncertainty: Uncertainty in obtaining supplies; uncertainty in finding customers; uncertainty regarding the actions of competitors; and uncertainty about

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942 See Fligstein (1996) supra note 815 at 657.

943 For example see *ibid* at 657, where he indicates the conflict nature of his view when talking about the internal structure of firms: “The internal power struggle is about who will control the organization, how it will be organized, and how situations will be analyzed and responded.” In this regard, Fligstein’s theory is remarkably similar to Lynn Dallas’ power coalition theory. To the extent possible, his model has been stripped of its conflict characteristics in this section to increase its acceptability to North American scholars.

944 Fligstein (2001) supra note 815 at 97.
general economic conditions. Therefore, the primary goal of any collective actor in a market is the creation of stability to allow for its survival.

The purpose of action in a given market is to create and maintain stable worlds within and across firms that allow firms to survive. Stability has always been recognized as an important contributor to long-term economic growth. A “stable market” is a successful market. Societies that have stable governments, stable relationships between the government and economic interests, successful mediation between workers and capitalists and a history free from war, persecution or natural disasters, are more likely to enjoy long-term economic growth.

Stability is created by social means – by creating stable social relationships with customers, suppliers, stakeholders and competitors. This is accomplished through the creation of formal and informal rules. Formal rules are often imposed in markets by the government. Informal rules are the rules that govern in social relations among market participants. They are the culture or social norms of a market. Fligstein highlights the importance of rules:

Why do rules matter? Complex patterns of interaction that are stable require actors who share cognitive assumptions and expectations. To get such stability people need either long experiences with one another, such that they settle into habitual patterns, or more formal rules to govern novel interactions. Rules based on experience or tradition or formally agreed to through negotiation then frequently become habitual in interaction... It is the instability produced by

945 See ibid at 16 and (1996) supra note 815 at 659.
946 In this section the term “collective actor” is used to describe any form of social group or organization. The obvious example of a collective actor for the purposes of the analysis in this book is a corporation.
948 Fligstein defines a stable market in the following way: “A stable ‘market as field’ means that the main players in a given market are able to reproduce their firms.” Fligstein (1996) supra note 815 at 17. He also states it slightly differently: “A stable market is a social field in which a conception of control defines the social relations between incumbent and challenger seller firms such that the incumbent firms reproduce those relations on a period-by-period basis.” See Fligstein supra note 815 at 35.
949 For example see Fligstein (2001) supra note 815 at 60.
950 Ibid at 18.
interactions in which actors do not share meanings that pushes actors to seek out more stable conditions under which to interact.\textsuperscript{951}

Government has a very big role to play in producing stable markets. As markets have become more complicated, actors have been increasingly incapable of providing rules for themselves.\textsuperscript{952} Therefore, the government’s primary role with regard to markets is to intervene to create rules that promote stability.\textsuperscript{953} Fligstein believes that markets require four elements to exist: Property rights, governance structures, conceptions of control and rules of exchange.\textsuperscript{954} The state is crucial in providing these institutions:

While most modern discussions of state-building have focused on welfare and warfare, modern capitalist states have been constructed in interaction with the development of their economies, and the governance of economies is part of the core state-building. . . Property rights, governance structures, and rules of exchange are arenas in which modern states establish rules for economic actors. States provide stable and reliable conditions, under which firms organize, compete, cooperate and exchange. The enforcement of these laws affect what conceptions of control can produce stable markets.\textsuperscript{955}

Therefore, any argument that is based on non-intervention of the state in markets, ignores the reality that states are essential to the creation and maintenance of any market system.

One of the insights offered by Fligstein’s markets as politics approach is that there is no single best way to organize a market.\textsuperscript{956} As long as there are institutions in the four

\textsuperscript{951} Ibid at 28.
\textsuperscript{952} This incapability is a function of two different effects: First, actors need to spend their time and energy surviving and so they have little resources left for rule creation. Second, in the environment of extreme competition and uncertainty that characterizes modern markets, actors often are unable to agree on common rules. See Ibid at 27-28.
\textsuperscript{953} Ibid at 19.
\textsuperscript{954} Fligstein provides the following definitions of the four institutions: Property rights: “are social relations that define who has claims on the profits of firms.”; Governance Structures: “refer to the general rules in a society that define relations of competition, cooperation, and market-specific definitions of how firms should be organized. These rules define the legal and illegal forms of how firms can control competition; they take two forms: (1) laws and (2) informal institutional practices.”; Conceptions of control: “refer to understandings that structure perceptions of how a market works and that allows actors to interpret their world and act to control situations.”; Rules of Exchange: “define who can transact with whom and the conditions under which transactions are carried out.” See Fligstein (1996) supra note 815 at 658.
\textsuperscript{955} Ibid at 660.
\textsuperscript{956} This is an insight that is shared by population ecology and evolutionary economics.
areas, property rights, governance structures, conceptions of control, and rules of exchange, then stable markets can be created and economic growth can occur. It matters less what the content of those institutions are. It is just important that they exist. The form of these four institutions in a particular society are set by the state as it emerges into capitalism or market economy. Once set, these institutions create a cultural template for the organization of markets and organizations that changes very slowly, unless there is a major societal crisis like war and depression. In this regard, its ability to resist change, the market template is similar to the organizational template discussed above.

Fields

Fligstein also view markets as fields. He describes them in the following way:

The key insight of this approach is to consider that social action takes place in arenas, what may be called fields, domains, sectors or organized spaces. Fields contain collective actors who try and produce a system of domination in that space. To do so requires the production of a local culture that defines social relations between actors. [footnotes omitted]
Fields are simply groups of similar organizations. DiMaggio and Powell have defined fields in the following way:

Those organizations that, in the aggregate, constitute a recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies, and other organizations that produce similar services or products.

Dominant corporations within fields (or industries) create stability by creating the organizational template and rules by which all of the other competitors follow.

*The Market Actor*

This sociological view of markets replaces the profit maximizing actors of economic theory with actors who are focused on ensuring the survival of their organizations. Fligstein states it this way:

Market actors live in murky worlds where it is never clear which actions will have which consequences. Yet, actors must construct an account of the world that interprets the murkiness, motivates and determines courses of action, and justifies the action decided upon. In markets, the goal of action is to ensure the survival of the firm. No actor can determine which behaviors will maximize profits (either a priori or post hoc), and action is therefore directed toward the creation of stable worlds.

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Summary – Markets are Stable not Competitive

Markets are stable not competitive. Markets require stability to exist. They do not naturally exist in a competitive state. Throughout history there has been a natural progression in markets from small and simple markets to large complex ones. As markets get larger and more complex they get more stable.

Complexity in market structures and a growth in the size of markets tends to produce stability, not fragility, in societal economic growth. This is because the diversification of products and firms and the diversification of economies makes firms and economies more stable.

Markets could not have gotten more complex without the assistance of the state – especially when they reached the point of becoming national markets.

Similarly, as corporations grow and become more complex they become more stable. Especially through diversification. Neil Fligstein has written:

Through diversification, a firm that produces multiple products can reduce its dependence on any one product, and hence, increase the likelihood that the firm will survive. This allows the firm to grow larger, which increases firm stability as well.

6.2.9 Society and the Economy

Markets are social constructions because the market is embedded in society. Human beings are ‘embedded’ in a web of social relations. The market is but one subset of those relations. Therefore, market interactions are simply a subset of social interactions and are governed by the same characteristics as social actions. Karl Polanyi’s summarized this concept of strong form embeddedness in the following quote:

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965 For a historical account of the development of markets see Swedberg supra note 33 at 131-157.
966 Fligstein (2001) supra note 815 at 91.
967 Swedberg supra note 33 at 140.
968 Fligstein (1996) at 659.
969 See Guillen supra note 805 at 6. Karl Polanyi’s discussion of markets includes three forms of integration or ways to stabilize the economy: reciprocity, redistribution and exchange.
The outstanding discovery of recent historical and anthropological research is that man's economy, as a rule, is submerged in his social relationships. He does not act so as to safeguard his individual interest in the possession of material goods; he acts so as to safeguard his social standing, his social claims, his social assets. He values material goods only in so far as they serve this end. Neither the process of production nor distribution is linked to specific economic interests attached to the possession of goods; but every single step in that process is geared to a number of social interests which eventually ensure that the required step be taken. These interests will be very different in a small hunting or fishing community from those in a vast despotic society, but in either case the economic system will be run on non-economic motives.\textsuperscript{970}

The concept of strong form embeddedness is in direct contrast to the argument made by economic theory that market interactions are separate from social relationships.

\textit{Summary – Narrow vs. Broad}

To conclude this section, the sociological view of actors, organizations and markets is broader and more inclusive than the corresponding economic view. This difference occurs at every level of the analysis outlined above.

For example, at the individual level, actors are reasonable \textit{in the circumstances} and not rational all the time. Their behavior is capable of being rational at times, but it is also affected by other circumstances including information, history, social structure etc. The relationship between the narrow concept of rationality and the broader concept of reasonableness is depicted in Figure 6-1. Rationality is but one of many determinants of behaviour that is taken into account in determining the behaviour of the reasonable person.

At the structural level, the goal of organizations is effectiveness, not efficiency. The primary goal of an organization is to survive, not to generate a profit. Profit maximization is certainly one of the determinants of organizational behavior but it is not

\textsuperscript{970} Polanyi \textit{supra} note 19 at 48.
the only one. Survival requires a minimum level of profit, but it also involves other concerns including legitimacy, reputation, trust etc. The relationship between the narrow concept of profit maximization and the broader concept of effectiveness is depicted in Figure 6-2.

At the ecological level, the goal of markets is stability, not competition. A certain level of competition is healthy for markets because it ensures that there is enough organizational and product diversity to allow their natural evolution. Homogeneity in organizational forms and products is not good for markets or society.971 However, competition is just one aspect of healthy markets. Markets that are characterized by unlimited competition are bad. Human beings, organizations, and society are poorly equipped to deal with constant change. The role of institutions in society is to create stability. The relationship between the narrow concept of competition and the broader concept of stability is depicted in Figure 6-3.

At the societal level, the economy is embedded in society. This relationship is depicted in Figure 6-4. It is one of the key differences between sociology and economics. This difference can be illustrated by looking at the different way in which they define the economy. The focus of the economic definition of the economy is very narrow. The focus of the definition offered by economic sociology is much broader. This difference has been highlighted by sociologist Carlo Trigilia. He compared the following broad sociological definition of the economy:

[A] body of activities which are usually carried out by members of a society in order to produce, distribute and exchange goods and services.972

To the following narrow economic definition of the economy:

971 This is an insight offered by population ecology and evolutionary economics.
972 Trigilia supra note 805 at 2. This definition is based on the work of Karl Polanyi.
Activities which involve the rational allocation of scarce resources in order to obtain the most from the means available.\textsuperscript{973}

Trigilia points out that the sociological definition of the economy in more general and it allows for variation among societies in the different ways that they choose to satisfy their economic needs. Societies need not choose efficiency as their overriding goal.\textsuperscript{974}

In all of these cases, the broader approach is better able to accommodate the complexity of social life.

6.3 \textit{Summary Of Insights From The Historical Review Of Corporate Theories}

Before offering an updated version of the social theory of the corporation, it is important to summarize the insights into corporate theory that were collected in the historical review in Chapter 3. The purpose of collecting these insights was to ensure that lessons already learned in the past are not repeated in the updated version of the social theory of the corporation.

The most significant of those insights are the following:

1. \textbf{Normative Assumptions}: Clearly state the normative assumptions behind the theory and explain why those assumptions were chosen,\textsuperscript{975}

2. \textbf{Based on Reality}: The definition of the corporation adopted must be based on reality and not on abstractions. It should be based on the latest understandings of organizations from the social sciences,\textsuperscript{976}

\textsuperscript{973} \textit{Ibid.}

\textsuperscript{974} Trigilia provides the example of primitive societies where economic relationships are not distinct but are embedded in social relations (i.e. the family unit) as an example of such a situation. \textit{Ibid} at 3.

\textsuperscript{975} This insight is the result of the normative analysis of corporate theories that was conducted in Chapter 3. It is based on the works of Edward Freeman, Stephen Bainbridge, Lynn Dallas, Rob Yalden and W. Richard Scott. \textit{See} Chapter 3 – “Normative Assumptions.”

\textsuperscript{976} This insight resulted from the critiques of corporate theory offered by John Dewey and H.L.A. Hart. Abstract theories or short-cuts have in the past led to unintended results. \textit{See} Chapter 3 – “The Relevance of Corporate Theory”. For example, fiction theory’s treatment of the corporation as a person enable modern corporations to successfully argue for rights of free speech.
3. **Empirically Tested Propositions**: The theory should be based as much as possible on empirically tested propositions.\(^{977}\)

4. **Results Oriented**: The theory should recognize the group as a valid right and duty bearing unit in society and focus on the circumstances in which the law should accord the group legal rights and what those rights should be.\(^{978}\)

5. **Consistent Practical Results**: The theory needs to generate consistent results so that it can be used by practicing lawyers to replace the current theory.\(^{979}\)

The social theory of the corporation takes into account and overcomes the limitations associated with each of these insights: The normative assumptions behind the theory are clearly stated; the theory is based on the latest observations of reality from organizational theory and economic sociology on the behaviour of individuals, organizations (including corporations) and the market; where possible the insights upon which the theory is built is based on actual studies done by organizational researchers and economic sociologists; the theory recognizes the group as a valid right and duty bearing unit in society; and, to the extent possible in the limited space provided in this Chapter, it will be shown, by way of an example, that the theory is capable of producing results that are at least as predictable as the current theory, if not more predictable.

### 6.4 The Social Theory Of The Corporation

The updated version of the social theory of the corporation is presented in this section in four separate parts. First, the normative assumptions of the theory are clearly stated. Second, the question: “what is a corporation?” is answered. Third, the question:

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\(^{977}\) This insight came out of Chapter 4 and Alfred Eichner’s critique of economic analysis that showed that some of economics’ most basic propositions had never been empirically tested.

\(^{978}\) This insight is the result of H.L.A. Hart’s criticism of abstract definitions. *See Chapter 3 – “The Relevance of Corporate Theory”*

\(^{979}\) This insight is a result of the doctrinal criticisms leveled against corporate theory by Adolph Berle, Morton Horwitz, Mark Hager and William Bratton. *See Chapter 3 – “The Relevance of Corporate Theory”*. 

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“what is the purpose of corporate law?” is answered. Finally, an initial assessment is made of whether the social theory of the corporation is better than the Nexus of Contracts theory of the corporation by focusing on the theory’s descriptive, illustrative and normative aspects.

6.4.1 The Normative Assumptions of the Social Theory of the Corporation

There are three important normative assumptions at the core of the social theory of the corporation:

1. Humans are social beings whose behaviour is affected by their social relations.
2. Groups are valid units of analysis in society and are acceptable right-and-duty bearing units.
3. The corporation is a public entity.

These assumptions locate the social theory of the corporation in the upper-left quadrant of the Assumptions Chart in Chapter 3. They also make the theory consistent with natural systems perspective in organizational theory and the approach of economic sociology. Each of the assumptions is discussed briefly below together with the reason why the position on the particular assumptions was adopted.

Humans are Social Beings

The social theory of the corporation assumes that humans are social beings. This choice is reasonable based on observations made of real human behaviour by economic sociologists. Network analysis and studies of social capital have shown that an individual’s place within social networks affects the way they make decisions. Human beings act rationally some of the time. But they also are capable of acting irrationally or
altruistically. This irrational or altruistic behavior is most often explained by the social constraints or influences on the individual. Individual’s act reasonably in their circumstances. Their circumstances include their social position, race, gender, history etc.

As has been mentioned throughout this book, this conception of human nature goes back a long way. It was supported by the early sociologists (Weber, Durkheim and Marx), the entity theorists (Gierke, Maitland, Pollock, Carr etc.), the post-war sociologists (Polanyi, Parsons etc.) and more recently by economic sociologists (Granovetter, Fligstein etc.). Karl Polanyi wrote about the enduring character of this belief:

For if one conclusion stands out more clearly than any other from the recent studies of early societies, it is the changelessness of man as a social being.\footnote{See Polanyi \textit{supra} note 19 at 48.}

This understanding of human nature when applied to the corporation allows corporate theory to overcome one of the greatest weaknesses of the economic nexus of contracts theory of the firm – its lack of humanism. This lack of humanism is a direct result of economics’ focus on rational behaviour and it is a legacy from the early rational systems theories like Taylor’s scientific management. The result is that modern corporations are not very comfortable places for human beings. They are often characterized by long work hours, high demanded productivity, isolation, lack of physical fitness, high levels of stress, and “human resources”. Good corporations are the corporations that value their human participants and purposely take into account their human and social qualities.
The Group as a Unit in Society

The social theory of the corporation assumes that groups are valid units in society. Organizational theory has shown that groups and associations are a natural occurring phenomenon in society and they do not depend on any assistance from the state for their formation. These groups have taken many different forms over the course of human history but, in all those forms they have shown the ability to act as a collective body. W. Richard Scott summarized this view of organizations:

We will fail to perceive of the importance of organizations for our lives if we view them only as contexts- as arrangements influencing the activities of individual actors. Organizations must also be viewed as actors, in their own right, as collective actors. They can take actions, utilize resources, enter into contracts, and own property. Coleman describes how these rights have gradually developed since the Middle Ages to the point where now it is accurate to speak of two kinds of persons – natural persons (such as you and me) and collective or juristic persons (such as the Red Cross and General Motors). *The social structure of modern society can no longer be described accurately as consisting only of relations among natural persons; our understanding must be stretched to include as well those relations between natural and collective actors, and between two or more collective actors.*\(^{981}\) [emphasis added]

Organizations must therefore be given a rightful place in the legal system. Once the group is recognized as a valid right-and-duty bearing unit in society it becomes important to assure that they are assigned the correct rights-and-duties and not simply treated as individuals. It is not sufficient to take the short-cut of treating them like human beings. The legal rights of organizations needs to take these special characteristics of organizations into account.

The Corporation is a Public Entity

The social theory of the corporation assumes that the corporation is a public entity. Karl Polanyi was the first two introduce two very important concepts. First, the

\(^{981}\) Scott, *supra* note 683 at 8-9.
economy and economic activities are embedded in society and their purpose is to provide for the material well being of society. Second, economic markets cannot exist without regulation. These two ideas have been validated by other researchers. A number of anthropological studies that show that in pre-capitalist societies the economy was always a portion of larger social activities and was not important, in and of itself, as a separate pursuit. Also, modern economic sociologists such as Neil Fligstein have shown that markets cannot exist without regulation.

The combination of these two insights leads to the conclusion that the corporation is a public entity. Corporations as economic and social units are not private interests to be owned by specific individuals in society. They are part of a larger economic system whose purpose is to provide for the material well being of our societies. The question is not should the corporation be subject to public regulation. It always has been and it always will be. The question is how much regulation it should be subjected to.

_What is a Corporation?_

The Corporation is a social institution. It is an organization of human beings that has become so important as an organizational type that it has become institutionalized and now provides meaning and stability to social life. The primary goal of a corporation is survival which it accomplishes by creating a stable environment for itself. Corporations are characterized by goal complexity and the importance of informal structures.
The primary goal of a corporation is to survive – to reproduce itself over time. Stability, effectiveness and legitimacy all play a large part in ensuring the survival of the corporation.

Corporations attempt to create stability for themselves by dominating their fields by creating social relationships with their customer, suppliers, stakeholders and competitors. They also create stability for themselves by attempting to control their environments.

Legitimacy plays an important role among corporations. Corporations often mimic each other’s behaviour in order to gain legitimacy. Most often, smaller firms mimic the behaviour of larger, more successful, firms because the behaviour is believed to have contributed to the success of the larger firm. This mimicry occurs even if the behaviour was not the cause of the larger firms success. Over time, this mimicry has contributed to the institutionalization of the corporation in modern society.

Corporations pursue effectiveness and not efficiency. The primary goal of a corporation is not to maximize profits. Profit maximization is more often than not inconsistent with survival. Studies have shown that stability is increased in economies, markets and organizations when they become more complex. Economies or corporations that are diversified are more stable than economies or corporations that depend on a single product or service because they have protected themselves against unforeseen events. This increases their chances of survival. This would tend to suggest that large corporations should be diversified organizations. However, that is not the current trend

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982 This is isomorphism.  
in Anglo-American societies. As a result of our fixation on short-term profit, the large diversified organizations in Anglo-American societies have been dismantled since the 1980’s.\textsuperscript{984} This makes our largest corporations and our economies less stable. In other societies, large corporations have always been diversified. The Korean chaebol and Japanese Keiretsu are the best examples of this phenomenon.

\textit{Goal Complexity}

Corporations are capable of pursuing multiple goals at the same time. This is possible because they are organizations of individuals each pursuing multiple interests. Corporations do not necessarily need to pursue a single goal to be effective. Economic considerations (i.e. profit) are one of many considerations to be taken into account when setting corporate goals but they are not the only considerations. A business organization that does not pay attention to whether it is making money or not is not likely to survive for long. But other goals can also be pursued at the same time, including both official goals (set by management) and unofficial goals (for example, personal agendas).

Understanding how corporations operate with complex sets of goals is important. Henry Mintzberg has proposed that firms organize their complex goals in the following hierarchical structure depending on the organization’s stage of development:

1. Survival
2. A certain level of efficiency [profit] to ensure survival
3. Control of the Organization’s environment to ensure a degree of survival

\textsuperscript{984} It is interested to note that this may not be the natural state for large business organizations worldwide. In most other economies particularly the economies in Asia large business organizations are characterized by their diversity. For example Korea, Japan, China etc.

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4. Growth

This is an extremely interesting list because it echoes the increasing complexity argument made throughout this book. It acknowledges that survival is the primary goal of the firm – showing the consistency between the natural systems perspective and Mintzberg’s theory of organizations. It also acknowledges that a certain level of concern for economic performance is one of the factors that impact survival. Finally, it acknowledges that as organizations become stable and increase in complexity they begin to alter their environment to increase chances of survival. Only once all of these other goals are accomplished does the organization begin to think about growth.

Goal complexity calls into question the whole justification for shareholder primacy. Adolph Berle’s argument that we need to continue to use shareholder primacy until another simple system of accountability can be developed is no longer persuasive. Corporations have never had simple accountability. They are complex places with complex goals. Managers are always dealing with competing interests when making decisions. Lynne Dallas has provided a strong argument against the simplicity of shareholder primacy that is based on this insight:

At the heart of the argument against employee participation in corporate governance is the idea that without a single goal (to pursue shareholder interests) the board will lose its ability to make decisions and cannot be judged or held accountable. However, organizational life is replete with decision making in the midst of conflicts of interests. Professors Cyert and March, in their early behavioral studies, of organizations found that corporations do not “aggregate preferences,” but deal with multi-peaked preferences whereby corporate goals are attended to sequentially. . .The existence of inconsistent and vague or ambiguous goals is not harmful as is often believed. Such goals contribute to the

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986 This hierarchy of goals is also important to the extent that it sheds some light on how social theories and economic theories can be combined. It is an example of Scott’s ‘Layered Approach’.
corporation’s survival and growth by enlisting the support of various constituencies, such as lower- and upper-level employees and consumers. Thus, as a practical matter, directors/managers do not have one goal in their stewardship of the corporation, and neither should they.\textsuperscript{987}

\textit{Informal v. Formal Rules}

Within corporations informal rules, including norms, culture, and beliefs, are as important as formal rules, including laws, roles and responsibilities, codes of conduct etc. This is because participants in a corporation develop informal structures to interact with each other and to perpetuate the corporation. If formal rules were the only determinant of the internal structure of the corporation, we would expect most corporations to look similar because of the consistency of the formal rules. But, that is not the case. Different corporations have dramatically different cultures. The existence of these influential informal structures means that decision makers take into account not only formal structures (for example, the corporate law’s commitment to shareholder primacy) but also the prevailing informal structures (for example, the corporation’s historical commitment not to lay-off employees) when making decisions.

This insight has serious implications for the purpose of corporate law and the role of regulation.\textsuperscript{988} Changing the formal rules (the law), does not necessarily mean that behaviour within the corporation will change. In order to change behaviour within corporations it is necessary to change corporate culture and norms. Regulators in North America are beginning to recognize this. For example, the U.S. Securities and Exchange Commission has recently stated that its goal in enforcement is to change the long-term

\textsuperscript{987} Dallas (2005) \textit{supra} note 55 at 518.
\textsuperscript{988} Using the term broadly here to refer to corporate governance, corporate law and securities law.
behaviour of corporations. In furtherance of this goal, it has recently begun experimenting with the practice of Reform Undertakings. This practice recognizes that monetary penalties alone are not enough to change corporate culture. Instead, under a Reform Undertaking, a corporation enters into a settlement agreement with the SEC whereby the corporation hires an approved third party to oversee its compliance procedures and policies for a period of time. This approach has a number of advantages over traditional enforcement, the most important of which is that the focus is on changing behaviour. Christie Ford had argued that the Reform Undertakings approach of the SEC could lead to a new paradigm of enforcement in securities law. This kind of approach can also lead to a new paradigm in corporate law.

**Interaction With The Environment**

Corporations are affected by their environment. The environment includes not only material resources (including people, supplies, capital etc.) but the institutional environment as well (including laws, norms and culture). Corporations structure themselves in the best way to allow them to survive in their environment.

Corporations are also able to affect their environment. In fact, in order to create stability and survive, it is almost imperative that large corporations gain a certain level of control over their environment. Fligstein argues that they do this by dominating their "field". The environment includes laws and the political system. Therefore, it should

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990 For a description of Reform Undertakings see Ibid at 797 to 806.
991 See Ibid at 759-760.
992 Ibid.
993 This is discussed in more detail below under “What is the Purpose of Corporate Law?”
994 Dallas argues the same thing in power coalition theory see Dallas (1995) supra note 445 at 55.
not come as a surprise to us to learn that corporations are influencing both the political process and the formulation of law. It is merely a legitimate attempt to create stability.

Corporations are also loosely coupled systems that are open to their environments. This means that it is extremely difficult to draw boundaries around them and determine what is a part of the corporation and what is not. In fact, there is no single correct way to make this determination. It is largely decided by the corporation's participants themselves based on one of the three methods of determining boundaries: people, roles and activities. As corporations evolve and become more loosely coupled boundaries should expand to become more inclusive. Shareholder primacy has limited the expansion of the boundaries of corporations because it mandates a very narrow boundary. Employees, directors and shareholders are within the boundary. Everyone else is outside the boundary. In order to expand the boundaries the concept of shareholder primacy needs to be abandoned. It is interfering with the natural evolution of corporations.

Universal Theories, Homogeneity and Organizational Evolution

Another way that shareholder primacy is interfering in the evolutionary process of corporations is by contributing to organizational homogeneity. This is not a good thing. Japan is an example of a society that through homogeneity of organizational form is unable to naturally evolve when faced with new environmental circumstances. The result is that Japan relies on exogenous shocks to progress its organizational forms forward. Fischel and Easterbroook have admitted that the Nexus of Contracts theory of the firm halts the evolutionary process:

995 See West infra note 1011.
Mandatory terms prescribed by law halt the process of natural selection and evolution.996

To make matters worse, Anglo-American societies are attempting to export our version of shareholder primacy to other countries under the belief that it is the best system available. If this occurs it could cause a serious organizational homogeneity problem that would make the world economy extremely susceptible to environmental changes. We need to recognize that there is no single best way to organize and that each corporation’s preferred method of organizing is the structure that best fits its particular environment.

**Particular As Opposed To Universal Theories**

The social theory of the corporation is particular and not universal. All of the insights outlined above contribute to its particular nature: the need for survival, the importance of the environment, the ability to accommodate complex goals and the importance of informal rules and culture. Since environments are different in each country and they change over time, there is no one prescription that can be written for all corporate law. The social theory of the corporation is not capable of providing a universal model of corporate law. It is only capable of producing particular theories of corporate law that are suitable for a particular society at a particular point in time. Economic sociologist Carlo Trigilia explained the particular nature of the social sciences:

[T]he social sciences cannot aspire to producing general theories; instead, they can develop historically oriented models, with definite boundaries in time and space, largely based on comparative methods. Society is in a process of continual change as a consequence of interaction between human beings. Thus, relations between economic and society, which are the focus of this work, are subject too to

996 Fischel and Easterbrook 348 *supra* note at 31.
perpetual change. This means that the tools needed to understand society must take account of its diversity in time and space.\textsuperscript{997}

For example, the social theory of the corporation could be used to develop a theory for Canadian corporate law in the 21\textsuperscript{st} century. This theory would be based on empirical evidence about the tasks that Canadian corporations are performing\textsuperscript{998} and the environment in which they operate.\textsuperscript{999}

\textit{What Is The Purpose Of Corporate Law?}

The social theory of the corporation provides that the purpose of corporate law is twofold:

1. To facilitate the formation, survival and evolution of corporations, and
2. To provide stability to society, markets and corporations by managing the relationships amongst the corporate participants in a way that is consistent with the normative views of the society in question.\textsuperscript{1000}

This purpose is very similar to the purpose of corporate law that was provided by Frederick Hallis’ 1930 version of Early Sociological Theory. For Hallis, the purpose of corporate law was to recognize lawful organizations and to safeguard the public or private interests.\textsuperscript{1001}

The first purpose deals with the fact that corporations (as a type of organization) form naturally. They do not owe their existence to the state. Beyond that, corporations are constantly evolving to adapt to their environments and ensure their survival. The

\textsuperscript{997}Trigilia \textit{supra} note 805 at vii.
\textsuperscript{998}The Canadian economy is unique in that it has a very high proportion of natural resource and financial services companies.
\textsuperscript{999}Unique features of the environment in Canada include the use of multiple-voting shares, the number of family controlled companies and the extreme density of the networks among Canadian boards of directors.
\textsuperscript{1000}This is similar to the purpose proposed by Lynn Dallas’ socioeconomics approach: To “manage the relationships among individuals in groups to assure fairness in terms of the opportunities available to various actors and the distribution of entitlements.” Dallas (2005) \textit{supra} note 55 at 6.
\textsuperscript{1001}Hallis \textit{supra} note 90 at 232.
corporate law needs to be flexible enough to allow them to do this. There is at least some
evidence to suggest that the current version of Anglo-American corporate law is not
flexible enough. Modern corporations are increasingly becoming more loosely coupled
and their boundaries are constantly expanding. The current Anglo-American corporate
law, with its commitment to shareholder primacy, is artificially constraining the
boundaries of corporations. Shareholders and employees are within the boundaries but
everyone else is outside. This boundary is not consistent with the reality of corporations
that are increasingly expanding their boundaries to include customers, suppliers,
competitors etc. by entering into joint ventures, alliances and other non-traditional
business relationships.

Also built into the first purpose of corporate law is the recognition that
corporations are valid right and duty bearing units in society. Corporations are different
than people and, therefore, they should not have the same rights and obligations as a
natural person. This insight combined with the insight that corporations are constantly
evolving leads to the conclusion that corporations may not be around forever. As a social
institution, the corporation could conceivably evolve into something entirely different if
the environment changed in any significant way. Therefore, it would make more sense to
conceive of the corporate law as the law of business associations or the law of rights and
obligations in society for all groups. In this view, the corporation is simply the preferred
method of organizing at the current time, but the law would be flexible enough to
accommodate other future legitimate methods of organizing large business ventures.

The second purpose of corporate law deals with the public nature of corporations,
the role of government in creating stability and the fact that corporate law has distributive
effects in society. The corporate law has a regulatory role to play. The purpose of corporate law is not just to allow corporations to form naturally. It is to make sure that the formation occurs in a stable way that is beneficial to society and consistent with society’s views on the distribution of wealth. Stability is created by the corporate law by providing clear and concise rules that generate consistently predictable results.

Once it is acknowledged that the corporate law has a regulatory role to play, there are at least three options for how that role can be fulfilled:

1. Self regulation by corporations
2. Regulation by law: either within or outside of the corporate law
3. Regulation by internal governance

Self regulation will never work because it ignores a crucial fact highlighted by the social theory of the corporation: markets cannot exist without government regulation because society is too complex for participants to negotiate their own stable relationships. An example of the failure of self-regulation is the recent “Code of Conduct” movement. Most large publicly traded corporations in North America now have a corporate code of conduct. These codes were heralded as the beginning of self-regulation and to a certain extent they had promise. However, in practice, they have simply become a way for the corporation to protect itself from its own employees than actual standards of behaviour that are created, reinforced and taken to the level of internal regulation. If an employee engages in behaviour that is detrimental to the corporation by breaking the

\[1002\] In fact, they are required by Sarbanes Oxley and NYSE listing requirements.
\[1003\] Most corporations do not engage in the kind of training exercises that are required to make these codes effective. Many corporations simply have the employees sign an acknowledgment that they have “read” the code and agree with its terms.
code, the corporation simply blames the employee, fires the employee and absolves itself because it had adequate procedures in place.

More regulation has been advocated by progressive law scholars as the solution to the corporate responsibility debate.\textsuperscript{1004} In theory, more regulation should be effective. Unfortunately, in reality this does not work either because corporations are already subject to far too much regulation and they are incapable of, or it would be impossible for them to, abide by all of the current regulations. Just ask any corporate counsel, whose job it has become, to track all of the legal obligations of a corporation and report to the board of directors in a ‘risk assessment report’. Imagine the amount of regulation that a large publicly traded multinational corporation with operations in 50 countries that is involved in a regulated business like for example health care or pharmaceuticals is subject to. Could a corporation reasonably be expected to be aware of and abide by all these regulations? Is it possible? If it is – how much time and money is the corporation expected to invest into that process?

The fact is that corporate counsel cannot hope to keep up with all the current regulation. Especially, when it is dispersed throughout so many different pieces of legislation. The law relating to corporations in Anglo-American corporations is too complex. The law relating to corporations needs to be simplified and clarified. One way to do that is to abandon the concept of corporate governance and to bring all of the law relating to corporations back into the corporate law. Corporate governance is a relatively new term. Its development dates roughly to the same time period as the rise of the Nexus of Contracts theory of the firm which believed that the purpose of corporate law was to

\textsuperscript{1004} For example see Bakan supra note 39, where he states that the way forward is more regulation.
deal only with the internal relationships in the corporation and not the corporation's relationship with society.¹⁰⁰⁵

The result was that the corporate law became much less substantive and the regulations got pushed out into other legislation — creating the mess we now call corporate governance. Regulation clearly has a role to play. But, if it is to be effective it needs to be designed in such a way to make it as easy as possible for corporations to comply.

Another issue with regulation is the fact that it is unable to cause change in the informal structures within corporations. Corporate culture is resilient and only by actually engaging in active change processes at the organizational level can progress to be made. You cannot change the behaviour of thousands of corporations overnight by simply changing a law.

The final option is regulation by internal governance. This is different than self-regulation because it is more inclusive. It is based on the idea that everyone that is affected by a decision should be able to participate in or influence the decision making process. The social theory of the corporation provides a simple way to accomplish internal governance: by redefining the boundaries of the corporation, or, at the least, to eliminate the current narrow boundaries dictated by shareholder primacy. Corporations' adapt their structures and practices to fit their environments. By redefining the boundaries of the corporation to include more participants like customers, suppliers and other stakeholders, corporations will be forced to change both their formal and informal structures to take into account the new participants. For example, it is better to have the

¹⁰⁰⁵ Contractarians argue that corporate law should manage the internal affairs of the corporation only and the relationship between the corporation and society should be regulated through other laws. See Bainbridge supra note 16 at 26.
employees actively involved in decision making processes (both formal and informal) determining for themselves within each particular corporation what is best for them, than to try and regulate from outside employment standards for all corporations.

In the end, effective regulation of corporations will be a combination of self-regulation, regulation and internal governance but internal governance shows the most promise for making significant changes to the current regulatory system.

6.5 Is The Social Theory Of The Corporation Better?

In chapter 3, the criteria for determining whether a particular corporate theory is better than other corporate theory was provided. The evaluation criteria is based on the three aspects of corporate theory: the descriptive, illustrative and normative aspects. These three aspects of theory were highlighted by Neil Fligstein in his development of his sociological view of markets:

A sociology of markets should not just produce a conceptual framework to describe particular market situations or state-firm relations. It should have some predictive and explanatory power. It should also have a normative edge that has policy implications for policy communities and for political groups who are struggling with the stark anti-state prescriptions of neoliberal theory.1066

Based on these criteria, a corporate theory is superior if it is more descriptive of reality, better at predicting outcomes, and more consistent with the normative views of the society in which it is being used.

This part compares the social theory of the corporation to the Nexus of Contracts theory of the corporation to make an initial determination of whether it has the potential to be a better theory of the corporation. A definitive determination is not possible at this

1066 Fligstein, supra note 696 at 21.
time because the predictive power of the social theory of the corporation will need to be
tested further in future studies.

6.6.1 Descriptive Aspects

There is no doubt that the social theory of the corporation is far more descriptive
of reality than the Nexus of Contracts theory of the corporation. The Nexus of Contracts
theory is an abstract theory that reduces the corporation into nothing but intangible
concepts: “contracts” and “a nexus”. These intangible concepts cannot be observed. In
contrast, the social theory of the corporation is based on actual observations and our latest
understandings of corporations and how they structure themselves, how they act and the
role that they play in society.

6.6.2 Illustrative Aspects

The social theory of the corporation will need to be tested a lot more before any
definitive conclusion can be made about its predictive power. However, initial work with
the theory, in relation to corporate governance convergence, has shown that it has the
potential to be more predictive than the Nexus of Contracts theory and its corresponding
economic theories. This potential will be illustrated by exploring an example of its use in
the corporate governance convergence debate.

The term “corporate governance convergence” refers to the process whereby the
rules and regulations relating to corporations are becoming similar across countries.
There are four different groups of theories that seek to explain the convergence process:
economic theories, culturally based and divergence theories, selective adaptation theories
and the ‘Layered Approach’.
The economic based convergence theories contend that due to the competitive forces of economic efficiency there will be a global convergence in corporate governance rules towards the Anglo-American shareholder oriented model. The strong-form of convergence theory was argued by Henry Hansmann and Reinier Kraakman in their 2001 article *The End of History for Corporate Law*\(^{1007}\) where they predicted 'the end of history' for corporate law because, in their view, global ideological convergence on the U.S. shareholder oriented corporate governance model had already occurred. In fact, they went so far as to say:

> There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value. This emergent consensus has already profoundly affected corporate governance practices throughout the world. It is only a matter of time before its influence is felt in the reform of corporate law as well.\(^{1008}\)

The softer version of the convergence theory is offered by John Coffee who argues that there will be some convergence in the corporate governance regulations of the largest publicly traded companies, even if corporate law convergence may not happen.\(^{1009}\) The weakness of these theories is that they tend to ignore the role that local culture and institutions play in structuring the economy and determining corporate governance structures.\(^{1010}\)

Culturally based and divergence theories generally argue that local institutions or culture make convergence unlikely, or, alternatively, that they will actually cause

\(^{1007}\) Hansmann and Kraakman *supra* note 11.

\(^{1008}\) *Ibid* at 439.


divergence, as opposed to convergence. The most well known theory is Lucian Bebchuk and Mark Roe’s theory of ‘path dependence’ which argues that political forces and the historical path of development in a society will limit the ability of the competitive forces to cause corporate convergence and that the “corporate structures that an economy has at any point in time are likely to depend on those that it had at earlier times”. The criticism of divergence theories is that they appear to argue that convergence of corporate governance regimes is not possible or that changes are possible only within a narrow band – which history has shown is clearly not the case because some convergence is occurring among global publicly traded companies.

Selective adaptation theories focus on the role that individual actors play in the convergence process both in the selection of which foreign corporate governance institutions to import and the way in which those institutions are interpreted by the local individuals. The theories argue that true convergence never really occurs. Instead, individuals and governments play an active role in selecting institutions to import and in melding those institutions with the local institutions. The outcome is usually a


blending of the foreign institutions with the local institutions into something that is
unique.

The ‘Layered Approach’ to corporate governance convergence is based on the
social theory of the corporation.\footnote{This theory was developed by Michael Cody in two articles: Michael Cody, “Selective Adaptation and Corporate Governance Reforms in the P.R.C.” (on file with author) and Michael Cody, “The Arrival of Hostile Takeover Bids in Japan: Is it Convergence or Selective Adaptation?” (forthcoming).} It utilizes the following concepts from the theory: First, the corporation is a social institution. Second, the institutional structure of an industrialized nation is set at the time that the country emerges into industrialization.\footnote{This insight was offered by Neil Fligstein see Chapter 6 - “Markets as Politics”.
} Third, institutional structures change very slowly except in the case of social crisis. In the context of the convergence debate it is best to think of social institutions (including the corporation) as ‘shock absorbers’ for society. Their role is to create stability and to insulate society from dramatic or constant change. In performing this function they affect the pace and direction of change, even for corporate governance reform. The stronger a society’s existing social institutions the longer it will take for changes to occur and the more the existing institutions will absorb the change and redirect it in a way that is complimentary to the existing institutions.\footnote{For example, because of the strength of the existing social institutions in Japan – corporate governance changes there took over a decade to come to fruition. For a discussion of this see Michael Cody, “Mergers and Acquisitions in Japan: Convergence or Selective Adaptation?” (manuscript on file with author). For the opposite view of the Japanese situation that views the domestic Japanese social institutions as simply being in the way of convergence see Curtis Milhaupt, “A Lost Decade for Japanese Corporate Governance Reform? What Has Changed? What Hasn’t? And Why?” Columbia Law School Working Paper No. 224 available at www.ssrn.com.} Trying to bypass or speed up the process as is often advocated by the economic theories can have disastrous results.\footnote{This is the lesson that the ‘shock therapy’ treatment undertaken in Russia taught us.}

The ‘Layered Approach’ to convergence uses the levels of analysis concept to combine the insights from the social theory of the corporation with all previous

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convergence theories for a more complete explanation of how the convergence process actually works. The levels of analysis that are relevant to convergence are:

1. Individual actor level
2. Social structure or institutional level
3. Societal level

The "Layered Approach" proposes that convergence happens in the following way:

1. Economic drivers trigger corporate governance reform. \(^{1017}\)
2. Corporate governance convergence is more likely to occur among firms that operate in the same field (i.e. global companies listed on public exchanges). \(^{1018}\)
3. The speed and direction of convergence is affected by local social institutions. \(^{1019}\)
4. Government and market participants play a significant and active role in "selecting" which foreign corporate governance rules will be "adapted" into the local corporate governance regime. \(^{1020}\)

It has been shown that the 'Layered Approach' is better at explaining the actual convergence results in China and Japan than the traditional economic theories. \(^{1021}\) The economic theories predicted that U.S. style corporate governance institutions would be adopted by both China and Japan. But, in reality, it did not occur in either country, even

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\(^{1017}\) This element relates to the societal level of analysis and it preserves the insight from the economic theories that economic efficiency creates pressure for corporate governance convergence.

\(^{1018}\) This element relates to the institutional level of analysis and it is based on the concepts of fields and isomorphism from institutional analysis and the weak-form convergence theory offered by Prof Coffee.

\(^{1019}\) This element of the theory also relates to the institutional level of analysis and it preserves the insight offered by path dependence theory and utilizes the basic insight of institutional theory: that social institutions affect the process of change.

\(^{1020}\) This element of the theory relates to the social actor level of analysis and it includes the insights offered by the selective adaptation theories. In short, actors are able to make choices that direct change and there is nothing inevitable about corporate governance convergence.

though both countries took steps to purposefully adopt U.S. style corporate governance rules. Instead, the imported rules blended with local institutions to create systems that are uniquely ‘Chinese’ and ‘Japanese’, respectively.

This example has shown the potential for the social theory of the corporation to be used to predict outcomes of policy choices: like the importation of foreign corporate governance rules. However, the character of the social theory’s predictions is different than the predictive characteristic of economic theories. While economic theories attempt to predict actual results, the social theory, because of its complexity and descriptive qualities, predicts the way a process will occur and predicts results within a specified range. For example, the economic theories predicted (erroneously) a specific result that all countries would adopt the U.S. style shareholder primacy model of the corporation because it is the most efficient. In contrast, the ‘Layered Approach’ predicts that instead there will be a blending of local institutions with any imported corporate governance institutions to create something unique in each country. The social theory version is more accurate in describing what is actually going on in the convergence process and its predictions of both the process and the outcomes are more accurate. The difference in the predictions, however, is that the exact end result is not predicted. This is understandable. It is very difficult to predict outcomes in social systems that are complex and loosely coupled. Policymakers need to become comfortable with the fact that we cannot predict exactly what the outcome of a policy choice will be (not even economics can do that), but that we can generally predict the range of outcomes that the policy choice will produce.

1022 In the case of China, the Chinese government imported the ‘corporation’ and purposefully embarked on a corporatization process in 1994 that hoped to convert Chinese state-owned enterprises into corporations in an attempt to increase economic efficiency. See Cody (2006) supra note 1021. In the case of Japan, the Japanese government imported U.S. style hostile takeover bid regulations in an attempt to jump start the Japanese economy. See Cody (forthcoming) supra note 1021.
6.6.3 Normative

The normative core of the social theory of the corporation contains the three normative assumptions outlined above: humans are social beings, the group is a valid unit of analysis in society and the corporation is a public entity. Is this normative core more consistent with the normative view of Anglo-American society than the normative core of the Nexus of Contracts theory? This is a difficult question to answer, but it is the most important one. The analysis presented in Chapter 4 showed that the success of the social theory of the corporation will depend more on the normative position of society than it will on the intellectual appeal of the theory itself.

Many commentators support the idea that the normative assumptions at the core of the social theory are consistent with the norms of Anglo-American societies, or if they are not, that they should be. The number of such commentators seems to grow each year and notable examples include: Noam Chomsky, Joel Bakan and Alan Hutchinson.\footnote{For examples of these commentaries on the corporation see Noam Chomsky, Profit over People: Neoliberalism and the Global Order (Toronto: Steven Stories Press, 1999); Bakan supra note 39; and Hutchinson supra note 56.} However, the empirical evidence suggests otherwise. Studies that have been done of the cultural differences between societies indicate that Anglo-American countries including the U.S., Canada and the U.K., are the most individualistic countries in the world.\footnote{This was a finding of studies conducted by Charles Hampden-Turner and Alfons Trompenaars see Hampden-Turner and Trompenaars supra note 162.} This finding is not consistent with the assumption that groups are valid units in society. In fact, the countries which generally support the idea of the corporation as a social or public institution, including Japan and Germany, are at the opposite end of the spectrum on measurements of individualism. Those societies are more collectively oriented.
However, it is difficult to know the answer to this question until survey work is done to answer it specifically.

Anecdotal evidence is also ambivalent and supports the normative positions of both the Nexus of Contracts theory and the social theory of the corporation, although, there has definitely been some movement away from the shareholder primacy paradigm, especially in Canada.\textsuperscript{1025} It may be that there is an emerging change in the normative views of Anglo-American societies that will be consistent with the social theory of the corporation. However, only time will tell.

6.7 \textit{Summary and the Recipe for Change}

In this chapter an updated version of the social theory of the corporation was offered. The updated theory was built on the foundations of the early sociological corporate theories, the natural open systems view of organizations, and the latest developments from economic sociology regarding the sociological conception of actors, organizations and markets. The social theory of the corporation has the potential to be better than the current Nexus of Contracts theory of the corporation because it is more descriptive of reality, has the potential to be at least as good at predicting behaviour and it may be more consistent with the emerging normative views of Anglo-American societies. Because it has this potential – it should be used and explored more by corporate law scholars.

One of the most interesting things about the social theory of the corporation is that it outlines the recipe for change in corporate law. Based on the insights from sociology it

\textsuperscript{1025} The Supreme Court of Canada, in its \textit{Peoples v. Wise} decision recently interpreted the duty for directors to act "in the best interests" of the corporation to be broader than just taking into account the interests of shareholders. \textit{See People's Department Stores v. Wise Department Stores.} [2004] 3 S.C.R. 461, 2004 68 (Supreme Court of Canada).
is clear that changes to corporate law of the kind advocated in this book are not going to happen solely within corporate law or within corporate theory. The changes will need to be a part of a larger movement in society away from economics and neoliberal ideals and towards more social ideals. The social theory of the corporation exists. The tools to generate it are waiting for anyone who wants to go looking for them. The problem is that right now too few people are looking for them. Maybe that will change.

Within corporations, the social theory of the corporation tells us that change will be slow. The corporation is a social institution. By its very nature it is built for stability – or built not to change. Within the field of the market, organizational changes happen when smaller companies adopt new strategies and are successful. Larger companies then begin to mimic them through isomorphism. Once the largest companies adopt the new structure it will spread very quickly. The result is that we need to support the development of a small number of alternate business forms based on social theory. Examples have occurred in the past, like: The Body Shop and Ben & Jerry’s. But in the end, they were not protected and they were absorbed into the mainstream. For example, the Body Shop raised public money for expansion. Shortly afterwards the founder was ousted and the company was sold. If these types of good companies are successful we need to nurture them and protect them. They may be the key to a utopian future.

The end result of the social analysis provided in this chapter is that sociologists and progressive corporate law scholars need to become political. We need to be able to express the social conception of the corporation in a digestible way to the public to make them aware that there are alternatives. We need to nurture a movement towards new forms of business. Then as those new forms develop and are successful we need nurture
them and protect them. Small changes to the law can assist with the protection. The watering down of the shareholder primacy paradigm will assist. In Canada, this movement may be occurring.\textsuperscript{1026} This is a good sign and it may be a harbinger of things to come.

It may not be possible to predict what those new business forms will look like — social institutions evolve out of previous forms — they cannot be designed.

\textsuperscript{1026} Ibid.
### TABLE 6-1

**ECONOMIC SOCIOLOGY**

**THEORISTS AND SELECTED WORKS**

<table>
<thead>
<tr>
<th>Theorist</th>
<th>Year</th>
<th>Representative Work</th>
</tr>
</thead>
<tbody>
<tr>
<td>Max Weber</td>
<td>1904</td>
<td>The Protestant Ethic and the Spirit of Capitalism</td>
</tr>
<tr>
<td></td>
<td>1908-1920</td>
<td>Economy and Society</td>
</tr>
<tr>
<td>Emile Durkheim</td>
<td>1893</td>
<td>Division of Labor in Society</td>
</tr>
<tr>
<td></td>
<td>Early 1900s</td>
<td>Professional Ethics and Civic Morals</td>
</tr>
<tr>
<td>Karl Marx</td>
<td>1848</td>
<td>The Manifesto of the Communist Party</td>
</tr>
<tr>
<td></td>
<td>1867</td>
<td>Capital</td>
</tr>
<tr>
<td>Talcott Parsons</td>
<td>1937</td>
<td>The Structure of Social Action</td>
</tr>
<tr>
<td></td>
<td>1956</td>
<td>Economy and Society (with Neil Smelser)</td>
</tr>
<tr>
<td>Karl Polanyi</td>
<td>1944</td>
<td>The Great Transformation</td>
</tr>
<tr>
<td></td>
<td>1957</td>
<td>Trade and Market in the Early Empires</td>
</tr>
<tr>
<td>Joseph Schumpeter</td>
<td>1942</td>
<td>Capitalism, Socialism and Democracy</td>
</tr>
<tr>
<td></td>
<td>1949</td>
<td>History of Economic Analysis</td>
</tr>
<tr>
<td>Georg Simmel</td>
<td>1900</td>
<td>The Philosophy of Money</td>
</tr>
<tr>
<td>Alexis de Tocqueville</td>
<td>1835</td>
<td>Memoir on Pauperism</td>
</tr>
<tr>
<td></td>
<td>1835-1840</td>
<td>Democracy in America</td>
</tr>
<tr>
<td></td>
<td>1856</td>
<td>The Old Regime and the French Revolution</td>
</tr>
<tr>
<td>Thorstein Veblen</td>
<td>1899</td>
<td>Theory of the Leisure Class</td>
</tr>
<tr>
<td></td>
<td>1915</td>
<td>Imperial Germany and the Industrial Revolution</td>
</tr>
<tr>
<td></td>
<td>1919</td>
<td>The Vested Interests and the Modern Man</td>
</tr>
<tr>
<td>Theorist</td>
<td>Year</td>
<td>Representative Work</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>------</td>
<td>---------------------------------------------------------</td>
</tr>
<tr>
<td>Pierre Bourdieu</td>
<td>2005</td>
<td>The Social Structures of the Economy</td>
</tr>
<tr>
<td>Ronald Burt</td>
<td>1982</td>
<td>Toward a Social Theory of Action</td>
</tr>
<tr>
<td></td>
<td>1983</td>
<td>Corporate Profits and Cooptation</td>
</tr>
<tr>
<td></td>
<td>1992</td>
<td>Structural Holes</td>
</tr>
<tr>
<td>Paul DiMaggio and Walter Powell</td>
<td>1991</td>
<td>The New Institutionalism in Organizational Analysis</td>
</tr>
<tr>
<td>Frank Dobbin</td>
<td>1994</td>
<td>Forging Industrial Policy: The United States, Britain and France in the Railroad Age</td>
</tr>
<tr>
<td>Neil Fligstein</td>
<td>1990</td>
<td>The Transformation of Corporate Control</td>
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<td></td>
<td>1996</td>
<td>Markets as Politics: A Political-Cultural Approach to Market Institutions</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td>The Architecture of Markets</td>
</tr>
<tr>
<td>Mark Granovetter</td>
<td>1974</td>
<td>Getting a Job: A Study of Contracts and Careers</td>
</tr>
<tr>
<td></td>
<td>1985</td>
<td>Economic Actions and Social Structure: The Problem of Embeddedness</td>
</tr>
<tr>
<td>Mauro Guillen</td>
<td>2003</td>
<td>The New Economic Sociology</td>
</tr>
<tr>
<td>Richard Swedberg</td>
<td>1994</td>
<td>The Handbook of Economic Sociology (with Neil Smelser)</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>The Principles of Economic Sociology</td>
</tr>
<tr>
<td>Carlo Trigilia</td>
<td>2003</td>
<td>Economic Sociology: State, Market, and Society in Modern Capitalism</td>
</tr>
<tr>
<td>Harrison White</td>
<td>1981</td>
<td>Where Do Markets Come From?</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td>Identity and Control: A Structural Theory of Social Action</td>
</tr>
<tr>
<td>Level</td>
<td>Description for Organizational Analysis</td>
<td>Description for Corporate Theory</td>
</tr>
<tr>
<td>------------</td>
<td>---------------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>1. Individual</td>
<td>Focuses on the behaviour of individuals within organizations.</td>
<td>Focuses on the behaviour of Individual corporate participants including directors, managers, employees and other stakeholders.</td>
</tr>
<tr>
<td>2. Group (e.g. organizations and corporations)</td>
<td>Focuses on the structural features that characterize organizations.</td>
<td>Focuses on the structural features that characterize the corporation.</td>
</tr>
<tr>
<td>3. Markets (e.g. groups of organizations)</td>
<td>Focuses on the actions of an organization (when viewed as a collective entity) within a larger system of relations.</td>
<td>Focuses on the actions of corporations (as entities) in society, the market or industries within the market.</td>
</tr>
<tr>
<td>4. Society</td>
<td>NA</td>
<td>Focuses on how the market functions in relation to society.</td>
</tr>
</tbody>
</table>
FIGURE 6-1

INDIVIDUAL BEHAVIOR DETERMINANTS

"REASONABLE NOT RATIONAL"

"REASONABLE"

History
Trust
Available Information
Gender
Social Structure
Rational
Race

360
FIGURE 6-2

ORGANIZATIONAL BEHAVIOR DETERMINANTS

"EFFECTIVE NOT EFFICIENT"

"EFFECTIVENESS"

- Culture
- Efficiency
- Legitimacy
- Survival
- Trust
- Profit Maximization
- Reputation

????????
FIGURE 6-3
MARKET CHARACTERISTICS
"STABLE NOT COMPETITIVE"

"STABILITY"

Regulation Isomorphism Signaling
Co-operation

Niche Seeking
Competition

Profits

???????
FIGURE 6-4
EMBEDDEDNESS OF THE ECONOMY IN SOCIETY

Society

Economy

NOT:

Economy

Society
CHAPTER 7: A MULTI-DISCIPLINARY CORPORATE THEORY - COMBINING SOCIAL AND ECONOMIC THEORIES OF THE CORPORATION

7.1 Introduction

In the introduction to this book the concept of balance was discussed. Up till now, the argument has been made to raise the profile of the social theory of the corporation. This chapter takes that argument a step further and argues for balance in corporate theory between its social and economic aspects. The social theory of the corporation provides the insight that no single theory can explain all the complexity of human social life. Therefore, the way forward to building a more complete, more robust corporate theory lies in combining insights about the corporation from as many different fields in the social sciences as possible. The two most important fields for corporate theory are economics and sociology.

This chapter illustrates why a multidisciplinary theory is needed, highlights the difficulties in combining insights from different social science fields, using economics and sociology as an example, and offers a method to overcome these difficulties: the ‘Layered Approach’.

The chapter is organized into five parts. The first part explains why the development of the social theory of the corporation is important even though the desired end state is a combined theory of insights from many disciplines. The second part highlights the need for a multidisciplinary theory of the corporation. The third part outlines the difficulties that will be encountered in any attempt to combine the economic and social theories of the corporation because of the significant differences in their respective approaches to assumptions, methodology and policy making. The fourth part
advocates the use of the ‘Layered Approach’ to overcome the difficulties of combining the theories. Finally, a summary is provided that highlights the need to continue to develop the social theory of the corporation and to look for way to develop layered models of individual actors, corporations and markets.

7.2 The Social Theory Of The Corporation Is Important

The social theory of the corporation is important because the combination of different corporate theories is not likely to be successful if the theories to be combined are not accorded equal value. The social theory of the corporation has not been accorded equal value in Anglo-American countries in the last century or so. The result is that good intentioned people who believe they are compromising and combining economic and social insights – are not really compromising because they have not taken the full range of insights and options into account. One example of this kind of combination effort gone awry is socioeconomics. Socioeconomics is not really a combination of theories because it is committed to the primacy of the neo-classical economics. Until the social theory of the corporation is accorded equal status there will not likely to be any fruitful combination efforts.

7.3 The Multidisciplinary Theory Of The Corporation

Throughout this book, the argument has been made that society and corporations are very, very complicated places. On Boulden’s systems classification chart, they are the most complicated types of system that we know about: Level 8 systems. At best, the
current theories in all of the social science disciplines are level 4 theories. Therefore, no single social theory yet explains all of the complexity of social life.

7.3.1 The One Social Science and a Multidisciplinary Corporate Theory

Some economists have argued that economics and the theory of rational choice are the one social science because they can predict all human behavior. The insights offered in this book prove that this view is wrong. However, those economists were correct to a certain extent. There is only one social science. But, it is not economics. It is social science, including all of its disciplines: economics, sociology, psychology, political science, philosophy, etc.

To understand the corporation, one of the primary social institutions of our time, we cannot look at it through the narrow lens of only one of these disciplines, or we will fail to truly understand its complexity. We need to consider the corporation from as broad a perspective as possible. This places a heavy burden on corporate law scholars because it requires familiarity with an enormous amount of material: moral philosophy, political theory, economics, management theory, finance and accounting, social theory, organizational theory, psychology, sociology, cultural studies etc. The list of disciplines that can add to our understanding of corporations is almost endless. Back in the 18th and 19th centuries, the depth of our knowledge on how society functioned was much more limited than it is today. At that time, it was possible for a single person to accumulate knowledge from a number of different fields, and make a meaningful contribution to

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1027 Examples of level 4 theories are the open systems perspective theories in organizational theory because they take into account how organizations interact with their environments. For a description of these theories see Chapter 5 – "Open Systems Perspective".

1028 This argument was summarized in Chapter 4 see "The Intellectual Appeal of Economics – Economic Theories are Universal".

1029 The limitations of rational choice theory’s ability to explain and predict all human behaviour were outlined in Chapter 4 and Chapter 6.

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corporate theory. Examples of such people were Adam Smith, Otto Gierke and Max Weber. They all had expertise in more than one field: Adam Smith was a moral philosopher first, and, then an economist, Otto Gierke was as much a historian as he was a jurist, and Max Weber was not a sociologist, he was a lawyer and a professor of economics.

At some point during the twentieth century, corporate theory in Anglo-American jurisdictions lost the broad focus represented by these early thinkers, and it separated into distinct fields by social science discipline. The advances in corporate theory in the last 40 years or so have mostly come from a single discipline: economics.

It is time for a change from this narrow approach to corporate theory. The way forward lies not in changing from economic theories of the corporation to social theories of the corporation, but by combining insights from the whole range of social science disciplines. There is just too much knowledge, too many insights for one discipline, let alone one person, to digest. The next stage in the development of corporate theory can only be accomplished as an academic community. Academics from each social science discipline should summarize, for those in the other disciplines, their insights of the corporation and do so in a way that makes those insights accessible for others to use. This book has attempted to do that for organizational analysis and economic sociology. If this were to be done for other disciplines new levels of understanding that could be attained. The future of corporate theory is as a multidisciplinary field. Its future is not as a political battlefield where social science disciplines wage war against each other for supremacy.
7.4 Combining The Social And Economic Theories Of The Corporation

Early gains can be made toward a multi-disciplinary theory of the corporation by combining the insights of corporate theory's two most important fields: economics and sociology. Each type of theory is good at explaining different aspects of society. For example, economic theories are particularly good at explaining the societal level of analysis while social theories are particularly good at explaining the social structure level of analysis. When used together in combination these two different types of theories provide a much more complete picture than when they are used in isolation.

The movement to combine the social and economic theories has been underway for a while and examples of attempts at combined theories abound. In economics, strides have been made towards a combined approach by the practitioners of behavioral economics and socioeconomics. In sociology, attempts to combine insights from both theories have been made by practitioners of economic sociology. Organizational theory also has a long history of theories that attempt to combine the rational and natural systems perspectives, including: Adam Etzioni's structuralist model, Lawrence and Lorsch's contingency model and James Thompson's three levels model. In corporate theory, the combination process was started by the progressive corporate law movement and its most promising current attempt is socioeconomics. However, as was stated earlier, socioeconomics will never be a true combined corporate theory as long as it maintains its commitment to the primacy of neoclassical economics.

1030 For a description of behavioral economics see Chapter 4 - "Critiques of Economic Theories - Consensus". For a description of socioeconomics see Chapter 3 - "Socioeconomics".
1031 For a description of economic sociology see Chapter 6. Three economic sociologists in particular focus on combining the insights from economics and sociology: Harrison White, Mark Granovetter and Richard Swedberg.
1032 For a description of these models and other attempts to combine the rational and natural systems perspectives in sociology see Scott supra note 682 at 102-122.
7.4.1 The Difference between Sociology and Economics

The process of combining the economic and social theories of the corporation is complicated because they are opposites in so many ways. For most of the past century, there has been little overlap between sociology and economics. In fact, the approaches of sociology and economics are so drastically different that the relationship between them, for most of the last century, has been one of conflict not compromise. \(^{1033}\)

The difference in the underlying assumptions of economic and social theories has been highlighted throughout this book. But there are other important differences between sociology and economics, including: their approach to methodology and their approach to policy making. \(^{1034}\) These differences will make combining the theories difficult. Hirsch, Michaels and Friedman emphasized the difficulties that will arise in any attempt to combine the two disciplines:

We argue that a serious convergence of perspectives will (and should) be restrained by each discipline’s fundamentally different world-views and intellectual traditions. \(^{1035}\)

The differences between economics and sociology with regard to assumptions, methodology and policy are summarized in Table 7-1 and discussed briefly below.

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\(^{1033}\) This led economist Joseph Schumpeter to comment that economists have had to develop their own primitive sociology and sociologists have had to develop their own primitive economics. See Joseph Schumpeter, *History of Economic Analysis* (London: Allen & Unwin, 1954) at 21. Guillen et al. have argued that Talcott Parsons contributed to the separation of sociology from economics see Guillen *supra* note 805 at 6.

\(^{1034}\) Hirsch, Michaels and Friedman have argued that economics and sociology are very different in their approaches to assumptions, theory and research and policy implications see Paul Hirsch, Stuart Michaels, and Ray Friedman, “Clean Models vs. Dirty Hands: Why Economics is Different from Sociology” in Sharon Zukin abd Paul DiMaggio, *Structures of Capital: The Social Organization of the Economy* (New York: Cambridge University Press: 1990) 39. For another good discussion of the differences between economics and economic sociology see Richard Swedberg, Ulf Himmelstrand, and Goran Brulin, “The Paradigm of Economic Sociology” in Sharon Zukin and Paul DiMaggio, *Structures of Capital* (New York: Cambridge University Press, 1990) at 57. Swedberg, Himmelstrand and Brulin identified significant differences between neo-classical economics and economic sociology in their respective approaches to the following seven aspects: the concept of the actor; the arena of action; types of economic action; results of economic actions; view of the analyst; concept of time and general scientific method.

\(^{1035}\) Hirsch, Michaels and Friedman *ibid* at 40.
Assumptions

The differences in the assumptions between sociology and economics are the same as the differences in the assumptions between the Nexus of Contracts theory of the corporation and the social theory of the corporation. These differences have been highlighted many times throughout this book. The assumptions of interest to corporate theory are: the view of human nature, the structure of society and the nature of the corporation. Economics assumes that human beings are self-interested, that society consists of individuals and the state and that corporations are private entities. Sociology assumes that human are social beings, society consists of individuals, groups and the state and that corporations are public entities. On these three assumptions, economics and sociology could not be more different.

Theory and Research

Sociology and economics are also very different in their approach to theorizing. Economics focuses on models and prediction — or the illustrative aspects of theory. The ability of developed models to cleanly predict behaviour is prized over the model’s resemblance to reality. The problem with this approach is that it ignores the real world:

Economists’ modeling of human behavior, deduced from that core assumption about human nature, is elegant, thoroughly consistent, and recently and increasingly claims universal applicability. But, despite the stability and power of economists’ core assumptions and the logical consistency they allow, there is a fatal flaw for sociologists in their deductive modeling: it leads them to ignore the empirical world around them... Economists pay a heavy price for the very simplicity and elegance of their models: empirical ignorance, misunderstanding, and relatedly unrealistic and bizarre policy recommendations.1036 [emphasis added].

1036 Ibid at 40-42.
In contrast, sociologists focus on the descriptive quality of models. They are primarily interested in how well the models resemble reality. The biggest problems with this approach are: There is no single widely accepted paradigm in sociology and sociological models are not very good at predicting behaviour.

*Policy Implications*

Finally, sociology and economics are very different in their approach to policy making. Economics, through Milton Freidman’s U-Turn, purposefully changed itself into a positive policy making science. This aspect of economics has been described in the following way:

[E]conomics, with its assumptions about individual choice and free-market options, can always provide an answer. Sociologists are ambivalent about the free market (their judgments are based more on how they value policy implications than on ideology about free market vs. regulatory choices.) They are more likely to hedge about answers and less likely to confidently offer predictions based on simplified assumptions, few variables and elegant models.

Traditionally, sociologists have avoided influencing policy decisions. Although, there is a growing movement in sociology calling for a more active stance among sociologists when it comes to presented the results of their research in a way that is useful to policy makers. Neil Fligstein and Pierre Bourdieu are two of the most prominent advocates of this new position.

**7.4.2 Summary – “Clean Models vs. Dirty Hands”**

The differences between economics and sociology have been referred to by Hirsch, Michaels and Friedman as “Clean Models vs. Dirty Hands”. Economics simplifies the complexity out of life and offers ‘clean models’ that can be used to attempt

\[1037\] *Ibid* at 46.
to predict behaviour and make policy decisions. The downside of this approach is that the models rarely are descriptive of reality. Sociology focuses on empirical observations for its theory building. It has ‘dirty hands’ because it takes into account all of the complexities of reality. The downside of this approach is that it is not very good at generating models that predict behaviour or that can be used for policy making. The result of these differences between economics and sociology is that it will be very difficult to combine them in any meaningful way without significant compromises being made by practitioners of each discipline.

### 7.5 The Layered Approach

However, compromise may not be required. One potential way to gain the benefits of the insights of both theories is Scott’s ‘Layered Approach’. Scott’s approach provides an important insight – we may not have to blend the theories – just realize which level of analysis they are best at explaining and then use them only for that level. Another way to put it is that different levels of analysis lend themselves to different types of theories.

To date, this approach has been used to successfully develop theories on de-institutionalization and corporate governance convergence. For example, Ahmadjian and Robbins used this approach in their work on the de-institutionalization of lifetime employment in Japan. They combined insights from economics and sociology to present a new formulation of how the process of de-institutionalization works: They argued that economic events trigger the process of de-institutionalization but that the pace and

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1038 This was introduced in Chapter 5
direction of the change is best explained by social theories. I have used a similar type of layered approach to explain the process of corporate governance convergence. The Layered Approach to corporate governance convergence recognizes that there are at least three levels of analysis relevant to the convergence process: the societal level, social structure or institutional level and the level of social actors. The Layered Approach recognizes that economic analysis is best at explaining the societal level; sociology and, in particular, institutional theory are best at explaining the social structure level; and selective adaptation theories are best at explaining the individual level. When all three sets of theories are combined in this way it provides a more complete analysis of how the corporate governance convergence process works.

7.6 Conclusion

A multidisciplinary theory of the corporation is required because no single theory can explain all of the complexity of human social life. Therefore, the best corporate theories going forward will be theories that combine the insights from as many social science disciplines as possible into their framework. Raising the profile of the social theory of the corporation is important because progress will not be made toward a true multidisciplinary theory of the corporation until the social theory (and other theories) is considered to be of equal profile as the economic theory of the corporation. The combination process will be difficult because of the fundamental differences among the social sciences on key issues such as assumptions, approach to theory and methodology and approach to policy making. To overcome these difficulties, theories can be


1040 This approach was developed in two articles: Cody (2006) and Cody (forthcoming) see note 1021.
combined using a 'Layered Approach', where different theories are used to explain different levels of analysis. This alleviates the immediate need to come to compromises on fundamental issues when attempting to combine theories.
TABLE 7-1

THE DIFFERENCES BETWEEN SOCIOLOGY AND ECONOMICS

Note: This page was removed for copyright restrictions. It contained a comparison of economics and sociology. It was based on a chart developed by Hirsch, Paul, Stuart Michaels, and Ray Friedman. "Clean Models vs. Dirty Hands: Why Economics is Different from Sociology" in Sharon Zukin and Paul DiMaggio, Structures of Capital: The Social Organization of the Economy (New York: Cambridge University Press: 1990)
CHAPTER 8: CONCLUSION

This book has attempted to raise the profile of the social theory of the corporation as a prelude towards a new multidisciplinary theory of the corporation.

A corporate theory is a theory that answers the following two questions:

1. What is a corporation?
2. What is the purpose of corporate law?

A particular corporate theory is better than another corporate theory if it is more descriptive of reality, better at predicting results and more consistent with the normative views of the society in which it is located. Based on this criteria the social theory of the corporation has the potential to be better than the current Nexus of Contracts theory of the corporation because it is more descriptive of reality, has the potential to be at least as good at predicting behaviour and it may be more consistent with the emerging normative views of Anglo-American societies.

The need for an updated social theory of the corporation and the superiority of a multi-disciplinary approach to corporate theory was illustrated in this book using a six-part analysis.

In chapter 2, it was shown that the corporation is a social institution. It is an organization of human beings: An organizational type so important in Anglo-American societies that it has become institutionalized. It provides stability and meaning to social life. The most important insight of the conclusion that the corporation is a social institution is that it should be analyzed using social theories, including sociology and organizational theory etc., and not just economic theories.
In chapter 3, a historical survey of corporate theories was conducted to show that the idea that the corporation is a social institution is not new. In the past, corporations were viewed as social institutions and earlier corporate theories that acknowledged this were built on insights from sociology. Entity theory and Early Sociological Theory were highlighted as examples of these theories. However, for some reason, during the 20th century, these social theories of the corporation lost their prominence and economic theories of the corporation became dominant in Anglo-American societies. Chapter 3, also provided the important insight that at the core of every corporate theory there is a set of normative assumptions about the way we want the world to be. The existence of these assumptions means that there is no single corporate theory that is intellectually superior to another theory. Each theory is merely a choice about the way we want our society to be structured.

In chapter 4, two insights from chapter 3 were explored in more detail. The normative core of corporate theories was illustrated by showing that the Nexus of Contracts theory of the corporation came to dominate Anglo-American corporate law largely because of its normative assumptions and not because of its intellectual superiority. The theory was adopted because it was normatively consistent with the ideal views of capitalism that permeated Anglo-American societies during the period of the Cold War: Individuals acting in their own self-interest and generating economic growth through the invisible hand of the market. The chapter also illustrated that the intellectual superiority claimed by economic theories has proven not to be true. Economic theories are too simple because their assumptions did away with all of the complexity of real life, their universal application only holds within the institutional structure of western
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capitalist societies, their predictive value in capitalist societies has been questioned, their objectivity has been recognized as merely normative theory and their own proponents are starting to question the theories' most basic assumptions. The economic theories are also having negative effects on our society including, most importantly, the removal of the moral and social aspects of business and the economy.

In chapter 5, the relevance of sociology and organizational theory to corporate theory began to be introduced—starting with organizational theory. The chapter showed that there has always been a strong link between organizational theory and corporate theory. In fact, most of the advances in corporate theory in the last half-century came first as advances in organizational theory. In the last 40 years, organizational theory has advanced to a new perspective on organizations called the “natural open systems” perspective. Unfortunately, corporate theory has not kept pace and it is still using the previously popular “rational open systems” perspective. The natural open systems perspective is an improvement over the rational open systems perspective because it is more descriptive of reality and is able to account for more of the complexity of real life. The need for a new “natural systems” model of the corporation in corporate theory was highlighted.

In chapter 6, the building blocks of an updated version of the social theory of the corporation were outlined. The updated theory was built on the foundations of the early sociological corporate theories, the natural open systems view of organizations, and the latest developments from economic sociology regarding the sociological view of actors, organizations and markets. The social theory of the corporation provides the following:

- Definition of a corporation:
The Corporation is a social institution. It is an organization of human beings that has become so important as an organizational type that it has become institutionalized and now provides meaning and stability to social life. The primary goal of a corporation is survival which it accomplishes by creating a stable environment for itself. Corporations are characterized by goal complexity and the importance of informal structures.

- Purpose of corporate law:

The purpose of corporate law is twofold:

1. To facilitate the formation, survival and evolution of corporations, and

2. To provide stability to society, markets and corporations by managing the relationships amongst the corporate participants in a way that is consistent with the normative views of the society in question.

It was illustrated that the social theory of the corporation has the potential to be better than the current Nexus of Contracts theory of the corporation. The conclusion was offered that since it could be a better theory – we should use it a lot more than it is currently being used.

In chapter 7, the need for a multidisciplinary theory of the corporation was outlined. One of the most important insights of the social theory of the corporation is that social life is very, very complex and no single theory can completely explain it. The need to incorporate insights from all of the social sciences was highlighted and the difficulties of doing so were discussed. A ‘Layered Approach’ was offered to overcome these difficulties. By acknowledging that there are different levels of analysis in all social behaviour and that different theories are better at explaining different levels of analysis, the insights from the theories can be combined without having to engage in the difficult process of combining theories at their most basic levels: assumptions, methodology or approach to policy. In fact, having multiple theories to use in the analysis of a phenomenon as complex as human organizations is a strength, not a weakness.
8.1 Themes Of The Book: Politics And Balance

There were two themes that ran throughout this book: politics and balance.

8.1.1 Politics

It was stated in the introduction that, even though this book is about corporate law, it has broader implications. That is because corporate law and corporate theory are normative. They deal with our basic understandings of human society and our ideas about what we want it to look like. In order to develop corporate theories and corporate law we need to address questions like: What is human nature? How is society organized? What expectations do we have for our important social institutions, including the state and the corporation? The answers to these types of questions cannot be solved by a purely intellectual exercise. The answers have a political component. Therefore, at the core of each theory are a set of normative assumptions about the way the world "ought to be".

We need to take very seriously the contentions of Adolph Berle and Stephen Bainbridge that for a social theory of the corporation to take root in Anglo-American societies, it will require nothing less than the complete remaking of our social system. I hope that it is not true. But, it might be. At the very least, a broader social movement away from strict economic analysis to more multidisciplinary analysis will be required to make it happen. The historical analysis provided in this book in Chapter 4 indicates that changes in our approach to such important questions as these are not going to happen within the corporate law alone.
Karl Polanyi and John Ralston Saul predicted that the broader social movement may already be forming as a reaction against the attempts to create the self-regulating market. For example, Polanyi predicted that society will always protect itself against the satanic mill of the unregulated free market because the negative consequences to people are too great to be ignored. Without, weighing in on whether such a movement is here, or coming, this book has shown that current Anglo-American societies (and specifically our corporate theory) are consistent with the views of the self-regulating market. The normative cores of our current dominant theories are extreme in their commitments to individualism, self-interest and private enterprise over public obligation. When we look at these normative commitments critically, we need to ask ourselves these important questions: Do we like these commitments? Do they help create the kind of society that we want to live in? If the answers to both those questions are “yes”, then our corporate theory and our corporate law are appropriate for our society. However, if you are uncomfortable being treated as a human “resource”, being laid off at will, having your economy (and your society) engaged in a constant state of instability, if you are uncomfortable with the phrase, “don’t take it personally – its just business”: then it is time for a change.

This book has highlighted what many others have previously pointed out: there is nothing inevitable about the self-regulating market, economic theory, or the way corporations are structured. It is merely a political choice that has been made and the choice can always be made to change. People are social beings. We value each other and rely on each other too much to allow our society to be torn apart by individualism and the neo-liberal approach to the disembedded free market. As has been emphasized
throughout this book, society is about people not profits. We need to start conceptualizing and drafting our laws to reflect that fact. Within corporate law, that change can occur by first accommodating the insights from sociology into corporate theory to develop a social theory of the corporation. Beyond that a multidisciplinary theory of the corporation can be developed.

The time is right for this law and society approach to the economy and the corporation. The economic approach has ignored the human and social aspects of the economy and corporations for so long that the deficiencies in the approach are now apparent everywhere. Commentators such as Ralph Nader, Joel Bakan, Michael Moore, Naomi Klein, Noam Chomsfky and others have highlighted time and again the negative effects that the economic theories of markets and corporations are having on our societies.

There are easy wins to be had in applying sociology to corporate theory because concepts that have been well proven in economic sociology and organizational theory have thus far been overlooked in corporate theory because of its recent devotion to economics. Mark Granovetter said it best when he made the following comments about economic sociology in the 1980's:

I think that right under our noses there is a gold-mine of subject matter that we [sociologists] can analyze very profitably. In the introduction to the new edition of Foundations of Economic Analysis Samuelson talks about the golden age of the 1930's, when mathematics first started to be introduced into economic analysis and all of a sudden all kinds of unresolved problems in economics could be solved that had been fruitlessly debated over the years. Suddenly, with a little bit of application of mathematics, all these problems started to yield. Samuelson says, ‘It was like fishing in a virgin lake: a whopper at every cast . . .’ That was the golden age and now, of course, things are not so easy. But in those days anybody that could do a little mathematics could jump in and get out with some wonderful results. I think that something like that is true now for economic sociology. I
think there is a huge, untouched territory here, a whole ‘virgin lake’ – again – for anybody who knows some sociology. Corporate law and corporate theory are definitely ‘virgin lakes’ for sociologists and practitioners of law and society analysis.

8.1.2 Balance

This book has also argued for balance. More specifically, the restoration of balance to corporate theory and corporate law between their economic aspects and their social aspects. The social theory of the corporation outlined in this book has shown that any real progress that we make in corporate theory will come as a result of the combination of many different theories. This combination will inevitably require the balancing out of the normative positions of each theory. This will be a positive outcome but it will take a long time.

Three normative assumptions were discussed in this book: human nature, the structure of society and the nature of the corporation. Each of the assumptions was presented as a continuum of potential options. This was a purposeful choice. Traditionally, these assumptions were presented as dichotomies of opposite positions. The dichotomy approach allows no room for compromise or common ground. In Chapter 3, it was shown that there are varying degrees of commitment to the ideal normative positions of each corporate theory. For example, among the economic theories, transaction cost analysis has the most individualistic view of human nature with its

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1042 For example see Horwitz supra note 90 and Millon supra note 90.
1043 This is graphically depicted in the Assumption Chart in Chapter 3.

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concept of ‘opportunism’ while socioeconomics has the least individualistic view of human nature because it acknowledges that human are social beings.\textsuperscript{1044}

At this point in time, the assumptions are normative because we are unable to prove which ideal type is correct. However, in the future, as our understanding of human beings and society increases we may be able to make more definitive statements about human nature, the structure of society and the character of our social institutions. In the meantime, the most realistic statement of each of the assumptions is that the answer probably lies somewhere in the middle of each continuum.

Human beings act rationally in their own self-interest but they are also affected by their social relationships. As Mark Granovetter pointed out in 1985, the ‘oversocialized’ conception of human nature is as inaccurate as the ‘undersocialized’ conception of human nature. In the end, humans probably just act reasonably in their circumstances. Reasonable behaviour is rational some of the time, irrational some times and constrained by social relationship at other times. One way to conceive of human nature is with a ‘Layered Approach’. When humans are functioning in an environment where their survival is at stake (e.g. starvation, dehydration, physical security etc.) they are more likely to act in their own self-interest. These situations are reminiscent of the Hobbesian state of nature. However, in modern Anglo-American societies, these situations occur infrequently and are limited to a relatively small portion of the population.\textsuperscript{1045} The farther social reality moves away from the Hobessian state of nature and more towards the benevolent modern society that insulates individuals from that environment, the more

\textsuperscript{1044} See The Assumptions Chart in Chapter 3 to see a graphic representation of the varying levels of commitments of the corporate theories to the ideal forms of the assumptions.\textsuperscript{1045} Although, alarmingly, this portion of the population seems to be growing.
considerations other than self-interest start to impact on decision making. The key will be in finding the balance between self-interested behaviour and social behaviour.

Similarly, both the individual and the group are valid units of analysis in society. Society has always consisted of both individuals and organized groups. This book has highlighted the arguments against an overly individualistic version of society where groups are not considered as valid units. John Ralston Saul and Stephen Bainbridge warn us against the opposite or 'statist' position where society is dominated by special interest groups and individuals can only gain political power by associating with one of those groups. A society dominated by special interest groups may be just as bad as a society dominated by individualism. The key will be finding the balance between the individual and the group.

Finally, corporations are both public and private in nature. Samuel Williston recognized this in 1909. He noted that a tension had always existed between the public and private aspects of a corporation and that it really was both. The corporation was public to the extent that it always traded goods for the government (and later the community). The corporation was private to the extent that it was permitted to earn a profit for owners. The key will be trying to find the balance between these two different aspects. The choice of where to set the balance is a political one and different societies set it at different levels. For example, in Japan, until quite recently, corporations were considered to be public entities that were run for the benefits of employees. In

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1046 This idea is similar to Mintzberg’s hierarchical structure of organizational goals that was discussed in Chapter 6.
1047 See Saul supra note 617 and Bainbridge supra note 16.
1048 Williston supra note 78.
contrast, Anglo-American countries view corporations as essentially private entities to be run for the benefit shareholders

The exercise of finding balance between these assumptions is happening elsewhere in the world. China is introducing market institutions into its socialist economy and Japan has modernized its corporate law to accommodate a more individualistic Western approach to business in an attempt to jump start its stagnant economy. Each of these examples is support for the position that change can occur on toward more balanced normative views and economic systems. But, the process of change requires political commitment, intellectual support and it takes time – a long time. It does not happen overnight. In Anglo-American societies we are a long way away from change because the balancing process does not appear to have started yet.

8.2 The Process Of Change

The sociological view of markets contains the recipe for change. It indicates that major changes to Anglo-American corporations may not be coming anytime soon. Corporations are social institutions. They create stability in society. Therefore, they take a long time to change. Even more, they usually do not change unless there is a social crisis, like war, depression or other similar catastrophes. Crises have a habit of highlighting the deficiencies in current systems. An example of how this change process works is Japan. It has been in a financial crisis since 1990. The result of that financial crisis is that many of the traditional Japanese institutions such as the employee based corporation, *keiretsu* corporate groups and lifetime employment have undergone massive change. But, the change took a long time: over 15 years.
It may be that crisis has already arrived in Anglo-American societies in the form of Polanyi’s double movement against the self-regulating market. The protests against the WTO in Seattle and the growing critique of the economic system and corporations by prominent commentators may be the beginning of that movement. It could be that war will cause the changes. As this book is being written, the United States is occupying Iraq, Israel has invaded Lebanon and North Korea is firing rockets over Japan. Both John Ralston Saul and Karl Polanyi warned that war is an inevitable result of the devotion to economics and the self-regulating market, as nations resort to nationalism in order to protect their citizens from the consequences of unfettered economic policy. Finally, catastrophe may not be far off either. The externalities generated by our current economic system and our population density are destroying the earth. It is possible that we may ruin it in this human lifetime. Overpopulation, unregulated burning of fossil fuels and global warming all contribute.

If any of these crises occur, a change in the institutional structure of Anglo-American societies is likely to occur. Intellectuals have a role in that change process. It is to clearly delineate the options for change - before the need for change occurs. That way the options can be used by political powers when the time is right. This book began to outline some of those options. Let's hope that we can make balancing changes to our societies and our economic systems and avoid social crisis.

Whatever happens, we always need to remember that corporations are for people – not for profit.
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