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# ECONOMIC THEORIES AND COMPANY LAW

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# ABSTRACT

Today corporations have ammamessed an awesome power over the productive resources of the world, this thesis explores the key economic theories that provided the largest insights into questions about the internal structure of corporations, issues of corporate governance, and the potential role of company law in addressing these issues.

The research traces the revolutionary impact of agency theory and the contractual understanding of the firm as a nexus of contracts in both explaining the internal dynamics of the firm and explores how legal and corporate governance strategies may help in mitigating agency costs. Throughout the work, other economic theories related to the firm are also explored such as the market for corporate control. Finally, the normative aspects of both the company and company law are considered through the exploration of different theories relating to shareholder value.

The methodology employs legal, historical, and comparative approaches to explore how economic thought, relating to the firm, has evolved and whether or not our current understanding of the company provides adequate answers to solve some of the most important problems relating to companies.

**Keywords**: principal/agency theory, agency costs, agency theory, shareholder theory, transaction costs, economics, law and economics, corporate law, corporations, corporate governance, stakeholder theory, enlightened shareholder value, the market for corporate control, comparative analysis.

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## INTRODUCTION

Virtually all large-scale business enterprises across most jurisdictions in the world are organized as corporations. To some extent, these enterprises are not new, and some types of business enterprises sharing many of the same characteristics as modern corporations have existed for several centuries. Inquiries into the nature of the firm, on the other hand, are a much newer endeavor taken up by economists, and arguably, our modern understanding of the corporation and issues relating to it is only several decades old.

As we will see, many of the key problems relating to corporations that modern economic theories relating to firms, seek to address, have been articulated by economists for several centuries. However, as we will see many of these early inquiries by economists struggled to develop a concrete theoretical foundation to understand what differentiates the economic relationships found in corporations and firms from those found within the market. It is worth noting that within the thesis no major distinctions are drawn between different types of companies and the terms firm, company, and corporation are used interchangeably. Most of the work focuses on corporations and corporate law and most of the economic research is focused on studying corporations due to their aforementioned importance.

This did change over time with the publication of works by economists such as Ronald Coase whose theoretical contributions laid the foundation for modern understanding of the corporation and informed subsequent authors, such as Jensen and Meckling to make further key contributions to our understanding of the firm through their exploration of the principal/agent relationship. However, within their analysis arguably lay an important normative claim on the role and purpose of both the corporation inspired by the shareholder primacy movement and free market economists such as Milton Freedman.

The motivation behind this research is rooted in the importance of the modern corporation in governing all aspects of global and national commerce and the importance of economic theories in not only exploring all aspects of the economy and economic policy but also in making important positive and normative on the nature of the corporation. Thus, the economic theories developed by economists are of paramount importance to businesses, legal practitioners, and policymakers.

The object of this thesis encompasses a comprehensive examination of the key theories that have had the most impact on understanding of the company and company law. The thesis first explores the early evolution of the corporation and its ascension as the dominant form to organize economic activity. It explores early attempts by economists and legal theoreticians to explain the nature of the firm as well as the key issues that concern it. It explores modern theories of the firm as well as their applications to aspects of corporate governance and company law. Finally, the thesis explores the different theories relating to the role of shareholders and other constituents of the corporation in its decision-making by examining what claims economic theories can make on the purpose of the company.

This research is highly relevant as it addresses frequently underexplored aspects of the evolution of economic theories relating to both the corporation and corporate law. The novelty of this thesis lies in its in-depth exploration of the evolution of different problem statements relating to the firm, the evolution of modern theories of the firm, and their potential application in solving many of the problems relating to corporate governance. This thesis does not aim to comprehensively explore any particular aspect of company law. Rather this aims to explore how different economic theories have impacted our understanding of the firm and their implications for company law.  To achieve this aim, the following tasks will be pursued:

1. To explain the impact of Jensen's and Meckling's work by explaining the problems it addresses and exploring earlier attempts by economists to explain the nature of the firm and the problems associated with it.
2. To explore the corporate governance and legal strategies that firms that shareholders may employ to address agency problems and consider the extent to which existing company law helps to alleviate these problems.
3. To explore the normative claims of modern economic theories of the firm by discussing shareholder value and enlightened shareholder value theories and how they relate to company law.

The research will employ a combination of methods, including legal analysis, historical analysis, and comparative analysis. The comparative analysis component of the methodology involves assessing how major jurisdictions namely the U.S. and E.U. empower shareholders to address problems stemming from the principal/agent relationship. The historical analysis, component will seek to present a comprehensive history of how different economic theorists influence each other's work to form the most useful theories with which to analyze company law. In addition, empirical studies are used when available and necessary to gain further insights.

This master's thesis employs a wide variety of economic and legal literature to explore the relationship between economic theories and company law. Ron Harris's "Ron Harris. Going the Distance: Eurasian Trade and the Rise of the Business Corporation, 1400–1700." (2020) provided important foundational insights into the evolution of the firm. Moreover, the literature review sections in the works of Chris Florackis and others have also proved to be invaluable when looking for empirical research concerning agency costs.

Beyond these key texts, a myriad of other sources contributed to the comprehensive exploration of the history of economic thought that shaped the most impactful theories on the nature of the company.

# PART 1: THE SEPARATION OF OWNERSHIP AND CONTROL

### 1.1.1 Introduction

Arguably the birth of the company predates modern economic science by a few centuries. Thus, much of the economic analysis on early firms is done in retrospect using available sources which are frequently sparse. However, both early and contemporary economists have repeatedly identified similar problems with the firm and have proposed differing solutions for them. Thus, before beginning our examination of contemporary theories relating to company law, we must first understand what questions proposed by an earlier generation of economists these theories sought to solve.

The first chapter of this part of the thesis will discuss the birth of the firm, its evolution and attributes, and the first examinations of the firm by Adam Smith. We will discover that many of his insights are still relevant to our discussion of the firm. The second chapter will discuss the evolution of the business corporation within the U.S. and the company law that governs it. In particular, we will discuss both how the structure of the firm has evolved and how company law evolved with it in the 19th and early 20th century U.S. Finally, we will discuss the seminal work by Adolf Berle and Gardiner Means *The Modern Corporation and Private Property* and its contribution to our modern understanding of the firm, through its discussion on the separation of ownership and control which occurred within most large firms at the beginning of the 20th century.

## CHAPTER 1: The Firm

### 1.1.2 Birth of the firm

Economic Historian Ron Harris distinguishes four theories on the origins of the corporation. First points to the corporation originating from the Roman world. The second theory attempts to pinpoint the origins of the corporation to jurists and legal scholars studying the Justinian Code in medieval European Universities.

A somewhat similar theory points to the medieval Catholic Church, which developed rules under canon law to manage its collective property without relying on inheritance. Finally, legal theorists in the late 19th century, such as Otto von Gierke viewed ancient Germanic tribal traditions as the origin point of the corporation (Harris, 2020, p. 268-271).

All of these theories make the origins of the corporation to be somewhere in Europe (Harris, 2020, p. 268-271), but it is worth mentioning to avoid a completely euro-centric analysis, that comparable types of organizations existed both in Imperial China and ancient India. Thus, a more likely explanation, for the rise of the corporation in Europe, involves both the organizational innovations by pre-medieval and medieval institutions and smaller innovations such as double-entry bookkeeping. (Maxime, 2021)

The key innovation that occurred during the medieval era was the creation of a separate legal personality, which permitted representatives of institutions such as towns, universities, and monasteries to act on the institution's behalf without assuming personal liability for themselves or other members of the institution. However, these medieval institutions were not-for-profit organizations, and most business was conducted by traders employing early forms of partnerships. (Harris, 2020, p. 220).

The history of the business corporation begins with the Dutch East India Company (VOC) and the English East India Company (EIC) in the 1600s. These early chartered companies employed both much older legal attributes such as separate legal personality and centralized collective decision-making but also employed newer legal and financial innovations such as joint-stock equity financing, the locking in of capital and transferable shares (Gelderblom, Oscar, Jong, and  Jonker 2013).

### 1.1.3 Legal Attributes

The legal attribute considered to be the defining feature of the corporate form is limited liability. Narratives on the development of limited liability place the origin point of the innovation or at the very least the attributes availability, with the Limited Liability Act 1855 and cases such as *Solomon v Solomon.* Modern scholars, on the other hand, argue that forms of limited liability existed before the 19th century, but concluded that modern liability emerged within the last century (Hansmann, Kraakman and Squire, 2005).

The narrative surrounding the usefulness of limited liability emerged at the beginning of the 20th century and was further developed by economic-legal theorists in the 1960s. The arguments presented by academics such as Henry Manne focus on limited liability’s usefulness in the mitigation of risk as potential investors can limit their exposure to potential losses endured when a business becomes bankrupt (Harris, 2019). In a similar vein, Halpern argues that limited liability facilitates more efficient financial markets as it limits the amount of information a potential investor needs before investing. (Halpern, Trebilcock and Turnbull, 1980) Thus,  limited liability's mitigation of risk is the key attribute that enables firms to acquire large amounts of capital through investment by numerous shareholders.

However, historically firms were able to grow large and acquire investments without having the ability to employ limited liability to limit the risk to potential investors. Moreover, throughout the 19th and early 20th centuries several different limited liability regimes existed, all of which lacked the full protection provided by modern limited liability employed by modern firms. Thus, although limited liability is a useful feature, historically, it wasn't the defining feature that facilitated the rise of the firm.

Other theorists such as Henry Hansmann and others argued that *affirmative asset partitioning* or *entity shielding* is a set of legal features that protect firm assets from the creditors of its owners and were arguably more historically and economically significant for the development of the business firm. There are several key advantages that entity shielding provides. First, it enables firms to have distinct pools of assets independent from both firm owners and other interrelated firms. This may make the firm more attractive to potential creditors as they only need to evaluate the solvency of the particular enterprise that is being lent to, rather than the entirety of the enterprise. The same could be said about a potential investor who similarly only needs to evaluate the potential value of a firm and the assets associated with it and not the circumstances of the firm's owner or other interrelated firms (Hansmann, Kraakman, and Squire, 2005).

This also results in a reduced amount of oversight required for agents in charge of subsidiary firms who may potentially engage in risky behavior,  such as exercise borrowing as any potential detrimental decisions made by decisions will only affect the specific pool assets tied to that particular part of the enterprise and not the entire enterprise which may be composed of several firms. If bankruptcy does occur, as a result of the incompetent behavior of the agent, potential bankruptcy costs are reduced as one pool of assets will be of concern, instead of the entire enterprise. Moreover, liquidation protection against both the owners of the firm and their creditors can also be viewed as entity shielding as it protects the firm's assets from the potential premature withdrawal of one of the owners.

Whether or not entity shielding was historically more useful than the owner shielding provided by limited liability is beyond the scope of this thesis. However, for our discussion, it is important to note that both of these attributes of the firm have the effect of separating the assets of the firm from the assets of its owner but in different ways. Limited liability prevents claimants of firm assets from pursuing the personal assets of the firm's owner, while entity shielding prevents the claimants of the firm's owner from pursuing their claim against the assets of the firm. The result is the self-reinforcing of the firm to acquire and concentrate assets independently of the fate of its owner.

All of the modern attributes of the firm developed slowly over many centuries and many of the early innovations were borne out of necessity as international trade at the time was incredibly risky and required large amounts of capital to facilitate. This was also the case for the Dutch East India Company (VOC) and the English East India Company (EIC) in the 1600s which pioneered many of the legal innovations that define the modern corporation. These firms were also some of the firms to employ large amounts of agents to facilitate business transactions across the globe.

However, unlike modern business corporations, these institutions weren't purely private affairs, but rather organizations created via the passing of a special piece of legislation that granted certain (often exclusive) privileges to these companies. In return for the privileges granted these companies were considered to be performing special functions in regards to the state, such as facilitating trade. Thus, these firms in a way could be viewed more as extensions of the state rather than fully independent organizations. (Harris, 2020, p. 266)

### 1.1.4 Early Inquiries

The success of these firms did not go unnoticed both by prospective businessmen and early economists, who were also some of the harshest critics of these nascent organizations. One such critic was Adam Smith who discussed some aspects of these organizations which he found problematic in two of his seminal works *An Inquiry into the Nature and Causes of the Wealth of Nations* and *The Theory of Moral Sentiments.*

Authors Anderson and Tollison discuss Smith's criticisms in their paper on this subject. They distinguish three distinct criticisms that Smith had regarding the Joint-Stock company. The first criticism stemmed from the monopolistic aspects of these firms, which

Smith argued made these companies inefficient as evidenced by the fact that many of these companies frequently outcompeted their non-chartered counterparts which did not enjoy the same privileges as they did. Moreover, for Smith the monopolistic nature of these firms hindered the natural process of competition which resulted in higher prices for customers of commodities that these firms traded in. (Anderson and Tollison, 1982)

The second criticism stemmed from Smith's belief that the directors of these companies frequently incompetently managed the funds entrusted to them by investors of these organizations for themselves. This view is summarized in the frequently cited quote: "*The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.*"

Finally, these companies, and in Smith's criticism he referred to specifically the English East India Company, began to acquire direct political power within these regions and exploited it, with the local inhabitants of these regions suffering as a result. In particular, Smith discussed how the agents of the English East India Company after it acquired direct political power in what is now modern India used their influence to not only extort the local population but to personally enrich themselves in the process. (Anderson and Tollison, 1982)

Recent inquiries into chartered companies confirm Smith's suspicion, especially when it came to agents of these companies using their position within the organization to gain benefit for themselves. Carlos, Ann M., and Stephen Nicholas in their work discuss how the Hudson's Bay Company, which was chartered by the English crown in the 17th century and granted a trade monopoly within the Hudson Bay, developed sophisticated systems to deal with self-dealing employees, such as the setting of high standards for recruitment and increased pay. As we will see these problems not only exist in modern business firms but the strategies employed by these early companies to combat profiteering agents are also not dissimilar to the ones employed by modern firms. (Carlos, Ann and Nicholas, 1990)

## CHAPTER 2: The Evolution of the Business Corporation in the U.S.

### 1.2.1 Early U.S. Firms

Initially, most firms within the U.S. were partnerships composed of a few individuals participating in economic activity. These were frequently small affairs with producers both manufacturing, farming, and selling commodities within their local markets. Thus, these early American business enterprises operated more like cooperatives than modern firms. Corporations were uncommon before the 19th century and almost all of them at the time were churches, cities, or boroughs, rather than businesses. Of those corporations, which were businesses, a majority were public utility companies that organized and built bridges, canals, and turnpikes. The small remaining minority were financial institutions, such as banks and insurance companies. (Hansmann and Pargendler, 2013)

Initially, U.S. corporations operated within a charter system which the U.S. had inherited from Great Britain. and the individual merchants and traders had to lobby their local state legislatures to receive a corporate charter from them. These early charters imposed many restrictions on the organizations that were chartered. For example, some charters limit the number of years that the organization could exist, some impose limits on the alienability of shares or the number of shares that a shareholder could hold. Moreover, some attributes such as limited liability were completely unavailable for prospective charterers.

Nonetheless, requests for the creation of new corporations only grew due to the attractiveness of the corporate form. Eventually, state legislators began to both standardize these charters as well as implement many of the demands that businessmen were lobbying for. By far, the biggest development, during the period of the mid-to-late 19th century, was the passing of general incorporation laws, which streamlined the entire process of incorporation. (Friedman, 2005, p. 390-404)

At this time another key development began to take place, which was the unprecedented growth of the business corporation in size, complexity, and influence. In his work, "The Visible Hand: The Managerial Revolution in American Business" (1977), the economic historian Alfred Chandler, traces the growth of modern business corporations within the 19th and early 20th century U.S. During this period, what historians now call the the 2nd Industrial Revolution, technologies such as the telegraph and railroads had enabled productivity and efficiency to increase across virtually all sectors of the U.S. economy.

This economic transformation also resulted in structural changes within the largest business firms at the time as the complexity of operations both on a financial and operational level. For the first time, businesses created, marketed, and sold products to customers and did so throughout the entire continental U.S. Chandler, in his work, describes this transition as one where firms went from being ‘U-shaped’ to being ‘M-shaped’.

At the beginning of the 20th century, many firms were still ‘U-shaped’ meaning their decision-making structure was still highly centralized with a singular organizational unit at the top of the corporate hierarchy making most of the decisions within the firm. During the early 20th century, companies such as DuPont and General Motors began to adopt an ‘M-shaped’ structure where much of the decision-making power was delegated to different divisions within the firm, with the central corporate office only handling long-term strategic decision-making. This transition had proved to be successful for most firms and by the mid-20th century, most large U.S. firms had adopted an ‘M-shaped’ structure. (Chandler, 1993, p. 484-494)

### 1.2.2 Legal Transformation

As these corporations grew, the legal restrictions imposed on them were also rescinded. As discussed above, a corporation could only be chartered with the permission of the state.  The understanding of the firm, at the time, was based on the idea of *concession* whereby the creation of an artificial entity of the corporation was permitted by the state, and in return the corporation served the public good an important service to the community. Moreover,  the *ultra vires* doctrine restricted managers from participating in business activities that fell outside of the charter. Over time this doctrine became increasingly irrelevant, with judges expanding the spectrum of activities that these chartered firms could partake in.

Eventually, states such as New Jersey and later Delaware, attracted by the potential financial gains that liberalized incorporation could provide, allowed corporations to be chartered for any lawful purpose, thus greatly expanding the spectrum of activities that a corporation could partake in and, as a result, making the *ultra vires* obsolete. As the laws relating to the corporation liberalized, the corporation became more of a private affair conducted between individual entrepreneurs. (Friedman, 2005, p. 397-399)

This transformative period gave rise to new theories of the corporation. During the 19th century, the notion of a partnership was still considered the appropriate framework with which to analyze corporations. Thus, some legal theorists began to view the corporation as an aggregate of individuals entering into a contract. However, during this time adherents of Otto von Gierke's view of the corporation as a 'real entity' were also coming to prominence and would arguably become more influential during this transformative period. Real entity theory interprets the state's chartering as a recognition in law of a pre-legal group personality. However, the corporation is a 'real entity' that is separate from the interests and ambitions of its members. This theory is important to understand when considering the seminal work of Berle and Means (Claassen, 2022).

### 1.2.3 Berle and Means

By the time Adolf Berlen and Gardiner Means wrote their seminal work *The Modern Corporation and Private Property,* the public business corporation was in full ascension, with a small number of firms having achieved disproportionate control over economic resources within the U.S. and abroad. For the authors, the American economy and important societal aspects such as private property were at a crossroads as a result of the economic changes induced by what the authors called 'the corporate system'. (Weinstein, 2012)

Within their work, the authors identify three key issues that were at the root of the changes that were occurring. First, business corporations through their size and control over economic resources had amassed political power only comparable to that of a national state. Moreover, the function performed within society by these firms was comparable to that of a social institution. Thus, for the authors the corporation is no longer merely a vehicle for business operations, but an institution unto itself, which is line 'real entity' theory. (Claassen, 2022)

Throughout the book, the authors illustrate the power that corporations had amassed by meticulously documenting the assets, employees, and shareholders of various U.S. firms. The authors conclude that for the first time, economic power concentrated within powerful firms has created an unprecedented situation where the decisions made by these firms can positively and negatively impact large sections of society on an unprecedented scale. (Weinstein, 2012)

The second important aspect of the transformation occurring within the U.S. economy was the creation of a new type of property relationship that was a radical break from the past. The authors argue that initially in the U.S. most business firms were small and frequently the people who managed the firm were also the firm's owners. Thus, these owner-managers invested their property into the enterprise that they controlled and profited from its deployment. (Berle and Means, 1933, p. 2-4)

However, as the business firms grew and their shares became dispersed among a large number of shareholders this resulted in a new type of property relationship between the owners of stock who were entitled to only a fraction of assets owned by the firm. Thus, the deployment of property vested within the firm became the firm's exclusive domain. As a result, the owners of stock became the owners of what the authors call 'passive property' in this case stock which merely yielded a profit but could not be invested or deployed in the same way as older forms of property could be. (Berle and Means, 1933, p. 64)

Finally and most importantly, this new type of relationship enabled firm managers who, although not necessarily shareholders themselves, were the ones truly in charge of the decision-making within the firm. This separation of ownership and control, was problematic for the authors as these managers, as the interests of the managers and owner of the firm may diverge, with self-interested managers being able to exploit their position within the firm for their personal gain. (Berle and Means, 1933, p. 113-114)

### 1.2.4 Analysis

Berle and Means seminal analysis of the issues stemming from the separation of ownership and control has become an important building block for all further discussions on corporate governance. However, as we see from the first section of this chapter, much of the discussion found within their work echoes those made by earlier economists such as Adam Smith back in the 18th century.

Both authors essentially identify two problems within how corporations operate: the first being the management of the firm that results from the divergent incentives between the owners and investors of firms and the agents they employ to manage the business operations of those firms and what Berle and Means called the separation of ownership and control. The second problem, addressed more explicitly by Berle and Means but also by Adam Smith is the pernicious effect on society that is caused as a result of firms acquiring too much economic power within a given society. It can be also argued that this was the result

The legal attributes such as limited liability and asset partitioning arguably contributed to the separation between owner and manager as these legal attributes effectively have an isolating effect between the owner and firm assets.

Most importantly, modern economists and legal theorists are wrestling with the issues identified above to this day as we will see in the next chapter, modern Agency theory explicitly seeks to redress the problems stemming from the separation of ownership and control. However, the solutions proposed to the issue of excessive influence gained by business corporations over a particular society, discussed in the final chapter of this thesis, are far more ambiguous.

## PART 2: AGENCY THEORY

### 2.1.1 Introduction

Roland Coase's article *The Nature of the Firm* is arguably one of the most foundational studies into the nature and emergence of the firm and is the starting point for most discussions on the subject. However, like all economists, Coase's work was influenced by the writings of previous generations of economists.

Much of the foundation for the thinking presented in Coase's work (and modern economics in general) originates within the work of the marginalists, who flourished at the end of the 19th century. Along with their focus on the marginal utility of goods, the conception of the market was one that was dominated by utility-maximizing individuals, operating in a resource-scarce environment.

Another key work with an enormous impact on Coase and subsequent economists' understanding of the firm was Frank Knight's *Risk, Uncertainty, and the Firm,* which also built upon the insights of marginalists and subsequent neoclassical economists to study how uncertainty was the determining factor in the emergence of the firm and the entrepreneur as the coordinator of production within the market.

The insights presented by Coase, Knight, and others were later built upon by Alchian and Demsetz and Jensen and Meckling in their subsequent works which gave rise to the principal/agent theory of the firm, which arguably had the most influence on modern company law and our understanding of the firm in general. This chapter aims to discuss both the birth of agency theory and its application in corporate governance.

## CHAPTER 1: The Marginal Revolution & Early Inquiries into the nature of the firm

### 2.1.2 The Marginalist Revolution

Marginalism as a school of thought within economics traces its origins from early English utilitarian thinkers, such as Jeremy Bentham who articulated the earliest notions of marginal utility. However, it was the first generation of marginalists, such as William Stanley Jevons in England, Carl Menger in Austria, Leon Walras in Switzerland, and John Bates Clark in the U.S. who in the late 19th century would publish works that would be later formulated by economists such as Alfred Marshall to form the basis of a school of thought now known as neoclassical economics.

The marginalists rejected earlier notions of value proposed by classical economists such as Adam Smith, and David Ricardo which saw value as being determined by the amount of socially necessary labor invested into the production of a good or service. However, for the marginalists, value was an expression of subjective and based on willingness to pay for the next unit of a good or service, to the units already consumed.

Moreover, instead of focusing on economic growth, the marginalists directed their attention to the problem of resource allocation within a market, where resources are scarce. Thus, for the marginalists, one of the main problems in the whole of economics becomes the efficient allocation of resources by utility-maximizing economic agents. Within the marginalist analysis of the market, agents are portrayed as atomized individuals who can satisfy their needs and goals through one type of exchange or another, as long the decision made is the most optimal one for the agent. (Screpanti and Zamagni, 2010, p. 163-167)

The neoclassical analysis of the business firm was similarly reductionist, with the firm becoming a unit of production or ‘black box’ which responded to differing market conditions with the overall aim of its existence being to maximize profits. Thus, neoclassical economists focused their attention on how firms acted within markets and paid little attention to their internal workings as they considered the organizational aspects of the firm to be beyond their field of inquiry. (Demsetz, 1991)

Another important aspect to note is that within the neoclassical analysis of the market, resources are shifted from one place to another in a frictionless manner. However, It was Arthur Cecil Pigou, who in his book “The Economics of Welfare” challenged this view by developing the notion of what he called ‘the costs of movement’ which is the difference in value resulting from the movement of resources within the market. However, Pigou did not consider the cost of movement within the firm and focused his research on the allocation of resources across society as a whole. (Hovenkamp, 2011)

### 2.1.3 Risk, Uncertainty and Profit

Another key work to consider is the book “Risk, Uncertainty and Profit” (1921) by Frank Knight. One of the key contributions of Knight was his analysis of competition, specifically the concept of perfect market competition. For Knight, the key factor that distinguishes a perfect from an imperfect market is uncertainty. The uncertainty present in a market results in the existence of both the firm and the entrepreneur.

Knight argued that in a perfect market with no uncertainty and in combination with other criteria such as all actors possessing perfect knowledge, there would be no need for firms or entrepreneurs and the flow of goods and services would be automatic, with individuals only performing the necessary labor for production to occur. However, with uncertainty present, actual production becomes secondary to the process of figuring out what to do and how to do it. (Knight, 1921, p. 18-19)

The role of the entrepreneur is thus to coordinate every aspect of production from figuring out what are the wants and needs of potential consumers to coordination of production and delegation of activities within the firm. Thus, individuals within the market are split into two categories: those that participate in the production process and those that organize it. (Knight, 1921, p. 267)

For our discussion, the most important insight in Knight’s analysis of the firm is its role as a medium to organize production in an imperfect market. This insight is directly built upon by Coase in the seminal work *The Nature of the Firm,* which can be viewed as an extension of Knight’s work.

### 2.1.4 The Nature of the Firm

In his work, Coase both builds upon and challenges Knight's analysis of the firm. On one hand, Coase agrees with Knight's analysis that the firm arises as a result of the uncertainty that exists within markets. However, a key question that Coase considers is why only some transactions occur within firms, while others occur within the market.

Coase begins his analysis by discussing how market coordination comes with certain costs, referred to by economists as transaction costs (in the paper referred to as marketing costs). These costs can be anything from the time spent contracting to maintaining business secrets. The central argument presented by Coase is that firms can supersede costs associated with market coordination through firm coordination as firms can act as a central contracting structure, thus enabling it to organize production more efficiently.

The advantages of firm coordination are numerous, such as the vertical integration of production or the ability of the firm to contract on a more long-term basis. Other advantages can be more specific to the market in which the firm operates, such as the development of certain expertise or the creation of new technology that improves production. The way that the firm supersedes the costs of contracting through the market is largely irrelevant because as long as the firm can internally coordinate the production of goods and services more cost-efficiently than through market coordination, the firm will exist.

It is worth noting that, although the firm can supersede the price mechanism, the firm can never operate truly outside of it. It is also the reason why the size of the firm will always be limited and a situation where one firm organizes all production is unlikely as transactions might eventually become too costly to be carried within a firm due to its size and other and especially smaller firms, might be able to carry out transactions in a more efficient manner. Thus, firms will evolve to an optimal size through both coordination with the market and its internal governance.

Finally, Coase ends his analysis by looking at the relationship between employee and employer. From his analysis, we can conclude that the employee-employer relationship and especially the employer's right to direct the actions of the employee are central to the operation of the firm. However, no further analysis of the internal operation of the firm is provided. (Coase, 1991)

### 2.1.5 Coase's black-box

Coase's work, while initially not widely read, would substantially grow in importance by the 1970s. (Fontrodona and Sison, 2006) *The Nature of the Firm* was also frequently cited in conjunction with Coase's *The Problem of Social Cost, arguably* Coase's more famous and influential work. In *The Problem of Social Cost,* Coase analyzed the issue of externalities in the negotiation of property rights between firms. Coase in his analysis draws much of his conclusions by examining English cases and statutes relating to the common law tort of nuisance. He concludes that the free market when property rights are complete and the negotiation for said property rights is not too costly, will be able to internalize all externalities efficiently and without public intervention. (Coase, 1972)

This insight and its varying interpretations would be articulated into what is now known as the Coase theorem by George Stigler and would inform a new generation of economists and legal theorists studying law and economics (Medema, 2020). However, Like economists of previous generations, Coase once again did not focus much attention on the internal workings of the firm, instead focusing on how firms participate in the market as individual units, a flaw which is also present in many of the works of scholars employing Coase's work. An example of this would be Richard Posner and his work *Economic Analysis of Law* which employed Coase's analysis of transaction costs to corporate law but did not delve into how the bonds between members of a corporation operate (Posner, 1992, p. 363-371). However, the subsequent works by Alchian Demsetz and Jensen and Meckling in particular would aim to address this gap in our understanding of the firm.

### 2.1.6 Modern Theory of the Firm

The firm's conception as a 'black box' would remain dominant among legal and economic theorists until the late 1960s when this conceptualization was challenged by a series of papers that formed the foundation for modern agency theory (Gindis, 2020). The theory quickly became a foundational building block in both corporate finance and corporate governance, along with other theories such as the efficient market hypothesis and the market for corporate control. Moreover, the insights presented in Jensen and Meckling's paper also were able to solve the issues presented by Modigliani, F., and Miller on the capital structures of firms.

### 2.1.7 Team Production

The modern theory of the firm is to start with the publication of *Production, Information Costs, and Economic Organization* by Alchian and Demsetz. Although in their work the authors explicitly acknowledge their agreement with Coase’s and Knights's analysis of the firm, the authors focus their analysis on how the firm manages resources and transactions internally to explain the emergence of the firm.

For the authors, the firm emerges to coordinate team-based production that would be impossible to negotiate through the market. The authors identify three key aspects that define team production: first, several types of resources are used, second, the product is not a sum of separable outputs and finally not all sources used in team production belong to one person.

Within this process, the need for a central authority emerges to manage this process, thus the firm emerges to fill this role by becoming a central contracting authority which efficiently manages all of the inputs of the production process and reduces the costs of contracting between different resource owners. The authors conclude that the firm becomes an efficient market that collects and acts upon information from its collective inputs.

As long as contracting within the firm is more efficient than through the open market the firm will exist. However, in addition to the typical bonding and informational costs that occur within the market, other, more specific costs occur when production occurs within the firm. The main cost endured by the firm engaging in team production is the underinvestment by individual team members into the team production process is known as ‘shirking’. Shirking or free-riding occurs when team members underinvest in the team production process, as in many production processes only the collective effort by the team can be measured. Moreover, the monitoring of the marginal productivity of each member of the team can be costly and difficult to implement.

This problem results in the need for a specialized managerial authority that measures the performance of individual team members. However, the incentives of the aforementioned managers might also be such that shirking may occur on their part, thus creating the need to monitor their performance. The authors illustrate this problem by simply asking “Who will monitor the monitor?”

One answer proposed is that market competition for management will solve this problem. However, the authors point out two issues with this: first, the detection of shirking is costly, and thus potential usurpers will have trouble knowing where shirking occurs, second, a new manager might not be incentivized to attain his new position as this might require them to do so at a relatively reduced compensation or the promise of increased productivity.

Thus, the solution proposed by the authors is to incentivize the manager by making him a residual claimant to the firm's profits. The residual claimant manager will earn his residual by monitoring and managing the team members to reduce shirking and increase his residual claim. The owner-manager must also have substantial rights invested in them to fulfill their role, such as the ability to alter existing contracts between members of the team and the firm and to potentially cut ties with a team member entirely. (Alchian and Demsetz, 2009)

The central innovation in Alchian and Demsetz's work lies in their analysis on the internal workings of the firm by looking at the costs associated with the misalignment of individual incentives that govern the individuals that act as inputs into the team production process. This approach will be built upon and generalized into the principal-agent theory in the work of Jensen and Meckling.

### 2.1.8 A nexus of contracts

As mentioned previously, one of the key issues for economic theorists at the time was to move beyond the 'black-box' view of the firm and to develop an economic understanding of how the firm operates internally. This task is explicitly taken up by the authors. We saw how Alchian and Demsetz focused their attention on joint team production as the basis of their analysis, an approach that Jensen and Meckling on the one hand embrace and reject. Although the authors do not disagree with Alchian and Demsetz's insights, they do believe that the focus on joint team production was unwarranted and rather the essence of the firm is the contractual relationships that bind the employees, managers, suppliers, and other participants together.

For the authors, the firm does not have an 'inside' or an 'outside', nor is the firm a separate unit of production that participates in the market. The firm and other organizations like it is: *"legal fictions which serve as a nexus for a set of contracting relationships among individuals"*. These contractual relationships may vary depending on the circumstantial nature of the relationship. For the authors, the business firm is: "*simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized* *by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.".*

It is worth stopping here and examining why the medium of contract becomes the central medium for governing the nexus of contracts that make up the business firm. A line of reasoning can be found in the aforementioned work of Alchian and Demsetz. As firms are considered not to have real authority to compel individuals to act in a certain way, the contract becomes central to governing various arrangements found within the firm. Jensen and Meckling take up this line of reasoning directly and conclude that the specification rights, rewards, and costs will depend on the nature of the contracts negotiated by individuals (Jensen and Meckling, 1976).

### 2.1.9 Agency Theory and Agency Costs

Thus, if the firm is nothing more than a series of contractual relationships between individuals, by understanding the nature of these relationships we can finally develop an economic understanding of the dynamics that govern the nexus of contracts that is the firm. At the heart, of Jensen and Meckling's analysis is the neoclassical view of individuals as fundamentally utility-maximizing creatures, thus investors will invest with the exclusive aim of maximizing the return on their investment and the employees will seek the maximum compensation for their efforts.

The authors go on to argue that relationships that are found within the nexus of contracts are ones of agency, that is where a principle or principles contract an agent or agents to perform a service on their behalf of the principle or principles. However, as both parties aim to maximize utility for themselves the agent will not always act in the best interest of the principle. Moreover, the principal-agent relationship is subject to informational asymmetry due to the delegation of power from the principal to the agent, resulting in the agent possessing much more information about any given situation. As a result, the principal (which can also be viewed as a firm) will have to endure costs that stem from the misaligned incentives of the two parties.

The authors defined three types of costs associated with the divergent interests between owners and managers that form the totality of agency costs. The first cost is endured by the principal as a result of investing resources into monitoring and evaluating the agent. This could be anything from organizing the actual hiring process to appointing a board to monitor the managers of the firm. The second is the bonding expenditures endured by the agent as a result of monitoring the principle which limits their activity. What is interesting to note as bonding costs increase for the agent the monitoring costs decrease for the principal. Finally, the residual loss which loss endured as a result of the misaligned interests of the parties.

The authors then illustrate these costs by studying how agency costs may arise in firms with different ownership structures. Through different models, they, first, demonstrate that the owner-manager who holds the company's equity will have the incentive to monitor her decisions as they will bear the pecuniary and non-pecuniary costs for their actions. Thus, owner-manager firms will likely have lesser agency costs as the interests of the principal and agent align and will result in the optimal distribution of costs and benefits.

On the other hand, if the owner-manager sells their stake in a limited liability firm, this will result in limiting costs created by the manager as the result of outside monitoring. However, in either case, the owner-manager will bear the ultimate cost and the market will discipline their decision-making within the firm. The authors go on to further explore how the amount of debt held by the firm affects the manager's incentives. The authors demonstrate that higher debt levels increase potential agency costs as a result of an increased incentive on the managers to take on greater risks (Jensen and Meckling, 1976). The key point to emphasize here is that potential agency costs can also affect outside investors to firms.

### 2.1.10 Analysis

Previous generations of economists focused on studying costs that firms endured externally. Thus, a firm within the framework of analysis presented by economists such as Marshall was a 'black box' participating in a market in a way not dissimilar to individuals. Coase, building upon the work of the early marginalists and other economists such as Pigou and Knight, was able to explain the emergence of the firm, through his study of how firms deal with transaction costs within a market.

The work of Alchian and Demsetz delved deeper into the incentives governing the emergence of firms through their focus on team production. The insights presented were generalized into the principal/agent theory by Jensen and Meckling which can be used to study the costs associated with any type of relationship between principle and agent. Most importantly for us, through their modeling of principal/agent relationships within firms, the authors presented a framework to study and solve the misaligned incentives that are at the heart of the problems stemming from the separation of ownership and control. In the subsequent chapter, we will explore the different incentive alignment strategies employed within corporate governance.

## CHAPTER 2: Agency Costs and Corporate Governance

### 2.2.1 Introduction

The subsequent generation of scholars has substantially expanded the work of Jensen and Meckling both theoretically and through empirical research. As we will see, agency theory and coasian analysis of cost can be applied to study many aspects of the firm and thus the first section of the chapter will address Franco Modigliani and Merton Miller's work on firm value and capital structure. Subsequent sections will discuss different private ordering strategies that firms may adopt to better align incentives between owners of the firm and management. Finally, the chapter will conclude with a discussion of the market for corporate control.

The aim of this chapter is not to provide an in-depth discussion of the various legal strategies that firms can adopt to mitigate agency costs. The work of Armour, Hansmann, and Kraakman as well as Becht, Bolton, and Roell provides a much more in-depth exploration of these issues. Rather, this chapter aims to discuss how the aforementioned economic theories, in particular agency theory, can provide a framework to understand the dynamics that inform the various aspects of company law.

### 2.2.2 Firm Value and Capital Structure

As discussed above, many of the insights on agency costs presented by Jensen and Meckling were used to solve problems within financial economics. Franco Modigliani and Merton Miller in their 1958 article on the firm value, proposed that within a perfect capital market, that is in the absence of both transaction and information costs, the structural aspects of a firm capital, meaning its debt to equity ratio, were irrelevant to the firm's total value.

Jensen and Meckling, by analyzing the issue through the lens of agency costs and managerial monitoring, demonstrated the relevance of a firm's capital structure to the value of a firm. As we saw, in our discussion above, the ratio of debt to equity in Jensen and Meckling's model had a substantial effect on the behavior of the firm manager. In a scenario where the owner-manager owns all of the equity, they are incentivized to monitor themselves.

For the creditor, this is relevant as the owner-manager is less likely to take on risky decisions as they would be the ones that will have to bear the cost of their risky decision-making. Similarly, in a situation where a firm has a high debt-to-equity ratio and is on the verge of failure, the firm's owners will either be uninterested in making further investments into the firm, as it will be the creditors that will be the ultimate beneficiaries or will similarly partake in risky decision making at the expense of the creditors. The creditors are aware of this account of potential agency costs when evaluating the solvency of a firm and in response, the decision makers within the firm make the necessary decisions to minimize agency costs (Jensen and Smith, 2000).

(Easterbrook, 1984) similarly demonstrated, using Agency theory, why firms may prefer to pay out dividends to shareholders, even though the practice of doing so may be costly to the firm. The article demonstrated how the regular distribution of dividends to shareholders may help reduce agency costs of management, as for managers to keep making regular dividend payments they have to rely on the issuing of stock to raise further capital. To do this, managers must maintain the overall financial health of the firm which in turn lowers agency costs.

The key takeaway drawn from this discussion should be that firms should be able to flexibly adjust their capital structure to mitigate the potential agency costs relating to the owner-manager.

### 2.2.3 Strategies for Remedying Agency Costs

As we see from the section above, different capital structures within firms may be viewed as responses to different types of agency costs. Over the years a substantial body of empirical research has emerged measuring agency costs across different types of firms and jurisdictions. These studies usually measure different financial assets of the firm as a proxy to indicate the amount of agency costs endured by a particular firm. Examples of such assets are the rate of asset turnover, the ratio of administration, selling expenses, and the divergence between cash flow rights and voting rights. (Boardman, Shapiro, and Vining (1997)

Other studies look at the asset utilization of a firm to measure agency costs, which is calculated by dividing the total revenue by the total assets. The ratio produced indicates the effectiveness of the governance structure of the firm as it demonstrates how efficiently the assets of the firm are employed. Other ratios such as the expense ratio are employed to similarly measure how effectively firm resources are employed by management. High expense ratios generally indicate the company might suffer from higher agency costs.

Controlling agency costs has become an important aspect of corporate governance as it is generally accepted that firms with high agency costs will use capital less efficiently. The following section will discuss some of the empirical studies on corporate governance mechanisms employed to mitigate agency costs.

### 2.2.4 Managerial Compensation & Managerial Ownership

A particularly common strategy to align managerial interests with those of the owners is through compensation packages given in addition to the base salary including compensation, bonuses, and stock options. Studies seem to indicate the successfulness of this approach with (Jensen and Murthy, 1990) and (Mehran, 1995) demonstrating that manager compensation packages increase firm performance.

Other studies draw the same conclusion of the succesfulness of incentive schemes for managers that end up maximizing shareholder interest and also shows that outcome-based incentive contracts that decrease managerial opportunism (Eisenhardt, 1989). A more modern study by (McKnight and Weir, 2009) showed that in the US and UK economies, that agency costs is decreases with growing managerial ownership. However, other studies indicate that some of these measure might only provide short term benefits (Chen, 2003).

However, pure private ordering may not be a fully effective method for reducing agency costs. For one, the increase in compensation for managers whether through stock or salary also increases costs for the owners of the firm. In addition, some authors view managerial compensation as a potential source of agency costs as excessive compensation packages and the negotiations surrounding may result in further conflicts between shareholders and managers. (Bebchuk and Fried, 2003).

Similar issues occur when aligning managerial incentives through managerial ownership. As we saw, the original paper proposed a linear relationship between managerial ownership and lower agency costs. However, subsequent studies demonstrate that the relationship between managerial ownership and agency costs is more complicated. In particular, studies demonstrate that as levels of managerial ownership rise the potential for agency costs increases as managers exploit their position within the company to entrench themselves and collect benefits. Moreover, there are costs associated with parties holding a large stake in a firm, in particular, the conflict between minority and majority shareholders might its own source agency costs with large shareholders using their position to expropriate resources from the firm. (Cronqvist and Nilsson, 2003)

### 2.2.5 Debt Financing

As discussed above the right debt-to-equity ratio within a firm may help in reducing agency costs. The type of debt is a relevant factor when reducing agency costs as, for example, short-term debt can help address problems stemming from the underutilisation of company assets (Myers, 1977). Short-term debt may also serve as an important signal on firm performance as banks are typically more information rich than other participants in the financial markets (Fama 1985).

### 2.2.6 Board of Directors

The board of directors is an important feature of corporate governance as the existence of a board can serve an important role in shaping the long-term strategy of a firm and establishing a firm culture. The company board also serves an important function in monitoring management. However, studies have shown that board size and composition are relavent factors to consider when establishing it within a company as boards with too many members hinder the speed of decision making within a firm (Beiner et al. (2004).

### 2.2.7 Managerial Liability & Shareholder Suits

One potential recourse that shareholders might pursue is a shareholder suit against firm officers who through their actions breach the fiduciary duties owed. The suit is typically by a shareholder or a group of shareholders on behalf of the corporation. Such measures can serve as an important deterrence measure to discipline management or at least, if successful, can potentially offer a redress for shareholders. However, shareholder suits come with their own costs which can significantly diminish their attractiveness. For one, a shareholder or group of shareholders pursuing a shareholder suit will have to bear all of the costs associated with the suit, while the benefits of the suit will be distributed equally to all shareholders.

Moreover, the relationship between the disgruntled shareholder and his legal council is its source of potential agency costs as the interests of the principal (shareholder) might not align with those of his attorney, who may be interested more in collecting fees than redressing the grievances of their client. In addition, certain jurisdictions tend to be more restrictive than others in permitting legal action against the incumbent management, such as requiring a certain percentage of shareholders to be in favor of the suit, a reason why, for example, shareholder suits remain rare in continental Europe (Romano, 1991).

Finally, there is the problem of setting the standards of appropriate decision-making for an incumbent manager. Courts in jurisdictions, such as Delaware, offer particularly strong protections to managers, with fiduciary standards such as duty of care, loyalty, and good faith under the business judgment rule, arguably insulating management from accountability for making risky business decisions (Bainbridge 2004). It is worth noting that other jurisdictions have adopted similar standards, although with some variation.

### 2.2.8 Mandatory Rules

Recall that within Agency theory the corporate body is seen as a ‘nexus of contracts’ between the various participants in firm activity. From this perspective, a natural conclusion is drawn that the role of company law is to reduce the costs of entering and managing the various business relationships between shareholders, entrepreneurs, and managers that make up the firm (Macey 1993). Corporate law can serve this transaction cost-economizing function by specifying a set of standard default terms that prospective businessmen may choose and adapt for their purposes. (Easterbrook and Fischel, 1991, p. 22). Courts also play an important role in filling the gaps caused by circumstances unforeseen by contracting parties. Companies then demonstrate their preference for different standards set by jurisdictions by setting up in different jurisdictions that offer the most attractive rules for conducting business, which in turn promulgates those standards within other jurisdictions.

It is perhaps unsurprising then, that some have argued that all mandatory rules set for companies are trivial and could be negotiated by individual contracting parties as the true aim of company law seems to be to deal with out-of-the-ordinary circumstances (Black, 2002). However, as discussed in the first part of the thesis, recent scholarship has pointed to the importance of corporate law in partitioning assets and liabilities between the contracting parties of the firm. Moreover, aspects such as separate legal personality also play an important role in enabling the firm to be the central contracting party to conduct business transactions. (Gindis 2016).

Within this framework, it falls largely on the principal to negotiate the various contractual arrangements to align his interests with those of the agent. However, as we saw above corporate governance measures can be costly to adopt and thus both states and regulatory agencies do provide standards that potentially can mitigate agency costs. The purpose of such mandatory standards is to deter unsatisfactory behavior by management by imposing the potential costs as a result of prosecution. This in turn lowers the monitoring costs for shareholders as they can rely on regulatory institutions to monitor management.

In addition to serving as a deterrent, one of the most important aspects of a company is to empower shareholders to exercise power over the firm. Although shareholder rights may vary by jurisdiction, one of the most important rights provided to mitigate potential agency costs is the right to vote over certain company affairs. Available only to shareholders with a large enough share block, voting allows one to have a direct say over the company's affairs during the general meeting of shareholders. This includes the appointment and dismissal of company management, the modification of the company charter, and the making of all decisions otherwise not specified by the company charter (Easterbrook and Fischel, 1991, p. 161)

Other examples of mandatory rules would be the EU Shareholders' Rights Directive 2007/36/EC (2007) which both sets transparency requirements for companies to publish certain information and empowers them to have a say on certain corporate governance issues, such as directors' pay. In the U.S. state jurisdictions have always aimed to set minimal standards for corporate governance. However, in the light bankruptcies of companies such as Enron and the 2008 financial crisis the U.S. did adopt federal legislation to increase protection for shareholders and increase standards for corporate governance. An example would be the Dodd-Frank Act (2010) requirement that all public companies hold say-on-pay, say-on-frequency, and say-on-parachutes votes. The success of such measures is arguably mixed as there is some evidence that mandates provided to shareholders are rarely exercised. (Brossy, 2015)

### 2.2.9 The Market for Corporate Control

The Market for Corporate Control can provide arguably the most successful mechanism for disciplining and replacing underperforming managers. According to this theory, a firm's poor management decisions will be reflected in the firm's stock price as disgruntled shareholders who are dissatisfied with the firm’s management will be willing to sell their shares at a lower price relative to the firm's assets. This makes the firm vulnerable to a potential takeover by an external party willing to take control of the firm and to replace the incumbent managers with those more willing to serve the interests of shareholders, while at the same time acquiring firm assets at a lower rate than they would be able to otherwise. This is generally accomplished by the external party via a tender offer to existing shareholders to acquire their stock at a premium. When a controlling stake within a firm is acquired, the takeover is complete. As managers are aware of this fact, they will in theory try to avoid this by maximizing value for their shareholders (Manne, 1965).

The success of this approach is supported by some empirical studies (Jensen, Ruback, 2002). However, there might be legal hurdles that prevent this process from operating to its full efficiency. Within the U.S. federal legislature such as the Williams Act (1968) may hinder potential takeovers by imposing additional transparency requirements for tender offers. Moreover, managers themselves may seek to resist a potential takeover through the adoption of various strategies, such as a ‘poison pill’ which seeks to discourage potential takeovers, a practice approved by the U.S. The legality of other tactics enhancing the incumbent management's bargaining position is still to be determined (Subramanian, 2003). Arguably the E.U. has adopted a more friendly approach to takeovers with its Takeover Directive 2004/25/EC (2004) which requires incumbent directors to remain neutral during the bidding process.

Despite all of this, the theory of market for corporate control remains an attractive measure to combat agency costs for several reasons. First, the shareholders of most large firms are passive, numerous, geographically spread out, and disunited, thus even with the

appropriate mandates, it is unlikely that shareholders in most firms will be able to martial any substantial effort to redress grievances against incumbent managers. Large institutional investors also suffer from their own particular agency costs and are more likely to side with management than other shareholders. Bebchuk, Cohen and Hirst 2017)
Second, as discussed above, other measures to combat agency costs, such as managerial compensation or managerial ownership can be costly to shareholders and empirical studies have demonstrated that these strategies can have a mixed success rate. Finally, and most importantly, the market of corporate control provides the most effective external mechanism of controlling agency costs in which most of the costs of changing the incumbent management are absorbed by the party initiating the takeover, rather than the injured shareholders.

### 2.2.10 Analysis

There are various types of corporate governance mechanisms that shareholders may pursue to remedy potential agency costs. However, the various corporate governance mechanisms discussed, such as managerial compensation, come at a cost to shareholders and can be a source of their own problems as a result of misaligned incentives. Moreover, there might be limited redress available for injured shareholders pursuing litigation as courts are generally favorable to management.

Thus, company law plays an important function in reducing costs within firms by not only providing the legal means to form the contractual relationships between different corporate constituents but also mitigating agency costs through the setting of mandatory rules for firms which can both empower shareholders and deter agents from acting opportunistically. However, managerial discretion is still highly favored by the courts, and legal rules, such as the business judgment rule arguably disadvantage injured shareholders when making a claim. Arguably due to the complex nature of decision-making within large firms legislators likely avoid relying solely on mandatory rules to avoid potential rigidities (Armour, Hansmann, and Kraakman, 2017)

Arguably one of the most successful strategies for managing agency costs is the market for corporate control, which can serve as an important function to discipline sub-par managers. While opportunistic managers can still entrench themselves by pursuing different strategies to make a potential takeover more difficult, a takeover might still be the best option for the highly dispersed groups of shareholders that own large firms today.

## PART 3: WHAT IS THE PURPOSE OF THE CORPORATION?

### 3.1.1 Introduction

We've explored in the previous chapter how the work of Jensen and Meckling's discussion on the principal/agent relationship and the articulation of the agency costs associated with this relationship were able to provide a framework to understand and solve the problems stemming from the separation of the ownership and control found in most firms. It is important to point out that many of the works cited in the previous chapter take on the implicit assumption that agency costs endured by firms are something that should be mitigated and that shareholders should adopt clever strategies to align their incentives with those of management. Much of the legislature addressed in the previous chapter also contains explicit provisions to empower shareholders to better control corporate government bodies of the firms that they own.

But why? As we saw, firms have successfully existed and grown long before Adam Smith or Berle and Means made their insights and even longer before Jensen and Meckling made contributions. Moreover, by employing Coasian analysis we can conclude are efficiently able to coordinate production by merely observing their existence. However, the work of Jensen and Meckling is an important normative implication that firms and company law should privilege their owners due to their role as the residual claimants of the firm's profits. The view that the firm should privilege its owners is shared among the of advocates the shareholder value theory and as we will see in this part of the work, their work had a direct influence on Jensen and Meckling.

This part of the thesis aims to first explore the development of shareholder value theory and present the economic arguments in favor of privileging the shareholder constituency within the firm. Then we will move on to explore some of the criticisms of this theory and finally, we will consider how the enlightened shareholder may help address some of these criticisms. Most importantly we will discuss the implications that these theories have for company law.

## CHAPTER 1: From the Managerial Firm to the Shareholder Firm

### 3.1.2 The Birth of the Shareholder Value Theory

As discussed in part one of this thesis, early corporations had to obtain a royal charter to be established. Corporations had to also serve a public function to be chartered and thus many of the early corporations were non-profit institutions such as churches and universities. In the U.S. initially, corporations were subject to similar restrictions but over time many of these restrictions loosened until eventually a corporation could be established for any lawful purpose. A similar trajectory followed the evolution of the firm manager, whose decision-making rights were similarly initially restricted by the corporate charter but were also eventually replaced by the much less restrictive business judgment rule.

From the late 19th century up until the middle of the 20th century the managers of the company were considered to be the dominant power within the firm. There were several reasons for this, first, management organized the production and distribution of resources within a firm, something that was becoming increasingly important as the corporations grew in size and complexity. Second, managers dominated the administrative bureaucracies needed to manage these increasingly complex business operations and externalities associated with production. Eventually, managerial power reached an extent to which management was able to control and appoint members to the corporate board. (Bratton, 1989)

During the 1930s to 1960s, the manager-oriented model was the dominant model of the corporation. Corporate managers, who were granted substantial discretion, were viewed as people who would guide the corporation through their decision-making to serve the collective social welfare. (Hansmann and Kraakman, 2000) The state's role was to intervene only to stabilize the market and in return, corporate managers adopted the role akin to that of a public servant who was responsible for suppliers, customers, employees, and shareholders, along with other more peripheral constituents. (Bratton, Wachter, 2013). This view can also be found in Berle and Means seminal which called for corporations to pursue socially beneficial goals.

Shareholders were considered as playing no productive role in the economy other than collecting dividends for the stock that they owned, with Berle in his later writings even calling for their potential abolition (Berle,1969, p. 51-52). However, this state of affairs would not last for long. In the 1970s the U.S. faced stagflation, competitive decline, and a failing stock market. This state of affairs significantly diminished the appeal of the managerial firm (Hansmann and Kraakman, 2000).

Debates over the purpose of the corporation arguably reached their zenith in the 1960s and 1970s with the corporate social responsibility movement making significant regulatory gains in consumer, worker, and environmental protections. However,  spurred by the recent economic crisis and what they perceived as undue state influence in economic affairs, neoclassical economists began promoting a more shareholder and profit-oriented view of the corporation (Gindis, 2020).

To some extent, this was nothing new. Economists operating within the neoclassical tradition have always produced works advocating for less state intervention in economic affairs. Arguably one of the most illustrative examples of such works would be Fredrich Hayek's "*Road to Serfdom"*, which argued that economic freedoms which were the source of political freedom, were slowly abandoned by Western societies in favor of state intervention, especially spurred on in the wake of the great depression, and if not stopped this process will eventually result in the development of a totalitarian state. (Hayek, 1944, p. 13)

The 1970 essay published by economist Milton Friedman entitled: '*A Friedman Doctrine‑- The Social Responsibility of Business Is to Increase Its Profits"* would parallel some arguments presented by Hayek. However, its arguments in favor of the shareholder-oriented firm would end up laying the foundation for the theory presented in Jensen and Meckling's work. Within the work, several key arguments may be identified: first, a corporation should not have and cannot have any responsibility as a corporation is an artificial entity composed of the 'real' individuals that form it. The executives that govern these firms are merely the agents for the true owners firm, that being the firm's shareholders. Thus, while an executive may pursue societal welfare in his capacity as an individual, as an agent of the firm they must serve the interests of the shareholders.

Second, by engaging in social responsibility, whether by spending the firm's money on social initiatives or raising the prices of their customers, they are effectively imposing a tax, the proceeds of which are distributed according to the executive's discretion. Thus, the executive, by his own will, decides to become less of an agent for the owners of the firm and more of a public official but one that operates without the checks and balances inherent to the public office. Thus, the only group permitted to pursue social responsibility through the firm are shareholders as they are in essence, spending their own money in pursuit of their goals.

Finally, and most importantly, any agenda adopted by business in pursuit of social welfare should be viewed with suspicion as it fundamentally promotes collectivist agendas that impede the free market and, as a result, the freedom of the individual. Thus, Friedman concludes that: *“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.”* (Friedman, 1970)

Freedman’s words did not fall on deaf ears and Jensen and Meckling would use the article by Friedman as a starting point for their seminal work (Walking, 2020) which in combination with the contractual theory of the firm, will result in the continued promulgation of the shareholder value theory, to the extent that today as academics Hansmann and Krakmann points out *“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.”* (Hansmann and Krakmann, 2000).

### 3.1.3 Why Prioritize Shareholders?

Before we begin our analysis we must understand the difference between what a ‘contract’ means for economists and how it differs what the understanding of the contract found within law. A legal contract is a legally enforceable agreement between two or more parties, where one party either assumes an obligation or all parties undertake obligations to each other. General requirements for contracts across many jurisdictions are as follows: There must be an offer and acceptance, contracts must have certainty, intentions to create a legal relationship, and an absence of mistakes or other contracts that would make the contract void. The principle of freedom of contract applicable to most jurisdictions permits parties to arrange contracts on a wide variety of matters. (Andrews, 2015, p. 3-7)

The economic approach to the contract is much broader and contracts within economics are characterized by asymmetric information, bilateral monopoly, and opportunism. (Bainbridge, 2002). The concern when studying contracts for economists is efficiency and the primary concern of a contract is thus the maximization of joint welfare either through direct increases in wealth or other forms of satisfaction gained (Kornhauser, 1989). However, the key difference between contracts in economics and legal contracts is a formality. Legal contracts have to satisfy all of the requirements listed above, while contracts in economics recognize other more implicit contractual relationships. Thus contracts in economics can be ‘incomplete’ this is also the reason why the contractualist view of the firm as a nexus of contracts also recognizes the contract between shareholders and management even though no such ‘legal’ contract exists (Orts, 1998).

### 3.1.4 The Shareholder within the Nexus of Contracts

Recall that within the nexus of contracts the corporation is nothing more than a collection of contracts between different contracting parties, such as shareholders, managers, creditors, suppliers, and others. Each party enters into the contract to maximize their utility. (Jensen and Meckling, 1976). From the perspective of economics, the contract between the firm and the shareholder is incomplete as the welfare of the shareholder is not necessarily maximized.

Shareholders are the residual claimants over firm assets, meaning their claim on the firm assets, unlike the claims of employees or creditors, is not fixed and is satisfied only after the claims of other parties have been fulfilled. If their claim is satisfied in the first place the firm might go bankrupt, thus destroying the shareholder's investment. In addition, the rights conferred to shareholders over firm assets are intangible as a share gives a shareholder a claim of the totality of the firm’s assets, but no asset in particular. (Hart, 1995)

This particularly vulnerable position of the shareholder within the firm is what the coffering voting rights to them so paramount. Shareholders as the residual claimants are the only ones within the firm who have the appropriate incentives to make appropriate decisions over the firm’s future as it will be they who will have to bear the marginal losses as a result of a potential failure (Easterbrook and Fischel, 1991, p. 68). Moreover, (Macey, 1989) argues that due to their role as residual claimants within the firm, shareholders will value the right to vote over the company's affairs, the most out of any other constituency of the firm.

Before moving on, it is worth pointing out pointing out two things. First, shareholders are not the only residual claimants within a firm with creditors also being potentially able to exercise residual claims (Easterbrook and Fischel, 1991, p. 68). Second, advocates for a shareholder-oriented approach do not claim that the law should not protect other constituencies within the firm. Instead, they argue that company law specifically should give primacy to shareholders, with other constituencies given separate consideration by other types of law (Hansmann and Kraakman, 2000).

### 3.1.5 Analysis

The failure of the managerial firm left an opening for economists advocating for a more shareholder-friendly model, such as Friedman. Friedman argued that the firm manager is the employee of the shareholder and, thus should focus all of their efforts on to benefit the shareholder. As revealed, in subsequent interviews, Jensen and Meckling were directly inspired by Friedman's arguments to develop their analysis of the firm.

The economic arguments in favor of a shareholder-centric model focus on the shareholder as the residual claimant to an incomplete contract with the firm. The vulnerability of the shareholder constituency also provides it with the appropriate incentives for making key decisions for the firm. Within this analysis of the shareholder as the residual claimant lies an important normative claim as to the role of company law. As company law, defines the rights of shareholders, the conclusion is drawn by advocates of shareholder primacy that company law should strengthen the rights of this vulnerable constituency by allowing shareholders to exercise more control over the affairs of the company.

## CHAPTER 2: Stakeholder Theory and Enlightened Shareholder Value Theory

### 3.2.1 Introduction

Agency theory and the shareholder-value theory aim to provide us with a model that is internally disciplined and economically efficient. However, as we will see, many have argued that through their purely neoclassical analysis of the firm, the aforementioned economists have forgotten, another, arguably equally important criticism made of the corporation - that is of the permissions effect that corporate power might have on society. Thus, the following sections are an examination of both Stakeholder theory and Enlightened-shareholder value theories and the arguments made by their advocates as a response to the proposed purpose of corporation made by the neoclassicalists.

### 3.2.2 Stakeholder theory

One of the reasons for the promulgation of the shareholder value theory is the belief that shareholders by focusing on maximizing returns on their investment will, as a result, maximize the total wealth of the society in which they operate. This is because shareholders in pursuit of higher profits will as a result not only seek to make companies more efficient but also search for new streams of review, develop new products, and increase the quality of services provided. In addition, due to the wide shareholder dispersal found within most jurisdictions, most shareholders today are small and are typically retirees and other private citizens. Thus, when larger shareholders increase the value of their shares in the pursuit of a larger profit, these smaller shareholders also benefit (Cioffi and Höpner, 2006). Other lines of reasoning can also be found. One such reasoning, advocated for by Hansmann and Kraakman argues that economic dominance achieved by American firms, also be viewed as evidence of the successfulness of shareholder primacy. (Hansmann and Krakmaan, 2000)

However, critics of shareholder primacy argue that shareholder value theory merely enables the endless pursuit of endless profits which is the underlying reason behind of some the biggest corporate scandals of the last decades. Thus, shareholder value results through its enabling the endless pursuit of profit, while resulting in higher profits for the shareholders is detrimental to other members of society (Clarke, 2015).

Advocates for the Stakeholder theory claim to provide a solution to these problems by empowering management There are three main aspects to this theory. First, stakeholder theory views the firm as a set of relationships between all constituents that have a stake in the firm and could potentially include a wide spectrum of groups ranging from the first customers and employees to the firm's creditors. Thus, the firm’s management should take an active role in managing the interests of these constituencies by distributing the value created by the firm, among the firm’s stakeholders. Second, adopting a more stakeholder-friendly approach encourages the creation of internal firm values that make the firm more resilient to the moral hazard issues that plague businesses. Finally, stakeholder theory argues that as firms adopt greater consideration for their stakeholders this will result in a positive ripple effect throughout large society as a whole (Parmar et. al., 2010).

German firms are considered as having to have successfully adopted a stakeholder approach within their corporate governance culture. German companies maintain strong relationships with financial institutions that hold major stakes in these companies. The financial institutions, which are usually banks, act as stable shareholders for these firms and protect these firms from takeover attempts. Moreover, the employees of German firms enjoy a legally enforced (Fifka, 2013) representation within the company board, in addition, to a strong culture of tenure and long-term employment (Jackson et. al., 2004).

On the other hand, recent studies suggest that this model is arguably in retreat due to the increased influence of American firms (Jackson et. al., 2004), which could be viewed as an argument in favor of the effectiveness of the shareholder primacy model (Hansmann and Krakmaan, 2000). Moreover, it could be argued that by adopting a shareholder-centric approach firms create value to be distributed in the first place (Sundaram and Inkpen, 2001).

### 3.2.3 Enlightened Shareholder Value Theory

Enlightened shareholder value theory aims to resolve the tension between shareholder value and stakeholder value theories by providing a more pluralist approach to the purpose of the firm. The essence of the theory is that firms can and should promote the interests of shareholders, in addition to serving other constituencies. (Hannigan, 2021, p. 191-192).

There are several key arguments made in favor of the theory. The first argument is that activist shareholders have always made proposals during general meetings that aimed to adopt policies in favor of some socially conscious goals, such as increasing the diversity of the firm's board of directors and ensuring that labor rights are protected within the firm. Although, thus far there has been limited empirical research into the issue (Sjöström, (2008).

The second argument is that firms that adopt socially conscious standards enjoy higher profitability and in turn higher share prices. There are also empirical studies that show that companies with higher levels of CSR disclosures, also report higher share prices (De Klerk, 2015). Thus, an argument could be made that when firms embrace socially conscious policy the primary constituency that they are benefiting are the shareholders. Moreover, there has been a trend of institutional investors adopting sustainability criteria when evaluating their future investments (Chen and Scholtens, 2018).

Finally, it could be argued that by aiming to maximize value for shareholders, companies end up hurting them in the process. This argument has several components, first, it can be argued, in the same light as advocates of stakeholder theory have, that a shareholder-centric firm ends up behaving destructively which eventually results in the firm's collapse and thus the destruction of the resources that shareholders had invested in the company. Moreover, there are many different types of shareholders with varying interests and goals. This means that, in the end, whether a firm adopts a purely profit-oriented approach or a purely social-oriented one, some constituency of shareholders will be harmed. Thus, firms should take a more balanced approach and consider the different interests of their shareholders (Stout 2013).

However, critics of the enlightened shareholder value theory argue that the theory bases its analysis on unrealistic win-win situations, which in reality rarely present themselves. In reality, corporate decision-making is difficult and managers frequently have to make difficult decisions that negatively impact all constituencies. Thus, shareholder value theory is an inconsequential movement that will educate decision-makers within firms on the virtues of social responsibility without making having any significant effect (Bebchuk, Kastiel, and Tallarita 2022).

### 3.2.4 Analysis

Shareholder value theory bases itself on economic analysis of the shareholder as the residual claimant with the firm. As shareholders are the main residual claimants in the firm, they are a uniquely vulnerable constituency whose claim is based on the future performance of the firm. Thus, advocates of shareholder value theory argue that shareholders should be empowered by company law through voting within the firm, to protect their claim in the firm. Other constituencies are less important within this framework of analysis as their claims within the firm are fixed or they are protected through other types of law.

Stakeholder theory is the converse of shareholder value theory and advocates that firms must adopt policies to distribute resources to other constituencies that have an interest in the firm's success. The legal implication that follows is that company law should promote policies such as the ones found in Germany which explicitly aim to empower different constituencies of the firm to be involved in the firm's decision-making process. However, arguably firms may never be able to fully embrace this approach, as at the end of the day, will have to remain profitable to survive.

Shareholder value theory provides a middle ground between these two approaches. Arguably the key insight presented by shareholder value theory is that no two shareholders are the same, thus pursuing either of the approaches two approaches discussed above will end up hurting one constituency or the other. Thus, arguably the best approach is for company law to empower all types of shareholders to shape the policies of the firms that they control as it ensures that the most vulnerable constituency of the firm has a means to protect its interest which will arguably result in firms adopting many of the socially conscious policies advocated by stakeholder theory.

# CONCLUSIONS

1. The innovative work of Jensen and Meckling built upon the works of a previous generation of economists such as Coase and his analysis of the market conditions that make it possible for the firm to emerge and Alchian and Demsetz's analysis of shirking within the team production process. The resulting analysis of the firm as a nexus of contracts in which members of the firm operate within the principle/agent paradigm is the most comprehensive framework to understand the nature of the company devised thus far.
2. In addition to addressing the issue of the firm as a 'black box' that plagued an earlier generation of economists, such as the marginalists, Agency theory was able to provide us with a framework to understand and address the problems stemming from the separation of ownership of control discussed by an earlier generation of thinkers such as Adam Smith and Berle and Means. This separation is arguably further enforced by legal attributes of the firm such as limited liability and asset partitioning which further isolate firm assets from the fate of its owners.
3. Within their work, Jensen and Meckling concluded that the best way of addressing the issue of agency costs is to align the incentives of management with those of the owners. The owners can achieve their goal of better incentive alignment between themselves and the management by adopting a myriad of different corporate governance strategies. However, these strategies come with their costs and can be an additional source of principle/agent problems.
4. Legal strategies fair little better in addressing agency problems as courts in jurisdictions such as Deleware through the adoption of the Business Judgment Rule have made it very difficult for injured shareholders to hold management accountable. Other measures available to shareholders such as setting say-on-pay agendas during shareholder meetings, although theoretically sound still suffer from the dispersal of shareholders as a result of the separation of ownership and control which occurred at the beginning of the 20th century. The best way for shareholders to protect themselves remains to sell their stock within the firm.
5. This is an important observation for company law as it arguably does not offer enough protection for shareholders. However, first, we should consider the question of whether it should? If we look at the analysis of economists such as Milton

Freedman and Jensen and Meckling the answer would be yes, for several reasons, first, within the nexus of contracts the governors of the firm are the employees of its owners and thus are bound to this relationship. Second, within the nexus of the contracts that is the firm, the shareholders are particularly vulnerable as they are residual claimants within this nexus. As a result, legal theorists such as Henry Hansmann argue that company law, in particular, should privilege the firm's shareholders.

6. However, this shareholder-centric view of the firm is not without its critics, and many have argued that by embracing shareholder value theory society is enabling corporate greed and short-term profit-seeking, moreover, jurisdictions in continental Europe and Japan embrace more stakeholder-oriented approaches. A middle ground exists in the Enlightened Shareholder Value theory. Evidence suggests that corporations embracing more socially conscious policies enjoy better financial returns, moreover, there are plenty of examples of activist shareholders embracing advocating that the firms that they own embrace more socially conscious policies.
7. Thus, the author argues that the way best way for corporations to serve the interests of utility-maximizing shareholders presented in the models discussed in this thesis is by embracing more socially conscious policies. However, some of the existing legal features of the jurisdictions discussed in the thesis arguably prevent activist shareholders from pursuing such goals. Thus, the key implication for company law found in our study is that company law should embrace a more shareholder-friendly approach to enable shareholders to serve the interests of society.

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## SUMMARY

## PATRIKAS KARPENKO. ECONOMIC THEORIES AND COMPANY LAW

The thesis discusses and traces the evolution of the key economic theories that have had the most influence on our modern understanding of the corporation and their implications for company law. Older generations of economists such as Adam Smith were able to articulate early formulations of issues that modern economic theories aim to solve. A more modern articulation of these issues came in the work of Berle and Means and their discussion of the separation of ownership which was occurring in most large firms. One of the biggest contributions to our understanding of the firm came from the work of Coase whose analysis was able to explain the emergence of the firm within the market. However, within the framework of Coase and other economists at the time, the firm was a 'black box' and there was no framework to understand its internal dynamics. Jensen and Meckling's principal/agent theory and their formulation of agency costs provided an important insight into how firms operate. There is a myriad of corporate governance and legal strategies that shareholders may adopt to mitigate agency costs, however, most existing jurisdictions make it difficult to do so. The work of Jensen and Meckling also justifies shareholder value theory through its consideration of shareholders and residual claimants. This approach arguably leads to pernicious social effects stemming from corporate power. However, there is substantial evidence that activist shareholders pursue socially conscious policies and that this has a positive impact on firm value. Thus, the work concludes that company law should aim to empower shareholders to pursue socially conscious policies.

In summary, this research provides a comprehensive understanding of the key economic theories that have had the most impact on our modern understanding of the corporation. The nuanced examination of economic theories is then applied to contribute valuable insights into the role of company law.